ADVANCED PLANNING

WHAT IS A PRIVATE SURVIVORSHIP SPLIT DOLLAR ARRANGEMENT?

WEALTH TRANSFER THROUGH A PRIVATE SURVIVORSHIP SPLIT DOLLAR ARRANGEMENT

As you prepare to help your family handle your financial obligations after your death, you may come across many strategies. Each strategy has a slightly different purpose and different benefits.

If liquidity is a priority for you, and you want your family to have cash at the death of the surviving spouse to help pay estate taxes, liquidate debt, or replace assets given to a charity, consider establishing a private survivorship split dollar arrangement (non-equity collateral assignment) with the use of an irrevocable life insurance trust.

A private survivorship split dollar arrangement is a method of purchasing a survivorship life insurance policy that enables the insureds to reduce the amount of their gift tax annual exclusions used to pay life insurance premiums. It can be a valuable part of your overall financial strategy if:

- You want the life insurance proceeds to pass outside both your taxable estate and that of your spouse.
- You want to minimize the amount of your gift tax annual exclusions used to pay life insurance premiums.
- You are hesitant about making significant irrevocable gifts because of potential changes in estate tax legislation and the uncertainties that surround this tax.

BENEFITS TO THE INSUREDS

The insureds:

- Are able to provide survivorship life insurance protection for their heirs with minimal federal gift tax cost.
- Are able to leverage their annual gift tax exclusions and generation-skipping transfer tax exemptions into a potentially larger sum of money through the purchase of life insurance.
- Retain flexibility. If the insureds' economic situation changes or if there are future changes in the estate tax exemption, the split dollar agreement can be terminated and the insureds can recover the premiums advanced according to their contractual rights under the agreement.
- Have the ability to control the distribution of the death proceeds through the terms of the trust provisions in a manner consistent with their overall estate objectives.

BENEFITS TO THE FAMILY

- The trust leveraged as part of the strategy will receive life insurance death proceeds that can be used to help meet the needs of the estate and/or the trust beneficiaries.
- Life insurance proceeds can help replace estate assets used to pay estate taxes and/or to provide a charitable bequest.
- Trust assets are protected from the creditors of the trust beneficiaries.

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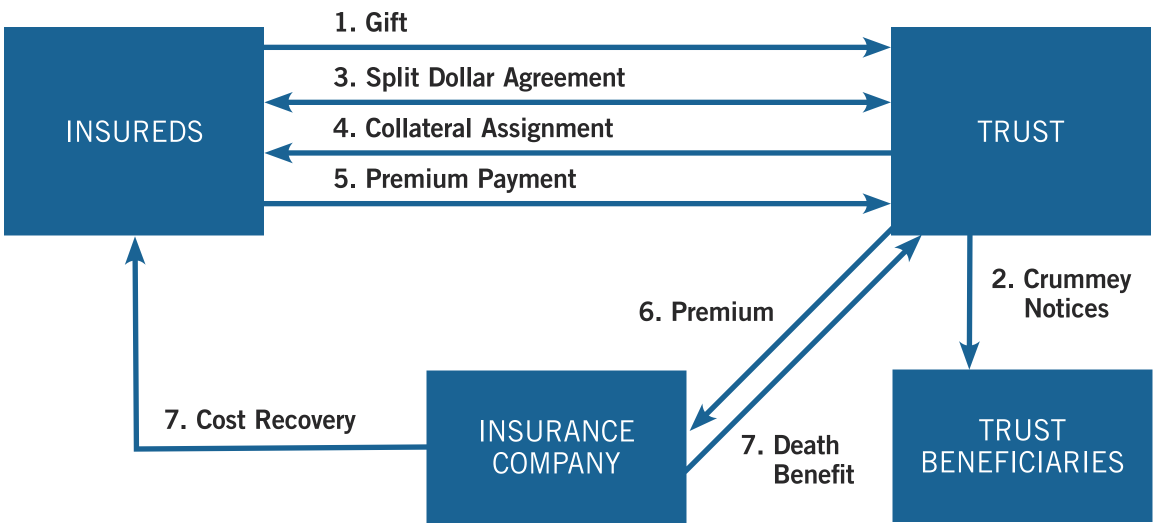
HOW IT WORKS

**PRIVATE SURVIVORSHIP SPLIT DOLLAR ARRANGEMENT
(NON-EQUITY COLLATERAL ASSIGNMENT)**



1. The insureds establish an irrevocable life insurance trust (ILIT) and "seed" the trust with a gift not subject to the split dollar arrangement.
2. The trustee sends "Crummey" notices to the trust beneficiaries, giving them a time period to withdraw their proportionate amount of the gift.
3. The trustee applies for a survivorship life insurance policy. The insureds and the trustee enter into a non-equity collateral assignment split dollar agreement where the trustee agrees to pay the portion of the premium equal to the economic benefit and the insureds agree to pay the balance.[1]
4. The trustee executes a restricted collateral assignment, giving the insureds a security interest in the policy cash value or death benefit in an amount equal to the greater of premiums paid or the total policy cash surrender values. Note: Different tax consequences may result if the split dollar arrangement is structured as an "equity" collateral assignment where the insureds' interest is limited to premiums paid.
5. Each year, the insureds advance premium amounts in excess of the economic benefit amount to the trust. This portion of the premium is not considered a gift.
6. The trustee pays the life insurance policy premiums to the insurance company using dollars advanced by the insureds and by using trust funds (from the seed money) equal to the economic benefit cost.
7. At the second death, the insurance company pays the death proceeds to the trust (generally, any death benefit greater than the cash value in a non-equity split dollar arrangement) (see step 4 above) and the second-to-die insured's estate according to the terms of the split dollar agreement and the collateral assignment.

[1]The economic benefit under these facts is the cost of the life insurance protection and is calculated using either the rules of Notice 2002-8 or the rules in other Internal Revenue Service (IRS) guidance, as applicable.

TAX CONSIDERATIONS

- The portion of the death proceeds paid to the ILIT should not be subject to federal estate tax provided the insureds do not possess any incidents of ownership in the life insurance policy. In contrast, the portion of the death proceeds paid to the second-to-die insured's estate as reimbursement will be subject to that insured's federal estate tax.
- In this type of split dollar arrangement, either the insureds will "seed" the trust before implementing the split dollar agreement with property or cash and the trustee can use the accumulated funds to pay the annual economic benefit cost of the insurance or the insureds will make annual gifts to the ILIT in an amount equal to the "economic benefit" (i.e., the cost of the life insurance protection). Such gifts from the insureds to the ILIT are not subject to the repayment terms of the split dollar arrangement but are subject to gift taxation to the extent the transfer does not qualify for the insureds' gift tax annual exclusion or gift tax applicable exclusion amounts. If such gifts are to be treated as present interest gifts eligible for the gift tax annual exclusion, they must be subject to Crummey withdrawal powers.
- The tax treatment of transfers to the ILIT subject to the terms of the split dollar arrangement (the premium payment) depends on a number of factors including:
  - the date the split dollar arrangement is entered into.
  - the type of life insurance policy (single life or survivorship).
  - the structure of the agreement (collateral assignment or endorsement, equity or non-equity, contributory or non-contributory).

The following discussion assumes that the private split dollar arrangement is structured as a non-equity collateral assignment between the insureds/donors and their ILIT funded with a survivorship policy as described earlier.

- **Gift treatment of premium payments while the private split dollar is in effect:** Each year the private non-equity collateral assignment split dollar arrangement is in effect, the donor is deemed to have made a gift equal to the "economic benefit", less any amount the trust has contributed. Consequently, if the insureds contribute the full premium, there will be a gift equal to the economic benefit which, under these facts, will equal the cost of life insurance protection only. However, if the trust contributes the economic benefit, the remaining portion contributed by the insureds is not considered a gift.
- **Value of the economic benefit:** Historically, the value of the economic benefit for a survivorship policy was based on Table 38 rates. Table 38 rates are the joint mortality rates based on the government's single-life measurement, P.S. 58 rates. In 2001, the government replaced the P.S. 58 rates with Table 2001 rates; however the only direction regarding the rates for a survivorship policy was that "appropriate adjustments" could be made to the Table 2001 rates.[2]
- **Contributory arrangements:** For contributory arrangements entered into after September 17, 2003, the insureds will be subject to income tax on amounts contributed by the trust. Your advisors may want to review Private Letter Ruling 9745019 and Regulations §§1.61-22 and 1.7872-15.

DESIGN CONSIDERATIONS

- When the private survivorship split dollar arrangement is implemented, it is important to prepare for the death of the first spouse. After the first death, the trust will have to pay a portion of the premium equal to the economic benefit cost of the life insurance based on the higher single-life rates (i.e., the Table 2001 rates).

  One solution to this problem is to "seed" the trust with income-producing assets or excess funds to accommodate larger premium payments expected in the future. Another solution is to make annual contributions in excess of the economic benefit amount necessary to pay the trust's portion of the premium.
- Another issue that needs to be addressed is the estate inclusion of the recovery amount (i.e., the amount the trust owes to the insureds under the terms of the split dollar agreement). Under a non-equity split dollar arrangement, at the death of the second spouse, the estate will include all the cash value of the policy. Only the trust's pure death benefit (amount in excess of the cash value) will be removed from the estate. The effect of the inclusion of this amount on the overall estate strategy needs to be considered.

[2] The economic benefit under these facts is the cost of the life insurance protection. In general, the rules for measuring the life insurance protection are contained in Notice 2002-8 or other IRS guidance, as applicable.

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