

# Private Split Dollar



**THE PRIVATE SPLIT DOLLAR TECHNIQUE** allows for the client to enter into an arrangement where the costs of a life insurance policy are shared or “split” between the client and his or her ILIT.

Fundamentally, this arrangement operates much like a loan to the ILIT: the grantor pays the life insurance premiums and possesses the right to be repaid at some point and time in the future. However, unlike more traditional loans, the repayment obligation requires that the ILIT repay the greater of cash value or premiums paid. Moreover, the “cost” to the ILIT in borrowing these premiums is measured by the cost of one year’s worth of annual renewable term insurance, commonly referred to as the “economic benefit” costs.

## A LENDING TECHNIQUE THAT:

- Utilizes economic benefit instead of interest rates
- Requires repayment equal to the greater of premiums paid or cash value
- Minimizes gift tax exposure

### PLANNING NOTE

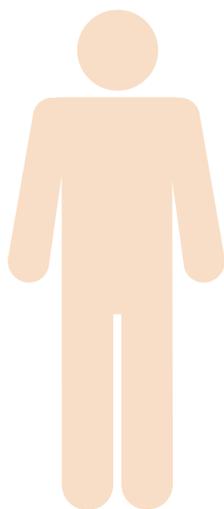
Pursuant to the Final Split Dollar Regulations, split dollar arrangements fall under one of two distinct regimes: the loan regime and the economic benefit regime.

This section focuses on split dollar arrangements governed by the economic benefit regime — in particular, non-equity collateral assignment split dollar. See *Private Financing (LIFE-7299-PF)* for arrangements that would fall under the loan regime.

### HOW IT WORKS

1

**The grantor creates an ILIT,** which will apply for insurance on his or her life; alternatively, a second-to-die policy could be purchased on the lives of the client and his or her spouse.



2

**The trustee of the ILIT enters into a split dollar agreement with the grantor** whereby the grantor will annually advance premiums on the life insurance policy owned inside the ILIT. As security for the premium advances, a collateral assignment will be placed on the policy, requiring payment of the greater of the policy’s cash value or premiums paid at death or rollout.

## Economic Benefit Costs vs. Loan Interest

Economic benefit costs typically are lower than the interest rates associated with annual premium loans, especially on survivorship policies or when the insured is younger than age 70.

Economic benefit costs are generally calculated by multiplying the portion of the death benefit receivable by the trust in a given year by the applicable economic benefit rate found in IRS Table 2001 or the carrier's alternative term rate table.

When a survivorship policy is used, the economic benefit can be extremely low since the value of the death benefit is based on two lives.

For clients looking to pay premiums annually inside the ILIT, but want to reduce their gift tax exposure, a private split dollar arrangement under the economic benefit regime may be a helpful solution.

3

**Each year the grantor will be deemed to have made a gift to the ILIT** equal to the "economic benefit" costs associated with the death benefit protection being provided to the ILIT. Alternatively, the ILIT can pay the economic benefit costs to the grantor to avoid a gift (if the ILIT is funded and has cash available).

- Because the economic benefit cost is the annual renewable term cost on the life of the actual insured, that cost increases incrementally each year as the insured gets older, unlike a fixed interest rate.
- Economic benefit costs increase over time as the insured ages. This increase becomes even more dramatic when second-to-die rates are used. Upon the death of one insured in a second-to-die scenario, the economic benefit calculation must switch to single life rates, resulting in much higher costs. In these situations, planners often employ a strategy called Switch Dollar. In a switch dollar plan, the plan is modified into a loan regime split dollar (private financing) when the economic benefit costs get too high.

4

**At the grantor's death, the estate will be repaid using the death proceeds from the insurance policy.** Alternatively, if the arrangement is terminated during the insured's lifetime, the ILIT will be responsible for repaying the debt or the grantor can choose to forgive the debt.





## BENEFITS OF PRIVATE SPLIT DOLLAR

- **MINIMIZE GIFT TAXES:** If a client has no gifting available, a direct gift of the premium would cause a significant gift tax issue. A private split dollar arrangement limits the taxable gift amount to the annual economic benefit cost, which is significantly lower than the premium amount.
- **LOW ECONOMIC BENEFIT COSTS:** The economic benefit cost is often less than loan interest offered under private financing techniques, especially for second-to-die cases, making private split dollar an attractive alternative to private financing.
- **RETAIN CONTROL:** Rather than making an outright gift to the trust, resulting in a loss of control of the gifted funds, clients who use a private split dollar arrangement retain some control of their premium outlay. During life, the premium payor is due back the greater of premiums paid or policy cash value under the arrangement. Should a change in circumstances occur, the trust could repay the split dollar obligation either by surrendering the policy or by using other trust assets.
- **ESTATE FREEZE:** The amount due back to the payor or the estate is the greater of premiums paid or cash value. If the chosen policy does not provide a cash value greater than premiums paid, the amount due back to the estate is exactly the premium amounts paid, without growth. This “freezes” the amount of premium in the estate.

## Repayment under a Private Split Dollar arrangement

Similar to other funding methods, there are various ways to repay the obligation. With a private split dollar arrangement, repayment can occur at death or while the insured is alive.

**The most common repayment methods include:**

### POLICY DEATH BENEFIT

Due to the nature of the split dollar arrangement, the greater of policy cash value or premiums paid is due upon the death of the insured(s). The repayment of premium/cash can provide liquidity to the estate. The trustee can also use the death proceeds to lend to the estate or purchase assets out of the estate, providing even greater liquidity if needed.

### RETURN OF PREMIUM

The Return of Premium rider can be used to repay the split dollar obligation to the estate, leaving increased liquidity to the trust.

### WEALTH TRANSFER STRATEGIES

During the insured's life, the split dollar arrangement can be repaid through a number of wealth transfer strategies, including GRATs, CLTs, sales to defective trusts, or gifts.

## HYPOTHETICAL CASE STUDY

Jim Smith, age 55, and his wife, Mary, age 50, have a total net worth of \$40,000,000. They want to purchase insurance outside of their estate to provide liquidity to pay estate taxes and ultimately to benefit their two children. They have already used most of their lifetime exemptions and are looking for an efficient way to add \$20,000,000 of life insurance to an ILIT for their liquidity needs.

The proposed second-to-die insurance policy with a \$20,000,000 death benefit will cost \$110,512 a year for both of their lives, but they currently only have \$60,000 of annual exclusion gifts (\$30,000 x 2). To help minimize gift tax exposure, their advisor suggests using a Private Split Dollar (PSD) arrangement. Under the PSD agreement, the

grantors will pay the premium each year and will make a gift of the “economic benefit” costs associated with the ILIT’s interest in the death benefit. At the death of the second-to-die, the trust will be required to repay the greater of premiums paid or cash value. See Figure 1.

**FIGURE 1**

YEAR	INSURANCE PREMIUM	PSD REPAYMENT OBLIGATION	ECONOMIC BENEFIT COSTS	NET DEATH BENEFIT (AFTER LOAN REPAYMENT)
1	\$110,512	\$110,512	\$195	<b>\$19,889,488</b>
5	\$110,512	\$552,560	\$441	<b>\$19,447,440</b>
10	\$110,512	\$1,105,120	\$1,222	<b>\$18,894,880</b>
15	\$110,512	\$1,657,680	\$3,660	<b>\$18,342,320</b>
20	\$110,512	\$2,210,240	\$10,291	<b>\$17,789,760</b>
30	\$110,512	\$3,857,987	\$53,594	<b>\$16,142,013</b>

**Jim and Mary could continue this arrangement until the death of the survivor, but the economic benefit costs will continue to rise, especially at the death of the first insured. For example, if we assume that Jim dies at age 85, the economic benefit costs would skyrocket from \$53,594 in Year 30 to \$174,759 in Year 31. Moreover, after Jim’s death, Mary would need to continue paying the premium each year along with gifting the economic benefit cost.**

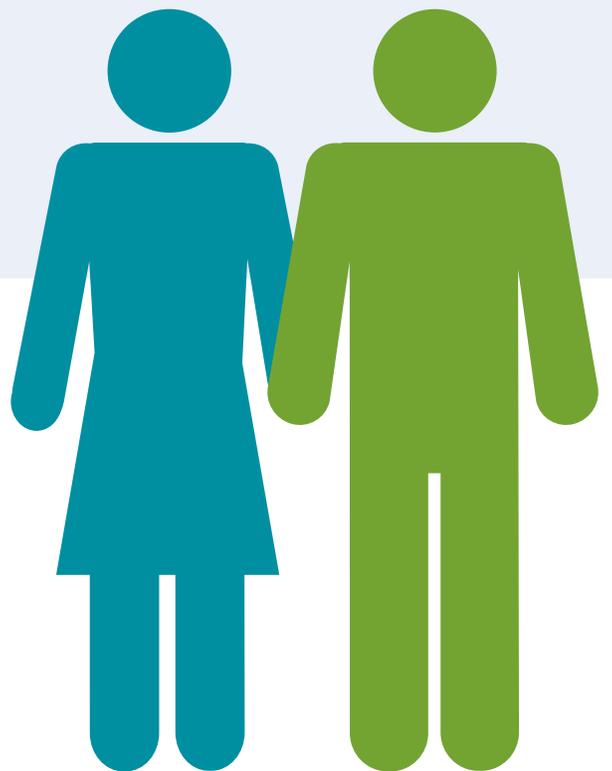
**To avoid the substantial increase in economic benefit costs at the death of the first to die, Mary and Jim could utilize one of the following planning strategies:**

#### **SWITCH DOLLAR**

At the death of the first insured, the trustee could execute a promissory note at the current AFR in an amount equal to the current repayment obligation. For example, if Jim dies in Year 30, the parties could agree to terminate the split dollar agreement and the ILIT trustee would provide a promissory note to Mary equal to the repayment obligation — e.g., \$3,857,987 — repayable at Mary's death. If the long-term AFR in Year 30 is 4%, the interest due on the note each year would be \$154,319, which is considerably less than what the economic benefit costs would be moving forward. If interest rates in Year 30 were much higher than 4%, then Mary may be better off sticking with the economic benefit for a period of time.

#### **ANNUAL EXCLUSION SIDE FUND**

Although Mary and Jim do not have enough annual exclusion gifts to cover each annual premium of \$110,512 from the outset, they do have \$60,000 of gifting available each year. Mary and Jim could consider making gifts of \$60,000 to the trust each year (more as the annual exclusion amount gets indexed for inflation) in addition to paying the insurance premium. These annual exclusion gifts could be used by the ILIT trustee for two purposes: (1) paying the annual economic benefit costs to Mary and Jim and (2) as assets to invest to grow a side fund. For example, if the trustee invests the net \$60,000 received each year, after paying economic benefit costs, at a 7% average return, in Year 21, the ILIT side fund will exceed the repayment obligation due under the split dollar agreement. Therefore, should Mary or Jim die prior to life expectancy, the trust will have assets from which it can either pay the much larger economic benefit costs or terminate the split dollar arrangement early and still retain the life insurance.



## GRAT Exit Strategy

Mary and Jim decide to fund a 15 year term GRAT at the same time as they enter into the split dollar arrangement, and name the ILIT as the remainder beneficiary of the GRAT. Mary and Jim then transfer approximately \$2,700,000 of securities into the GRAT assuming a 7520 rate of 3% and a rate of return of 7%. Mary and Jim will receive 15 annual annuity payments of approximately \$226,000 — which they could use to lend the annual premium of \$110,512 and make the annual exclusion gifts of \$60,000. At the end of the GRAT term, the remainder (projected to be approximately \$1,750,000) will be distributed to the ILIT and the ILIT trustee will use this amount plus other trust assets to pay back Jim and Mary and terminate the split dollar plan.

### **RESULT USING GRAT:**

Mary and Jim are repaid at the beginning of Year 16 (at the ages of 71/66) and the trust is expected to have enough assets to continue paying the \$110,512 of premium each year without requiring additional gifting or loans from the grantors.

## SUMMARY

Private Split Dollar is a powerful planning technique that allows a client to pay annual premiums on a policy owned in an ILIT without having to make large gifts that would exceed the client's lifetime exemption and incur gift taxes. This technique is often preferred over annual premium loans because the economic benefit costs are often lower when compared to current interest rates — especially for younger insureds or on a survivorship policy while both insureds are alive.

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