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The *WR Marketplace* is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led by Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca S. Manicone. *WR Marketplace* #17-36 was written by Greenberg Traurig Shareholder Jonathan M. Forster.

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TOPIC: Case Study Series - Turbo-Charged Split-Dollar.

MARKET TREND: Split dollar life insurance arrangements remain a popular tool for incorporating life insurance into a multi-purpose legacy plan, which can provide family security and generate needed liquidity.

SYNOPSIS: Private split-dollar arrangements ("SDAs") typically involve a trust creator ("grantor") that advances life insurance premiums on behalf of his or her irrevocable life insurance trust ("ILIT"), subject to a repayment right for such advances (the "SDA receivable"). While this structure removes the life insurance death benefit from the grantor's estate, the value of the SDA receivable remains. Further, the grantor may not always have available liquidity to pay premiums under the SDA, particularly if the grantor has a net worth concentrated in illiquid assets and/or has already engaged in other significant legacy planning. For such clients who have existing trusts, a trust-to-trust SDA may offer a solution.

TAKE AWAYS: The customizable nature of private SDAs allows highly-illiquid clients to obtain needed life insurance coverage on a sustainable, long-term basis, even if they have minimal federal gift and GST tax exemptions to pay premiums. For example, a trust-to-trust SDA approach may be used where an existing trust, rather than the grantor, lends premium amounts to the ILIT. This "turbo-charged" approach (1) allows the client to leverage liquidity in an existing plan to provide for needed life insurance coverage without adversely impacting his or her personal liquidity or remaining transfer tax exemptions and (2) keeps both the life insurance death benefits and the value of the SDA receivable out of the grantor's estate under general estate tax principles.

PRIOR REPORTS: 14-15; 14-27; 09-32; 08-55.

Private SDAs provide a flexible yet relatively conservative tool for funding life insurance purchases, particularly for highly-illiquid clients who need liquidity to support their families and preserve their family legacy after their passing. While these SDAs typically involve the grantor and his or her ILIT, the grantor may not always have the liquidity needed to advance premiums under the SDA. For such clients who also have existing trusts, a trust-to-trust SDA may offer a solution.

PRIVATE SDAs – QUICK OVERVIEW

Typical SDA: Grantor & ILIT. The private SDA shares the costs of buying a life insurance policy between the ILIT's grantor (who is often the insured) and his or her ILIT. The grantor pays the premiums and retains a right to repayment upon the SDA's termination (a loan, in effect), as secured by the policy proceeds. After repayment, the ILIT retains any remaining policy benefits. As the SDA receivable effectively remains a part of the grantor's estate, only the net death benefit under the ILIT policy is excluded for estate tax purposes.

A Subtle Twist: Trust-to-Trust Option

Overview. Suppose, however, that the client creating the ILIT is also the grantor of an existing, funded trust that has sufficient cash/income to cover the premiums for the new life insurance policy. While the existing trust could just acquire the policy directly, this approach may not always be preferred. For example, the ILIT may have different beneficiaries than the existing trust (such as a spouse and descendants rather than just descendants), the existing trust may have specific provisions tailored to the assets it holds (e.g., business interests), or the advisors may want to hedge the risk of IRS audit/review by separating pots of assets among different trusts. As an alternative, the existing trust could lend the ILIT funds for the premiums subject to a private SDA.[1] If both trusts are grantor trusts with respect to the same grantor for federal income tax purposes, there should be no income tax consequences from the SDA.

Potential Advantages. This option may:

1. Reduce the need for the client to find additional liquidity to make premium payments;
2. Not require the client to use federal gift and/or generation-skipping transfer ("**GST**") tax exemptions to fund the premiums;
3. Avoid any reliance on annual exclusion gifts to the ILIT for funding, and the corresponding beneficiary "Crummey" withdrawal powers and beneficiary notices of withdrawal (which often create administrative hassles for the trustee and lead to possible errors and resultant gift or GST tax exposure); and
4. Crucially, remove both the policy death benefits and the SDA receivable from the grantor's estate, preserving 100% of the death benefits from estate tax.

SDA Loans Generally. With a SDA loan:

- The lender makes interest-bearing loans to the ILIT for the premiums,[2] but has no specific interest in the policy or its cash value.
- The ILIT retains all rights to the policy's cash value and death benefit, subject to its obligation to repay the loan(s) at the specified maturity date(s).
- Per the so-called "loan regime" of the split-dollar Treasury Regulations,[3] if the loan provides for sufficient interest (i.e., at the applicable federal rate ("**AFR**")),[4] it is governed by the general tax rules for debt instruments; otherwise, it will be classified as, and governed by the rules applicable to, a below-market loan.
- Under general estate tax principles, if the SDA parties are an ILIT, as policy owner, and a separate irrevocable trust that funds the premiums, neither the policy death benefit nor the SDA receivable should be includible in the grantor's estate.

TURBO-CHARGED SDA IN ACTION: CASE STUDY

Who's the Client? Meet Alex. Alex is 49, married, and the father of three children. He is a successful entrepreneur with most of his wealth concentrated in various closely-held businesses. He has implemented significant lifetime planning using most of his federal gift and GST tax exemptions, including gifts of various business interests to an irrevocable grantor trust Alex created for the benefit of his descendants ("**Descendants' Trust**"). One of the businesses owned by both Alex and the Descendants' Trust was recently sold, generating significant cash for each of them. Alex, however, has already re-invested his proceeds in another business venture, leaving him with limited liquidity.

To preserve his family legacy and provide a source of liquidity for his spouse and children after his passing, Alex created an ILIT benefiting his spouse and descendants, which will acquire $12 million in permanent life insurance. The total annual premiums for this coverage equal $65,000.

What's the Problem? Alex's Concerns:

1. ***Available Liquidity***. With his on-going concentration in illiquid investments, Alex does not have the current liquidity to make a substantial lump-sum gift or loan to the ILIT to pay premiums, nor is he certain that he would want to allocate his available liquid resources in future years to cover the $65,000 annual premiums.
2. ***Available Exemptions***. Annual contributions to the ILIT for the premiums would not be fully covered by Alex's annual exclusion gifts[5] and would require a commensurate annual allocation of federal GST tax exemption, a substantial drain on Alex's minimal remaining transfer tax exemptions.
3. ***Leaky Planning***. Alex wants to keep the full value of the policy death benefits outside of his estate, something a typical SDA does not accomplish, as the value of the SDA receivable remains with Alex.

What's the Answer? Split Dollar Loan from Descendants' Trust to ILIT. The trustees of the Descendants' Trust, as directed by the trust's investment advisor, agree to enter into a SDA with the ILIT, under which the Descendants' Trust will make annual loans to the ILIT equal to the annual life insurance premiums ($65,000). Each loan's term will be based on Alex's then life expectancy (as determined under applicable IRS actuarial tables), and each loan will accrue interest annually at the applicable AFR based on the month the loan was made and the loan term. For the exit strategy, the ILIT plans to repay the SDA loans and accrued interest at Alex's passing using the death benefit proceeds from the life insurance coverage.

Bottom Line: Turbo-Charged SDA Fits the Bill. With this approach:

- Alex has leveraged the liquidity in his existing plan to provide for needed life insurance coverage while also preserving his personal liquidity.
- As both the Descendants' Trust and the ILIT are grantor trusts with regard to Alex for federal income tax purposes, the loans are disregarded and should not generate federal income tax.[6]
- Assuming that the split dollar loans between the trusts charge adequate interest and are fully repaid, there should be no gift or GST tax concerns for Alex, the trusts, or the beneficiaries.
- Alex does not need to use any of his limited gift or GST tax exemptions to support the plan.
- The full $12 million death benefit and the SDA receivable remain outside of Alex's estate.

Practical Notes.

- While the Descendants' Trust initially provides annual loans, the trusts could later re-negotiate the SDA so that the Descendants' Trust provides a lump-sum loan to the ILIT to pay premiums to lock in the loan interest rate and help limit the ILIT's exposure to future interest rate hikes.
- Where the beneficiaries of the existing trust and the ILIT differ, the trust-to-trust SDA should be monitored to review the total SDA receivable (loans plus accrued interest) to ensure that sufficient death benefit remains in the ILIT for its specified beneficiaries. Otherwise, additional exit strategy planning may be considered, such as gifts to the ILIT to create a "side-fund" for repayment.

TAKE AWAYS

The customizable nature of private SDAs allows highly-illiquid clients to obtain needed life insurance coverage on a sustainable, long-term basis, even if they have minimal federal gift and GST tax exemptions to pay premiums. For example, a trust-to-trust SDA approach may be used where an existing trust, rather than the grantor, lends premium amounts to the ILIT. This "turbo-charged" approach (1) allows the client to leverage liquidity in an existing plan to provide for needed life insurance coverage without adversely impacting his or her personal liquidity or remaining transfer tax exemptions and (2) keeps both the life insurance death benefits and the value of the SDA receivable out of the grantor's estate under general estate tax principles.

NOTES

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[1] Note that the decision of whether to enter into a trust-to-trust SDA must be made by the trustees (and any other investment advisors or other fiduciaries responsible for investment decisions of the trust), in compliance with all their fiduciary duties and obligation, including the duty to act in the best interest of the trust beneficiaries.

[2] I.e., each premium payment made is deemed a separate loan to the ILIT. The lender also could make a lump-sum loan, which the ILIT then uses to pay premiums.

[3] See Treas. Reg. §1.61-22 for the final split dollar Treasury Regulations, made effective as of September 17, 2003 for SDA entered into or materially modified after September 17, 2003; and Treas. Reg. §1.7872-15 for rules applicable to SDAs qualifying as split-dollar loans. Note that SDAs also may be taxed under the "economic benefit" regime if they qualify as an economic benefit SDA. See Treas. Reg. §1.61-22(d)-(g).

[4] Whether interest is sufficient for a split dollar loan depends on the type and term of the loan (*e.g.*, term, demand, or hybrid (*i.e.*, loans payable on the death of an individual or conditioned on the future performance of services)) and the month of issuance. The sufficiency of interest for term and hybrid loans will be based on the monthly AFRs issued by the IRS for the term period of the loan (*i.e.*, short-term (3 years or less), mid-term (4 to 9 years), or long-term (more than 9 years)). Demand loans are a separate category, with AFRs based on the blended average of the January and July short-term AFRs for the applicable year.

[5] Assuming Alex's spouse could withdraw up to $5,000 of each annual contribution to the ILIT, this would leave Alex's three children as the remaining, living withdrawal power holders. Further, since Alex's spouse is an ILIT beneficiary, she cannot split gifts to the ILIT with Alex. Thus, multiplying Alex's $14,000 annual exclusion gift (current annual exclusion gift for 2017) by three powerholders, plus the $5,000 withdrawal power of Alex's spouse, Alex's gifts to the ILIT would only cover $47,000 of the premium, leaving $18,000 annually to be covered by federal gift tax exemption.

[6] While the SDA loan should not generate income tax, it is generally recommended that the borrower and lender file a so-called "loan representation" that meets the requirements of Treas. Reg. §1.7872-15 for the split-dollar loan with their income tax returns. Treas. Reg. §1.7872-15 provides in pertinent part that, if the parties to a split-dollar loan represent in writing that a reasonable person would expect that all payments under the loan will be made, the payment will <u>not be treated as contingent</u> for purposes of determining whether adequate interest is charged on the loan.