Recapturing Your Ability to Make Annual Gifts Through Private Split Dollar

Years ago, your advisor and your estate planning lawyer recommended to you, that you implement an irrevocable life insurance trust to help provide your family with a source of funds for income needs and to provide liquidity to pay estate taxes, in the event of your death. At the time, the suggestion made perfect sense because all of your net worth was tied to the business, and that was the source of the family’s income. Over the years, however, your business has become even more successful, allowing you to accumulate savings and other investments, but the size of your estate continues to grow as your business grows. Unfortunately, however, most, if not all, of your annual gift-tax free gifting is used to fund the insurance trust so you can’t use that strategy to help further reduce your estate . . . or can you?

The Solution: Private Split Dollar

Split dollar is a planning technique that allows one party to own a policy while another party pays the premium. This technique is often used in the business setting whereby the employer would pay for the insurance premiums. When the transaction involves just family members, it is called “private” split dollar. The key is that generally, the premium payor gets back the premiums paid (or the greater of premiums or the cash value, depending upon the type of split dollar used). By using private split dollar, gifts that qualify for the annual exclusion can be diverted for purposes other than funding an irrevocable life insurance trust (“ILIT”) because you’ve lowered the gift tax valuation of those used for the premium payments.

How Does it Work?

While there are two primary split dollar techniques known as “economic benefit regime” and “loan regime” split dollar, we’ll use what is known as loan regime. Here’s why: in the loan regime, the insured is going to get back the premiums he or she pays from this point on – no more, no less, making it easy to determine what the premium payor recovers, and allowing the trust to enjoy the equity growth above that amount. Loan interest can be either at a fair market rate or considered a below-market loan, which brings about significant adverse consequences. Therefore, a fair market rate is used. Fair market interest rates used to calculate the interest amount owed are determined by using IRS rates published monthly called the “Applicable Federal Rates” or “AFRs””. The right AFR to pick depends upon when the agreement is made and the time frame that the agreement will remain in place.
How Does it Work? (cont’d)

1. Let’s assume that your ILIT owns a whole life policy. You enter into an agreement, drafted by an estate planning attorney, with the trustee, to pay the premiums. The trustee executes a collateral assignment to secure the repayment to you, your estate or your spouse, of the premiums advanced from this point onward. Looks like a loan of the premiums to the trust, right?

2. You make the loan. Interest on the loan can either be paid or accrued. If accrued, care must be taken to ensure that you do not waive or forgive the loan interest in the future, to avoid adverse tax consequences. Loan interest can be paid from existing trust assets, or if accrued, at death. If loan interest is not paid, then the interest is deemed to be an imputed gift to the trust. In that case, by using private split dollar, the only “gift” you will be making is the interest amount that the trust would have paid on that loan. The tax leverage is that instead of the premium amount being the measure of the gift for tax purposes each year, it’s only the imputed interest on that amount.

   a. For example, assume the premium is $76,000, and there are 3 trust beneficiaries (e.g., your children). The current annual gift-tax exclusion amount is $12,000 per person per donee ($13,000 for 2009). You and your spouse are currently “splitting” the gifts to fund the trust each year. $12,000 x 3 x 2 = $76,000. That’s the limit for the annual gift-tax exclusion. But now, the leverage of Private Split Dollar comes into play: if the “AFR” is 3.00%, that reduces the gift for tax purposes from $76,000 to $2,280. The remaining $73,720 is not a gift, but a loan. Private Split Dollar allows you to use an additional $73,720 each year to make gift tax-free gifts to your children.*

(*Figures are hypothetical and for illustrative purposes only.)
3. Like before, your trust will still have to provide the Crummey notice to the trust beneficiaries to qualify the gift as a present interest gift. However, the gift is now much lower than before.

4. Also, like before, after the expiration of the Crummey notice period, the trust will pay the premiums to the insurance company each year.

5. Upon your death, the insurance company will pay most of the death proceeds to the trust and only the loaned amounts to your estate according to the terms of the split dollar agreement and the collateral assignment.

Advantages

- Your ILIT is maintained to continue providing your family and estate with a source of funds to meet lifestyle needs, as well as to provide liquidity to help pay potential estate taxes, in the event of your death.

- Your ILIT continues to operate in much the same fashion as before except that the trustee of the trust needs to enter into a split dollar agreement with you, the premium payor, and to give back a collateral assignment to repay the premium loan.

- You’ve now eliminated the need to use most of your annual exclusion gifting to fund the ILIT, and can redirect those gifts for other wealth reduction planning techniques. Only a small portion of the annual exclusion gift needs to be used to gift the amount of the loan interest payment to the trust.

- Many ILITs, especially the newer they are, provide for possible distributions during the lifetime of the insured, to his or her family members. In fact, some are considered “Spousal Limited Access Trusts” (“SLATs”), specially designed to give the creator of the trust “indirect” access to trust-held funds (e.g., policy cash values) through rights enjoyed by the trust creator’s spouse. This could be an added benefit if your ILIT was designed in this manner.

Generally, the private split dollar planning technique can be complex and there may be other considerations to take into account. You should consult with your Guardian Financial Representative as well as your tax and legal advisors to ensure that this planning solution is right for you.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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