The Way We Were! Rediscovering the Planning Magic in Traditional Split Dollar Life Insurance (With a Twist!)

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Split Dollar life insurance has been around since the middle of the last century, but it still offers some enticing tax planning opportunities. The IRS in recent years has tried, but largely failed, to take Split Dollar out of the planning game. As Congress considers and likely legislates increases in the income, estate, and gift taxes, Split Dollar will be an important tool to achieve income and wealth transfer planning benefits.

Introduction

One of the things that my wife, Mrs. Nowotny (a/k/a Long Suffering), and I enjoy doing is watching movies. We both enjoy foreign films. I became a foreign film aficionado as a double major in Spanish and Portuguese at West Point. The language department was the friendliest department at the military academy, which is also the oldest engineering school in the country. Frankly, for the worst engineering student in the history of West Point, language and foreign film were a path toward academic survival. A movie favorite of Mrs. Nowotny's is *The Way We Were*. She has seen it 10-12 times. (It's a good movie, but she probably has more of a Robert Redford fascination if you ask me!) But thinking about the way things used to be got me to thinking about Split Dollar life insurance.

This article focuses on the utility and survival of a life insurance planning technique known as Split Dollar life insurance. Split Dollar life insurance is a traditional life insurance planning technique the origin of which can be traced back 65 to 70 years. The original ruling dealing with Split Dollar life insurance was issued in 1955.[1] Over the course of decades, the IRS

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[1] Rev. Rul. 55-713, 1955-2 CB 23.

("the Service") and taxpayers and their advisors engaged in a dance regarding the tax treatment of Split Dollar. Part of the time it was "cha cha cha" and the other part of the time it was "rhumba."

In the eyes of the Service, it was always an interest-free loan arrangement. In the eyes of taxpayers, it was something other than an interest-free loan that did not result in current taxation. For decades, taxpayers prevailed. However, final Split Dollar regulations issued in 2003 were largely believed to have taken all the wind out of taxpayers' sails.

This article is designed to reassure taxpayers and their advisors that—much like Mark Twain, who supposedly quipped that reports of his demise had been greatly exaggerated[2]—Split Dollar life insurance remains alive and well, although under-utilized in the current planning landscape. On the contrary, ultra-high net worth taxpayers in the last decade weaponized Split Dollar in a manner that turned it into the most effective estate and gift tax strategy available. Discussions on possible tax reform create a planning urgency to rediscover the planning benefits of Split Dollar life insurance. This article will narrow the focus to the Loan Method of Split Dollar life insurance.

Overview of Split Dollar Life Insurance

Classic Split Dollar life insurance was originally cast in two forms, the Endorsement Method and the Collateral Assignment Method. Split Dollar life in its simplest form is nothing more than a contractual arrangement between two parties to share the benefits of a life insurance contract. In a corporate setting, Split Dollar life insurance has been used for 65 (or more) years as a fringe benefit for business owners and corporate executives. Split Dollar can also be used in a non-corporate setting—referred to as Private Split Dollar.

Endorsement Method. In the Endorsement Method within a corporate setting, the corporation is the applicant, owner, and beneficiary of the life insurance policy insuring a corporate executive. The company pays all or most of the policy's premiums, and has an interest in the policy's cash value and death benefit equal to the greater of the policy's premiums or cash value. The company contractually endorses the excess death benefit (the amount of death benefit in excess of the cash value) to the employee, who is authorized to select a beneficiary for this portion of the death benefit.

Collateral Assignment Method. In the Collateral Assignment Method, the employee is the applicant, owner, and beneficiary of the policy. The employee's

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[2] In fact, what Twain said, as reported in an article in the *New York Journal* on June 2, 1897, was that "[t]he report of my death was an exaggeration."

family trust may also serve as the policy's owner. The company pays all or most of the premiums, and retains an interest in the policy's cash value and death benefit equal to the greater of the policy premiums or cash value. The employee collaterally assigns an interest in the policy to the employer for its contributions and interest in the policy.

Private Split Dollar Arrangement. In a Private Split Dollar Arrangement, private non-corporate individuals are the parties to the Split Dollar Arrangement. In a typical Private Split Dollar Arrangement, an Irrevocable Life Insurance Trust (ILIT) will be the applicant, owner, and beneficiary of the policy. The patriarch (or matriarch or both) will enter into the Split Dollar Arrangement with the ILIT to provide funding for the life policy. The ILIT trustee will collaterally assign an interest in the policy's cash value and death benefit to the patriarch equal to the greater of the cash value or premiums. The excess death benefit is paid to the ILIT during the arrangement. The proposed insureds are the children and/or their spouses.

Restricted Collateral Assignment. Restricted Collateral Assignment is the classic form of Split Dollar Arrangement utilized by the majority shareholder of a closely held business. Under Restricted Collateral Assignment Split Dollar, a provision is added to the Split Dollar agreement which "restricts" the company's access in the policy under the Split Dollar Arrangement (greater of cash value or premium). The "restriction" limits the company's access until the earlier of the death of the insured, termination of the Split Dollar Agreement, or surrender of the policy.

The owner's business purpose is driven by concerns about the estate tax inclusion of the death proceeds for the business owner under Internal Revenue Code Section 2042. The incidents of ownership under Section 2042 over the policy would be imputed to the business owner due to the owner's control of the business as the majority shareholder. The proposed Private Split Dollar Arrangement would contain the same type of restriction as in the classic Split Dollar Arrangement.

Restricted Split Dollar Arrangements were used for decades in planning situations where a controlling shareholder sought to avoid estate tax inclusion for a policy owned within an ILIT. No one at the time considered the valuation leverage for gift tax planning purposes to transfer taxpayer wealth outside the taxpayer's estate at discounts of 75-90 percent. So much of the planning focus in the decade of the 1990s and moving forward was on the use of family limited partnerships to achieve valuation discounts for lack of marketability and lack of voting control. In my experience, these valuation discounts on their best days were incapable of achieving the valuation discounts of Inter-generational Split Dollar that were in the 75-90 percent range.

Intergenerational Split Dollar. Intergenerational Split Dollar is the application of private Split Dollar designed to favorably exploit the tax leverage of Split Dollar using the economic benefit method of Split Dollar using policies that insured younger family members. In this arrangement, the patriarch or matriarch ("senior generation") had already utilized their exemption amount for federal gift tax purposes but still remained with a large taxable estate. The senior generation was the sponsor in the Split Dollar Arrangement where an irrevocable trust was the policyholder insuring the life of a family member in the second or third generation.

This planning resulted in significant gift tax leverage due to the fact that the measure for gift tax purposes is the lesser of the life insurer's one-year term cost or Table 2001 term cost, *not* the amount of premiums paid into the policy. The second point of tax leverage in the Split Dollar Arrangement was the collateral assignment to the premium payer. The collateral assignment in the policy cash value was structured to be equal to the greater of the policy's cash value or cumulative premiums. However, the collateral assignment restricted the assignee's (premium payor's) access to its interest to the earliest of the insured's death, termination of the split dollar arrangement, or surrender of the policy. The terms of the arrangement and age of the insured created a significant discount in the Split Dollar receivable. These discounts, which ranged from 75 to 98 percent depending upon the specific facts, undoubtedly more than frustrated the Service, which has litigated against taxpayers in Intergenerational Split Dollar Arrangements.[3] The Service may have won the battle but remains very vulnerable in Intergenerational Split Dollar based upon more favorable facts and planning.

Key Rulings. Revenue Ruling 76-274[4] involved a Restricted Collateral Assignment Non-Equity Split Dollar Arrangement. The Service ruled that the policy proceeds were not attributable to the majority shareholder (insured),

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[3] The Service litigated against taxpayers in Estate of Cahill v. Comm'r, 124 TC Memo. 2018-84, Estate of Morrissette v. Comm'r, 146 TC 171 (2016) ("*Morrissette I*"), and, most recently, Estate of Morrissette v. Comm'r, TC Memo. 2021-60 ("*Morrissette II*"). Much to the chagrin of the Service, the Tax Court recognized a bona fide Split Dollar Arrangement in each case. Inevitably, the issue has narrowed to one item: valuation. In *Morrissette II*, the Tax Court significantly stated that IRC § 2703 did not apply to the arrangement as well. However, due to the specific pattern of the split dollar termination, i.e. the purchase by the trustee of the same trust owning the policy, the Tax Court disallowed the taxpayer's discount and assessed a tax penalty under IRC § 6662(h). The esteemed tax attorney and author Howard Zaritsky noted that had the facts been different—a transfer to a different trust rather than the trust that owned the policy—the result might have been different. See Howard Zaritsky, "*Morrissette II* Sets the Bar for Intergenerational Split Dollar Arrangements," Steve Leimber Estate Planning #2886, May 18, 2021 Available at http://www.leimbergservices.com/openfile.cfm?filename=C:\inetpub\wwwroot\all\lis_notw_2886.html&fn=lis_notw_2886.

[4] 1976-2 CB 278, modified by Rev. Rul. 82-145, 1982-2 CB 213.

due to the corporation's restriction to accessing the policy's incidents of ownership, and therefore were not included in the estate of the business owner. In Revenue Ruling 82-145,[5] the Service ruled that the corporation's right to borrow from the policy under a Collateral Assignment Split Dollar Arrangement involving a majority shareholder would result in estate tax inclusion of the policy proceeds.

In AALU Bulletin Notice 94-51, Association of Advanced Life Underwriting counsel referenced a favorable estate tax audit involving the use of Restricted Collateral Assignment Split Dollar. It became clear from this ruling that it is necessary to restrict the corporation's access to any of the policy incidents of ownership to avoid estate tax inclusion.[6] Private Letter Ruling 9511046[7] involved the use of Restricted Collateral Assignment Split Dollar in the context of a Private Split Dollar Arrangement. The favorable ruling stated that the "restriction" in the Split Dollar Arrangement limiting the Assignee's (premium payor) access in the policy to the earlier of the insured's death, termination of the Split Dollar Arrangement, or surrender of the policy, would not result in estate tax inclusion.

Revenue Ruling 55-713[8] held that a Split Dollar Arrangement with the employer and employee sharing ownership of the policy was an interest-free loan, which under the law in effect at the time did not result in taxable income. The IRS revoked Revenue Ruling 55-713 prospectively in Revenue Ruling 64-328,[9] holding that Split Dollar Arrangements were not interest-free loans.

Revenue Ruling 64-328 defined a Split Dollar Arrangement as a sharing of the costs and benefits of a life insurance policy between an employer and an employee (and his or her beneficiaries) while the employer provides the employee with life insurance protection for his or her family, as a part of an employee benefit plan. Economically, the employer advanced the premiums due on a permanent policy insuring the employee for the benefit of the employee's (or the insured's) named beneficiary or for the policy owner. The employer's advances were returned, without interest, at the insured's death out of the death proceeds of the policy or, upon earlier termination of the arrangement during the insured's lifetime, out of the policy's cash value.

Using the theory of Revenue Ruling 64-328, the measure of the economic benefit was the term insurance cost of providing a death benefit,

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[5] 1982-2 CB 213.

[6] Ass'n of Advanced Life Underwriters (AALU), Washington Report Bulletin Notice 94-51.

[7] Dec. 22, 1994.

[8] Rev. Rul. 55-713, 1955-2 CB 23.

[9] 1964-2 CB 11.

determined under a table known as the "P.S. 58" rates, first published in Revenue Ruling 55-747[10] for the purpose of valuing life insurance protection provided to an employee under an employees' trust. Alternatively, Revenue Ruling 66-110[11] (obsoleted by Revenue Ruling 2003-105[12]) allowed the use of the insurer's lower, generally available, published one-year term rate.

Revenue Ruling 66-110 also provided that any "other benefit" under the Split Dollar Agreement besides insurance protection (such as policy dividends) provided to the insured under the plan was currently taxable. Notices 2001-10[13] and 2002-8[14] did not apply this "other benefit" analysis to the taxation of policy equity. Instead, the notices treated the employee's right to the policy's cash value as a Section 83 transfer of property, as described in Technical Advice Memorandum 9604001.[15] However, the final Split Dollar regulations include a theory similar to Revenue Ruling 66-110's "other benefit" theory under Section 61 to tax policy equity on a current basis for endorsement arrangements subject to the regulations.

Revenue Rulings 78-420[16] and 81-198[17] set out the tax treatment for gift tax purposes where the policyholder is a third party. The rulings provided that the value of the economic benefit for insurance protection is the measure for gift tax purposes when a third party owns the policy under the Split Dollar Arrangement.

Ultimately, the proverbial straw that broke the camel's back was the life insurance industry's continued use of Equity Split Dollar. Under an Equity Split Dollar Arrangement, an employer would sponsor the purchase of life insurance for a key executive using the Collateral Assignment Method. Under the terms of the Collateral Assignment Agreement, the employer would retain an interest in the policy's cash value and death benefit equal to the lesser of the cumulative premiums or the policy's cash value. Under the arrangement, excess cash value beyond cumulative premiums accrued for the benefit of the executive without current income or gift taxation on this excess cash value. At retirement, the Split Dollar Agreement was terminated, and the executive was able to receive tax-free income from the policy through

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[10] 1955-2 CB 228.

[11] 1966-1 CB 12.

[12] 2003-2 CB 696.

[13] 2001-1 CB 459.

[14] 2002-1 CB 398.

[15] Sept. 8, 1995.

[16] 1978-2 CB 67.

[17] 1981-2 CB 188.

loans and withdrawals. The executive's family received an income and estate tax-free death benefit.

2003 Final Regulations. The final regulations governing Split Dollar Arrangements were issued on September 17, 2003.[18] The regulations apply only to Split Dollar life insurance arrangements entered after September 17, 2003, and to any arrangement entered on or before that date if the arrangement is "materially modified" thereafter. The Split Dollar final regulations define a Split Dollar Arrangement as one between an owner and a non-owner of a life insurance contract, pursuant to which:

1. Either party pays all (or a part) of the premiums on the policy, including payment by means of a loan secured by the policy.
2. At least one party is entitled to recover all or a portion of those premiums, which recovery is to be made from or is secured by the proceeds of the policy: and
3. The arrangement is not part of a group-term life insurance plan unless the plan provides permanent benefits to employees.[19]

Leveraged Split Dollar Rollout

Loan Regime Split Dollar Basics. The primary planning objective of the Loan Regime Method of Split Dollar is to provide the taxpayer with low-cost death protection and equity buildup in cash value. In the Loan Regime, the taxpayer is the applicant and owner of the policy and collaterally assigns an interest in the policy's cash value and death benefit to the employer equal to its cumulative loans plus any accumulated interest payments. In the Loan Regime, the taxpayer or, better yet, a family trust (irrevocable) established in a jurisdiction like Nevada, South Dakota, Wyoming, or Alaska, may be a better solution for asset protection purposes. Ownership within the trust removes the policy from the reach of personal and business creditors.

In the Loan Method Split Dollar realm, the premium payer, the taxpayer's business, provides a series of loans to the trustee of the family trust for all or most of the premiums. The loans are not treated as taxable income to the taxpayer provided the loan terms are arm's-length in nature. The loans also are not treated as taxable gifts where the loans are extended to the trustee of a family trust, providing that there is an adequate interest rate. The arrangement also may be structured as a Private Split Dollar Arrangement where the

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[18] See T.D. 9092, 68 Fed. Reg. 54,336 (Sept. 17, 2003) (setting out Treas. Reg. §§ 1.61-22, 1.83-3(e), 1.83-6(a)(5), 1.301-1(q), and 1.7872-15).

[19] See Treas. Reg. § 1.61-22(b)(1).

taxpayer as the sponsor provides a series of loans to pay the annual premiums. The policyholder is the taxpayer or the trustee of a family trust.

The Impact of Below-Market Rate Loans. Below-market rate or interest-free loans are sometimes used in Loan Regime Split Dollar where the employer desires to provide premium financing to the executive through a loan with little or no interest. When no interest is charged by the employer as a lender, the rules for below-market or interest-free loans under Section 7872 apply. Under that Code section, if no interest or an inadequate rate of interest is charged on a loan, the IRS recharacterizes the loan as an "arm's length" transaction and imputes an interest rate equal to the applicable federal rate based upon the term of the loan that is deemed to have been received by the lender and paid by the borrower. The long-term applicable federal rate in May 2021 is 2.16 percent per year.

Additional Loan Considerations. To avoid the application of the below-market rate loan rules in a Loan Regime Split Dollar loan, the parties should agree upon a stated interest at or above the appropriate applicable federal rate. Demand loans may be used in Split Dollar plans. If the Split Dollar loan is nonrecourse, meaning the policyholder is not personally liable, and the loan is payable only from values in the policy with no further recourse to the borrower, the parties must represent in a writing attached to their tax returns in the first year of the plan that a reasonable person would expect that all payments under the loan will be made. To avoid these rules, most Split Dollar loans are made on a recourse basis so that the borrower is personally liable for repayment of the loan.

ERISA Considerations. Split Dollar plans require a fiduciary (plan administrator) and a claims procedure. If a plan is contributory, it will not qualify for the select group of management/highly compensated employee exemptions that apply to non-contributory welfare benefit plans. If the business owner is required under the terms of the plan to contribute any part of the premium, the plan administrator must provide a summary plan description (SPD) to each participant and the Department of Labor (DOL), as well as provide other plan documents to the DOL upon request. If the Split Dollar plan is an employer-pay-all plan, the administrator is not required to file any plan documents with the DOL unless so requested by the DOL; however, an SPD must be made available to each participant.[20]

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[20] See ERISA § 201(2); 29 CFR § 2520.104-23.

The Application of Section 409A. New deferred compensation plans must meet the requirements of Section 409A. IRS Notice 2007-34[21] described the application of Section 409A to certain Split Dollar life insurance plans. In general, Section 409A does not apply to Non-Equity Endorsement or Non-Equity Collateral Assignment Split Dollar plans or Loan Regime Collateral Assignment Split Dollar plans, unless the employer agrees to forgive the loan, waive payments, etc. for purposes of bringing that plan into compliance with Section 409A without losing the Split Dollar grandfathering.

Split Dollar Termination. There are several possible approaches to terminating a Split Dollar plan.

Leveraged Split Dollar Rollout™. The Leveraged Split Dollar Rollout™ is a method to terminate an existing Loan Regime Split Dollar Arrangement at a significant discount. In the Loan Regime, the business, as the lender, receives a Restricted Collateral Assignment interest in the life insurance policy's cash value and death benefit equal to the value of the loan plus any accrued interest. The Collateral Assignment interest is restricted until the earliest of the insured's death, termination of the Split Dollar Arrangement, or surrender of the underlying policy. The value of the Collateral Assignment note is discounted due to this restriction.

At some point, the policyholder decides to terminate the Split Dollar Arrangement by purchasing the lender's Restricted Collateral Assignment interest in the policy. A valuation specialist values the note receivable. Due to the restriction, the receivable is likely to be discounted. Following the purchase of the Split Dollar receivable from the lender, the Split Dollar agreement is terminated. The policyholder uses a tax-free policy loan or withdrawal to purchase the note from the lender.

Court Decisions. A decent amount has been written about Intergenerational Split Dollar life insurance following recent Tax Court litigation in *Estate of Levine v. Commissioner*,[22] *Estate of Cahill*,[23] and *Morrissette I* and *II*,[24] cases involving Collateral Assignment Non-Equity Split Dollar and the Economic Benefit Method. These arrangements were Private Split Dollar Arrangements typically designed to transfer large amounts of value from the taxpayer's estate at large discounts. I am personally aware of

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[21] 2007-1 CB 996.

[22] Docket No. 9345-15 (Tax Court order and decision entered July 13, 2016).

[23] Supra note 3.

[24] Supra note 3.

exceptionally large transactions having taken place at obscene (in a good way!) discounts.[25]

In *Estate of Cahill*, the taxpayer claimed a 98 percent discount. Come on! How could anyone think that this level of discount wouldn't be challenged on principle alone? These cases were ultimately about valuation issues rather than whether the arrangements were valid Split Dollar Arrangements. The Tax Court in each case ruled that the arrangements were valid Split Dollar Arrangements. None of these arrangements used the Loan Regime Method of Split Dollar.

The use of the Loan Regime Method of Split Dollar in a business context is significantly different from the transactions in recent Tax Court cases involving Intergenerational Split Dollar:

- First, the use of Restricted Collateral Assignment in the context of business-sponsored Split Dollar has existed for over 50 years. In the early days, planners did not realize the valuation planning opportunities created by the restriction. Valuation in tax planning became much more mainstream in the 1980s and 1990s.
- Second, the audit exposure in Intergenerational Split Dollar using Private Split Dollar in large estates was almost 100 percent. The audit rate for regular corporations and LLCs that sponsor Split Dollar Arrangements is negligible at best (between 0.2-0.5 percent).
- Third, business Split Dollar has significant non-business purposes ranging from employee benefit planning to business succession planning, unlike the Intergenerational Split Dollar transaction. The IRS has seen and ruled favorably on the use of Restricted Collateral Assignments for controlling shareholders for at least five decades for these non-tax driven purposes. Finally, the Tax Court cases almost exclusively used the Economic Benefit Method of Split Dollar instead of the Loan Regime.

Implementing the Leveraged Split Dollar Rollout Strategy. To implement the Leveraged Split Dollar Rollout strategy, the trustee of the Dynasty Trust at his discretion may decide to transfer by sale the interest in the Split Dollar Arrangement, a/k/a the Split Dollar receivable. The Split Dollar receivable is valued based upon a third-party valuation. The right of recovery under the Split Dollar Arrangement is limited until the death of the

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[25] Supreme Court Justice Potter Stewart, in determining a threshold test for obscenity, is famously known to have said, "I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description ["hard-core pornography"], and perhaps I could never succeed in intelligibly doing so. But *I know it when I see it*, and the motion picture involved in this case is not that." Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring) (italics added).

insured or the termination of the Split Dollar Arrangement. The sales price based upon an independent valuation provides for a heavily discounted sales price, 75-90 percent.

Split Dollar Planning Strategies in Action

Case Study 1: Hedge Fund Manager. Sid Finkelstein, age 50, is the principal of an investment management firm in Greenwich that manages several hedge fund strategies. Finkelstein has a personal net worth of $40 million and is married with two children. His investment management firm has a management agreement with each domestic and offshore fund that it manages providing for a management fee of 2 percent and an incentive fee of 20 percent after providing investors a 5 percent return on their investments. The firm is no longer able to defer incentive fees from the management activities of its offshore fund and would like to implement a strategy that can provide a significant but tax efficient benefit to Sid. The investors agree to an arrangement whereby the offshore fund will provide a one-time loan to Sid in lieu of 50 percent of the incentive fee in 2021. The agreement provides that the loan amount will be at least $10 million.

The Planning Strategy. Sid's offshore fund is structured as a Cayman corporation ("Corporation") and is not subject to corporate taxation in Cayman or the United States. The investment management company ("Management Company") and the offshore fund (investors) agree to an arrangement whereby Management Company agrees to forgo 50 percent of any incentive fees earned in 2021 in exchange for an arm's-length loan between Corporation and Sid personally or, alternatively, his family trust, the Finkelstein Family Trust ("Family Trust"). The projected loan amount is $10 million. The loan will be an arm's-length loan at the current long term applicable federal rate of 1.0 percent. The loan is a recourse loan between the Corporation and Sid's Trust.

The trustee of an irrevocable trust created by Sid's wife is the applicant, owner, and beneficiary of a Private Placement Life Insurance (PPLI) policy insuring Sid's life. The policy has a $30 million death benefit and projected premiums of $2.5 million per year for four years. Corporation will have a Collateral Assignment interest in the cash value and death benefit equal to the amount of the loan plus any accrued interest. The Trust will own the cash value and death benefit in excess of the Collateral Assignment interest in the policy. The policy is a non-modified endowment contract, which means that loans and withdrawals from the policy will receive tax-free treatment to the trustee of the Finkelstein Family Trust.

Acme Life, a specialty life insurer in Bermuda, issues a PPLI contract featuring a separately managed account. Hector Heathcoat, an established money manager and friend of Sid's, is appointed by Acme to manage the investment account within the policy. The trustee transfers the entire amount

of the loan to Acme, which maintains the premiums for future years in a premium deposit account.

The Trustee of the Family Trust has the discretion to request policy loans and withdrawals and distribute the proceeds to Sid on a tax-free basis. The policy within the Trust is beyond the reach of Sid's personal and business creditors. The policy death benefit will receive income and estate tax-free treatment. The proceeds will also be multi-generational. The trustee pays the annual interest on the $10 million loan at a rate of 1.0 percent per year. The annual interest payment is $100,000. The loan term is 30 years. The projected growth rate within the policy is 8 percent.

Exhibit 1 projects the benefits to Sid under the arrangement.

Exhibit 1: Benefits of Case 1 Arrangement

Year	*Accumulated Loan*	*PPLI Cumulative Value*	*PPLI Death Benefit*
10	$10 million	$26.25 million	$30 million
20	$10 million	$56.67 million	$65.17 million
30	$10 million	$122.35 million	$128.47 million
40	$10 million	$264 million	$277.2 million

"End-Game" Planning. The planning includes an additional Death Benefit Only (DBO) option, which provides that the offshore fund will make a lump sum payment to Sid's family trust if Sid dies while the Split Dollar plan is in effect. The amount of the DBO benefit is equal to the amount that the Corporation receives from the death benefit portion of its Collateral Assignment interest in the policy. The payment from the Corporation to the Trust is treated as taxable income. Nevertheless, it is a substantial benefit.

The planning also calls for a termination or rollout of the Split Dollar plan after the policy is funded using the Leveraged Split Dollar Rollout technique. The Leveraged Split Dollar Rollout is a method to terminate an existing Loan Regime Split Dollar Arrangement at a significant discount. In the Loan Regime, the business, as the lender, receives a Restricted Collateral Assignment interest in the life insurance policy's cash value and death benefit equal to the value of the loan plus any accrued interest. The Collateral Assignment interest is restricted until the earlier of the insured's death, termination of the Split Dollar Arrangement, or surrender of the underlying policy. The value of the Collateral Assignment note is discounted due to this restriction.

At some point, the policyholder decides to terminate the Split Dollar Arrangement by purchasing the lender's Restricted Collateral Assignment interest in the policy. A specialist values the note receivable. Due to the restriction, the receivable is likely to be discounted. These discounts depend upon

a variety of actuarial and financial factors but generally average between 65 and 95 percent, largely driven by the age and life expectancy of the insured. Following the purchase of the Split Dollar receivable from the lender, the Split Dollar Agreement is terminated. The policyholder uses a tax-free policy loan or withdrawal to purchase the note from the lender.

Following the termination of the Split Dollar Arrangement, the policy is wholly owned within the Trust, beyond the reach of personal and business creditors. The trustee may make tax-free loans and withdrawals and provide tax-free distributions from the Trust to Sid and his family. The death benefit will receive income and estate tax-free treatment at Sid's death.

Case Study 2—Patriarch. Patriarch, age 80, has existing investment assets of $40 million and a net worth of $75 million. Irrevocable Life Insurance Trust (ILIT) #1 is the applicant, owner, and beneficiary of a policy issued by Acme Life, a New York-based life insurer. The policy will insure Patriarch's son and daughter-in-law, who are both age 50. The policy funding strategy calls for a single premium of $35 million. The policy has an initial death benefit of $55 million.

The planning strategy here calls for Patriarch and the trustee of ILIT #1 enter into a Restricted Collateral Assignment Split Dollar Arrangement. In the beginning of Year 2, Patriarch approaches the trustee of ILIT #1 with the idea of selling its interest in the Split Dollar Arrangement.

The valuation study reflects a 90 percent discount from the amount of cumulative premiums paid by Patriarch into the policy—$35 million. The discounted value of Patriarch's interest is $3.5 million ($20 million minus 90 percent discount). Patriarch creates a second ILIT, ILIT #2, to purchase the Split Dollar receivable. ILIT #2 utilizes trust corpus to purchase Patriarch's Split Dollar receivable for $3.5 million.

There are other options for Patriarch to consider, which are set out in the next two case studies.

Case Study 3—GRAT Substitute. Assume the same underlying facts as in Case Study 2, but in this alternative, the Split Dollar Arrangement is used as a Grantor Retained Annuity Trust (GRAT) to transfer property outside the taxable estate with a maximum amount of gift tax leverage.

Patriarch owns a valuable collection of fine art that he would like to transfer to his heirs without estate taxation. The collection is valued at $10 million.

The planning strategy here is as follows: ILIT #1 is the applicant, owner, and beneficiary of a policy issued by Acme Life, a New York-based life insurer. The trustee will use premium financing for the policy to finance a $10 million single premium. The policy insures Patriarch's son Junior and his wife.

Patriarch provides a personal guarantee for the loan as well as additional collateral. The policy has an enhanced cash value rider to minimize the collateral requirements.

Patriarch and the trustee of ILIT #1 enter into a Restricted Collateral Assignment Split Dollar Arrangement. At the beginning of Year 2, Patriarch approaches the trustee of ILIT #1 with the idea that Patriarch sell his interest in the Split Dollar Arrangement. Patriarch sells the "Split Dollar receivable"— the right to recover the greater of the policy cash value or cumulative premiums at the death of the insured—for $500,000, a price determined by a third-party valuation firm.

At the beginning of Year 4, the trustee cancels the policy and receives the cash surrender value. The cash surrender value of the policy exceeds the initial premium. Patriarch is personally obligated to repay the bank and borrows $10 million from the trustee on an arm's-length basis and repays the Bank.

At this point, Patriarch owes the Bank $10 million plus interest at the short-term applicable federal rate. Patriarch transfers $10 million of fine art to the trustee as repayment for the loan.

Bottom line: The tax cost of the transaction is negligible. The economic benefit costs are measured by the insured lives—Junior and his wife—not Patriarch's. The sales price of the Split Dollar receivable is discounted 95 percent. Unlike the GRAT, there is no risk of premature death. In the event of Patriarch's death, the estate could enter a sale of the Split Dollar receivable.

Case Study 4—Dividend Substitute. Again, assume the same underlying facts as in Case Study 2. Also assume Patriarch owns a C corporation ("Company") that has $10 million of retained earnings that he would like to transfer out of the corporation and out of his estate with minimal income and estate taxation. Patriarch uses the Restricted Collateral Assignment technique to transfer the retained earnings.

The planning strategy here is as follows: The policy insures Patriarch's son who serves the CEO of Company. The premiums are $4 million per year targeted for five years. The death benefit is $50 million.

Company and the trustee of ILIT #1 enter a Restricted Collateral Assignment Split Dollar Arrangement. In the beginning of Year 6, Company approaches the trustee of ILIT #1 with the idea of selling its interest in the Split Dollar Arrangement.

The valuation study reflects a 90 percent discount from the amount of cumulative premiums paid by the Company into the policy—$10 million. The discounted value of the Company's interest is $1 million ($10 million minus 90 percent discount). The CEO creates a second ILIT, ILIT #2, to purchase the Split Dollar receivable.

ILIT #2 utilizes trust corpus to purchase the Company's Split Dollar receivable for $2 million. The two trusts (ILIT #1 and ILIT #2) merge following the transfer.

Case Study 5—Postmortem Split Dollar. Jane Smith, age 75, is a widow. Her husband, Bob, was a wealthy business owner who died of prostate cancer two years ago. His estate plan provided for a traditional distribution—a credit shelter bypass trust for an amount up to the exemption equivalent and a marital general power of appointment trust. The marital trusts currently have $15 million of assets—mostly investment assets that are generating a substantial income to the trust. Additionally, the assets are appreciating at a rate that exceeds the rate of inflation. Jane's children and grandchildren are beneficiaries of the trust.

The trustee would like to minimize the tax impact of current income to the trust. The income is mostly short-term capital gain income and interest income.

This case uses the following planning strategy: Acme Trust Company serves as the trustee of the Delaware trusts. The trusts are non-grantor trusts for federal income tax purposes. The trustee implements a strategy that utilizes PPLI. The trustee is the applicant, owner, and beneficiary of a PPLI contract issued by Corona Life, a Delaware-based life insurer. The PPLI contract insures the lives of Jane's son, Bobby, and her daughter-in-law, Penny. The policy is a second-to-die policy with an annual premium of $1 million per year for a five-year period. The death benefit is $25 million.

The policy will be structured as a Split Dollar Arrangement between the marital trust and a dynasty trust using the Restricted Collateral Assignment technique described above. The marital trust will pay the premiums and have an interest in the policy death benefit and cash value equal to the amount of the Split Dollar loan plus any accrued interest on the loan. The right to reimbursement is the earlier of the death of the insureds or termination of the Split Dollar Arrangement.

At the beginning of Year 6, the trustee of the marital t rust proposes to sell its interest in the Split Dollar Arrangement—that is, the right to recovery at the death of the insureds who are 55 at the time. A specialist values the Split Dollar receivable at $1.25 million. The trustee of the credit shelter bypass trust purchases the Split Dollar receivable in a single payment. At the time of the transfer, the policy cash value is $7.5 million, and the death benefit is $25 million. As a result of the transfer, the value of the marital trust is reduced by $6.25.

Bottom line: The dynasty trust's value is increased by the additional cash value that was previously collaterally assigned to the Marital Trust, LLC. The PPLI contract is unencumbered within the dynasty trust and

growing on a tax-advantaged basis. The ultimate death benefit will also be income and estate tax-free. The policy cash value is also available to the trustee to take tax-free loans for distribution to trust beneficiaries.

Summary

Who would have ever imagined the tax planning potential of a life insurance planning technique that has 65 years or more of history? When you consider the tax advantages of permanent life insurance, such as the tax-free inside buildup of the cash value along with the tax-free death benefit and the policyholder's ability to access the cash value on a tax-free basis using policy loans, the addition of Split Dollar into the planning mix is very compelling for taxpayers and their advisors. The valuation leverage achieved using the Split Dollar Leveraged Rollout technique provides an ability to achieve transfers at a substantial discount. The Service has largely taken a "swing and a miss" at Split Dollar in the *Estate of Levine*, *Estate of Cahill*, and *Estate of Morrissette* cases[26] to neutralize the valuation discount. Split Dollar remains standing and has come back to life as an important planning tool to be considered. As Congress considers and likely legislates increases in the income, estate, and gift taxes, Split Dollar will be an important tool to achieve income and wealth transfer planning benefits.

[26] See supra notes 3 & 22.