SPLIT-DOLLAR INSURANCE

'PRIVATE' SPLIT-DOLLAR PROVIDES TRANSFER TAX SAVINGS

Split-dollar arrangements are not just for executive compensation, as a recent letter ruling suggests transfer tax savings for policies split within the family.

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Split-dollar life insurance plans have long been a popular component of executive compensation. A split-dollar life insurance plan is essentially an agreement between two parties under which a life insurance policy is acquired on the life of one of the parties, but with both parties sharing in the premium costs, cash values, and death benefits. Although the use of split-dollar plans has traditionally been concentrated in the employment context, **1** split-dollar arrangements can also be used in nonbusiness settings, most typically in situations where the costs and benefits of a life insurance policy are shared between two family members. Split-dollar plans in a nonemployment context are usually referred to as "private split-dollar" plans.

Recently, in **Ltr. Rul. 9745019** , the IRS endorsed a private split-dollar arrangement. The ruling also contains important statements bearing on the estate taxation of proceeds from life insurance policies subject to split-dollar plans.

What is split-dollar?

The earliest forms of split-dollar plans (now referred to as traditional or classic plans) were structured essentially as follows:

- An employer and an employee join in purchasing an insurance contract, in which there is a substantial investment element, on the life of the employee.
- The employer provides the funds to pay part of the annual premium to the extent of the increase in the cash surrender value each year; the employee pays the balance of the annual premium.
- The employer is entitled to receive, out of the policy proceeds, the cash surrender value or at least the funds it has provided for premium payments.
- The employee has the right to name the beneficiary of the balance of any proceeds payable by reason of death.

As split-dollar began to emerge as an increasingly popular type of employee fringe benefit in the early 1960s, the IRS issued **Rev. Rul. 64-328** , **2** which analyzed the arrangement and stated the applicable income taxation rules. Since then, numerous variations on the original split-dollar plan structure have developed, and split-dollar has grown in popularity as a tax-favored employee fringe benefit. Today, the original, classic form of policy split-dollar is infrequently used; other variations are more typical.

In addition to the income tax benefits, split-dollar also offers potential transfer tax advantages. This is achieved through ownership of the policy by a trust established for the benefit of the insured employee's heirs, as more fully discussed below.

Basic tax benefits. Ordinarily, when an employer pays for a benefit enjoyed by an employee, the employee is deemed to have received income equal to the value of the economic benefit received. For example, if the employer were to pay the premiums on an insurance policy owned entirely by the employee (i.e., the employer having no interest in the policy), the premium payments would be taxable income to the employee. With a split-dollar plan, because the employer holds an interest in the policy, the premium payments are partially for the benefit of the employer. Thus, the income to the employee is not measured by the total premium paid by the employer, but rather, by the portion attributable to the cost of pure term insurance protection.

In other words, the economic benefit conferred on the employee is the value (measured by the cost of term insurance) of having insurance protection equal to the employee's share of the policy's death benefit. If the plan calls for the employee to contribute to cash premium payments an amount equal to this pure protection element, none of the employer's share of the premiums is taxable income to the employee.

In the context of private split-dollar arrangements in estate planning, the tax focus is not income tax, but gift tax. Thus, the intended tax benefit in a private split-dollar arrangement is the payment of premiums (or a portion of the premiums) by a party other than the policy owner-without those payments being deemed

taxable gifts.

Private split-dollar

Although there is a considerable body of administrative law (primarily Revenue Rulings) dealing with split-dollar plans in the employer-employee context, and although the technical analysis is essentially the same in the private split-dollar context, the IRS has traditionally published relatively little dealing specifically with private split-dollar. In **Ltr. Rul. 9745019** , however, the Service has now confirmed that a private split-dollar plan can be effective in achieving the tax results sought.

The taxpayers in that Ruling, a husband and wife, created an irrevocable trust for the benefit of their three children. The taxpayers funded the trust with a cash gift, which the trustee used to purchase a second-to-die life insurance policy on the lives of the taxpayers/settlors. The trust was the owner and beneficiary of the policy. The parties proposed to enter into a split-dollar arrangement for future funding of the policy premiums. The trustee would pay that portion of each annual premium equal to the insurer's applicable current published premium rate for annually renewable term insurance generally available for standard risks, and the taxpayers would pay the balance of the annual premium. The trust would continue to own the policy, but the taxpayers would hold an indirect interest in the policy equal to its cash value at any given time. The taxpayers would be given a collateral assignment of the policy to secure this interest under the plan.

The agreement could be terminated by either the taxpayers or the trustee at any time that the trust had sufficient resources (including the loan value of the policy) to pay the taxpayers the policy's then cash value. On such termination the taxpayers would be entitled to receive the cash value. If the plan was not so terminated, then on the death of the second to die of the two taxpayers, the estate of the second to die (or its designated beneficiaries) would be entitled to the cash value of the policy immediately prior to death.

After reviewing the key Revenue Rulings applicable to split-dollar plans in the employment context, the letter ruling pointed out that, while determining a compensation element giving rise to income was not relevant, in the private split-dollar situation there could be a taxable gift.

The ruling held, however, that "since the taxpayer (if living) or the estate of the last taxpayer to die will be reimbursed by the trust for the portion of the premium payments made by the taxpayers, the portion of the premium payments made by the taxpayers will not constitute gifts to the trust for gift tax purposes." In a second holding, the ruling concluded that the taxpayers did not have "incidents of ownership" in the insurance policy that would cause the policy proceeds to be includable in the gross estate of the second to die under **Section 2042** .

Potential significance

Any discussion of the future importance of a private letter ruling as precedent in similar factual settings must include the caveat that private letter rulings are always directed only to the respective specific taxpayers who request them, and may not be relied on or cited as precedent in any other context. As a practical matter, these letter rulings are commonly discussed, written about, and relied on by tax professionals as at least indicative of the IRS's current position on a given subject or technical question.

While the letter ruling does appear to clearly endorse private split-dollar arrangements that fit the classic or traditional split-dollar model under which the non-owner participant is entitled to at least the cash value of the policy at all times, the potential breadth of its application is unclear. The type of insurance policy that was the subject of the split-dollar plan in the ruling was not discussed. What would happen, for example, if the policy were a universal life policy where the premium payments are totally flexible? As long as the owner-insured contributed the value of the current protection, would the other party to the agreement be free to contribute an unlimited amount as his or her "share" of the premium? Maybe so, if the non-owner party would eventually be entitled to reimbursement of the contributed amount out of the death benefit or surrender proceeds.

Insufficient cash value. On the other hand, suppose, for example, the cash value at the time of the insured's death was less than the total payments into the policy by the non-owner participant. If the plan provides that the non-owner is entitled only to the cash value, does **Ltr. Rul. 9745019** apply, so that there will be no gift? At first blush, the ruling would appear to apply, since under the facts of the ruling, the taxpayer-settlor's participation rights (on termination of the plan or death of the second insured to die) are stated *only in terms of the cash surrender value.*

Although these are the stated facts in the ruling, the key language in the favorable holding of the ruling does not refer to the cash surrender value, but states that since the taxpayers (or the estate of the second to die) will be "reimbursed ... for the portion of the premium payments made by the taxpayers, the portion of the premium payments made by the taxpayers will not constitute gifts...." Thus, the holding appears to make an erroneous assumption that a participation defined as cash surrender is full reimbursement of premiums paid.

In light of this, does the reimbursement right have to be keyed to cumulative contributions, or can it be based on the potentially lower cash value? Obviously, the lower the reimbursement to the decedent's estate, the greater the amount that will have passed estate-tax-free to the policy beneficiaries. Looking for guidance to the body of law in the employment split-dollar context, we note that plans that measure the employer's reimbursement only by cash surrender value are generally acceptable to the IRS as not generating income to the employee (even if the employer pays 100% of the premiums and cash value is less than the cumulative premiums paid).

Does this mean that in the private split-dollar context, the Service would apply the same rule? Not necessarily. The private split-dollar transaction may involve a different motivational underpinning. Thus, the issue of whether the non-owner's reimbursement right must be keyed to the cumulative premium payments, rather than just the cash surrender value, may not have been previously considered.

Reimbursement tied to premium payments. This issue was not actually considered in **Ltr. Rul. 9745019** either, but the fact that the holding was phrased in terms of reimbursement of the premium payments made, rather than cash surrender value, warns us that this ruling probably cannot be relied on as indicative that the IRS would approve a private split-dollar plan under which the non-owner's share of the proceeds is limited to cash surrender value, even though the cash value may be considerably lower than the cumulative premium contributions to the policy.

Relatively little has been written on the subject of private split-dollar plans. **Ltr. Rul. 9745019** is an important direct pronouncement by the Service on the subject. Private split-dollar plans can be an attractive adjunct to the use of an irrevocable inter vivos life insurance trust. Through a split-dollar plan, a taxpayer who is otherwise unable to fully shelter from gift tax his gifts to the trust for payment of premiums on the insurance policy, would be able pay the premiums directly without immediate gift taxation. The cumulative premiums so paid (or the cash value of the policy immediately prior to death), however, would be reimbursable out of the death benefit and, therefore, subject to estate tax at that time.

Estate tax

In addition to its apparent endorsement of private split-dollar plans in the gift tax context, **Ltr. Rul. 9745019** also contains an important favorable IRS statement regarding whether the right, under a split-dollar plan, to share in a life insurance policy death benefit represents an "incident of ownership" in the policy that would cause the entire death benefit to be includable in the gross estate of the insured. This issue is also important in employment split-dollar plans where the insured employee is also a controlling shareholder of the employer corporation, since any incident of ownership held by the corporation is attributed to the controlling shareholder.

Section 2042 . Under **Section 2042(2)** , life insurance policy proceeds are includable in the insured/decedent's gross estate if he or she was the owner of the policy or at the time of death held any incidents of ownership in the policy. The degree of interest in, or control over, a life insurance policy needed to be deemed an incident of ownership, where the insured is not the outright owner of the policy, is an issue dealt with at length in the regulations, rulings, and court decisions. One of the more basic objectives of estate plans involving significant face amounts of life insurance is to avoid having the client/insured hold any incidents of ownership in the policy. This is often achieved through creation of an irrevocable life insurance trust that acquires the policy.

Life insurance trusts. Irrevocable life insurance trusts are a prime example of estate tax leverage. They permit a very significant pool of money, i.e., the insurance death benefit, to be entirely excluded from the gross estate, and through use of the annual gift tax exclusion and the lifetime transfer tax exemption, the funds provided to the trust for payment of the annual premiums may also escape gift taxation.

The transfer tax leverage inherent in an irrevocable life insurance trust arrangement can be heightened still further when the premiums are paid by an employer pursuant to a split-dollar plan. When the trust

grantor provides funds to the trust to pay the annual premiums, the entire amount represents a gift. If, however, premiums are paid by the grantor's employer under a split-dollar plan, only the portion of the payment that represents income (if any) to the employee-grantor under the split-dollar tax rules is treated as a gift to the trust. Thus, a lesser amount of gift tax annual exclusion or lifetime exemption must be used to shelter the annual premium payments from gift tax.

Incidents of ownership

In the typical employment split-dollar arrangement, a life insurance policy is acquired on the life of the employee, with the employer and the employee sharing in the premium costs and the proceeds of the policy on death. In planning split-dollar arrangements, the focus is usually on income tax consequences, with little or no thought given to transfer taxes.

As a practical matter, a split-dollar arrangement that does not bring in a third party as the "owner" of the insured-employee's rights under the policy involves the insured-employee's possessing incidents of ownership. Thus, the entire death benefit (reduced by the employer's share) would be included in the insured's gross estate.

If, however, the employee-insured is attuned to transfer tax planning considerations when a split-dollar plan is initially established, the plan can be structured from the outset with the employee's interest in the policy held by an irrevocable trust, established by the employee. The trust would enter into a split-dollar agreement with the employer. As long as the insured employee does not have an interest in the trust and cannot exercise any control over the policy through control over the trust, the insured has no incidents of ownership attributable through the trust. What about incidents of ownership attributable through the employer when the employer is a corporation controlled by the insured-employee?

Attribution. Under **Reg. 20.2042-1(c)(6)** , incidents of ownership held by the corporation are attributed to the decedent through his or her stock ownership if the decedent is the sole or controlling shareholder. This rule does not necessarily cause the *entire* death benefit to be included in the decedent's gross estate, but only the portion of the death benefit allocable under the split-dollar agreement to parties other than the corporation. This can sometimes cause confusion.

The portion payable to the corporation is excluded from the scope of this attribution rule in order to prevent an effective double counting of this value in the gross estate. The shareholder-decedent's pro-rata share of the portion payable to the corporation is effectively included in the decedent's gross estate because it increases in the value of his or her stock, which is included in the gross estate.

Example. A policy is owned by the corporate employer under a split-dollar plan. The insured/employee has no direct incidents of ownership, but owns 51% of the stock of the employer corporation. The division of the death benefit pursuant to the plan works out to 60% being paid to the corporation and 40% to the sister of the insured. The 40% payable to the sister would be includable in the insured's gross estate.

Even though the controlling ownership was only 51%, anything more than 50% would be sufficient to cause 100% of the death benefit to be included in the gross estate. Under **Reg. 20.2042-1(c)(6)** , attribution of the corporation's ownership to the controlling shareholder does not include the portion of the death benefit actually payable to the corporation. This leaves only the other 40%, payable to the sister, as includable in the decedent's gross estate.

Definition of "controlling shareholder." The regulation provides that a decedent is a controlling shareholder if, at the time of his death, he or she owned stock possessing more than 50% of the total combined voting power of the corporation. In applying this rule, the regulation describes certain circumstances under which a decedent is treated as owning shares to which legal title is jointly held or held by a trust. In the joint ownership situation, the decedent is treated as owning the portion of the jointly owned shares corresponding with the portion of the total purchase consideration that he or she provided. With regard to shares owned by trusts, the decedent is treated as owning shares owned by a trust if the decedent, at the date of death, would have been treated as owner of the trust under the grantor trust rules **3** applicable for income tax purposes.

Because there is no attribution of ownership between family members, corporate incidents of ownership are never attributed to a "controlling" shareholder when the stock is held as community property. Even if 100% of the outstanding stock is registered in the name of one spouse, his or her community interest cannot exceed 50%.

Avoiding corporate incidents of ownership. Because of these attribution rules, estate taxation of a split-dollar plan between a corporation and its controlling shareholder can be avoided by having *all* incidents of ownership of the policy shifted to the trust established to hold the insured's interest. The plan must be documented in such a manner that the corporation's economic interest in the plan exists without the corporation possessing incidents of ownership, within the meaning of **Section 2042** . This would effectively preclude such rights as surrender of the policy or borrowing against the cash value. **4** The policy and all rights associated with it must be owned by the trust.

Because the controlled corporation cannot be the owner of the policy, the method typically used for documenting the employer's interest under a split-dollar plan is the collateral assignment method. The policy is owned by the life insurance trust, which makes an assignment to the corporation of an interest in the policy, strictly as collateral to secure the corporation's interest in the policy cash value or death benefit. The caveat here is that the collateral assignment must not be an incident of ownership. Otherwise, a portion of the policy would have to be included in the gross estate. Unfortunately, the status of a collateral assignment has long remained murky.

Reg. 20.2042-1(c)(2) states that "incidents of ownership" refers to "the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc." Under a literal reading of the first quoted sentence, the right to receive a portion of the death benefit (or surrender proceeds), pursuant

to the provisions of a split-dollar agreement, would seem to be the right to an economic benefit of the policy. On the other hand, this type of interest in the policy does not fall within any of the examples of economic benefit specifically listed in the succeeding sentence.

Based on the examples, one could argue that the essential element here is one of *control* over the economic benefits (i.e., the right to shift or use economic benefits during the insured's lifetime-not merely the inert right to receive a payment out of the death benefit or surrender proceeds, without any *control* over when it will be received). Such an argument is consistent with the general tax policy underlying the inclusion in the gross estate of property that the decedent may not have owned, but over which he or she exercised sufficient *control* as to be considered the economic equivalent of ownership. The passive reimbursement right as collateral assignee under a split-dollar plan is not this type of control.

Prior letter rulings. Before **Ltr. Rul. 9745019** , at least three letter rulings covered this issue. Two were favorable to the taxpayer, and one was unfavorable. **Ltr. Ruls. 9348009** and **9511046** both contain language indicating that the right to reimbursement of premium payments does not represent an incident of ownership; yet, in **Ltr. Rul. 9037012** the corporation was deemed to hold incidents of ownership in a proposed arrangement in which it would be "the owner of the cash surrender value" and would "possess a security interest therein." The unfavorable holding in **Ltr. Rul. 9037012** may be attributed to the manner in which the facts were stated (the corporation being characterized (by the taxpayer's lawyer) as the "owner" of the cash surrender value).

On the other hand, the utility of the favorable holding in **Ltr. Rul. 9511046** has been discounted because it cited as authority **Rev. Rul. 76-274** , **5** which has been reversed by **Rev. Rul. 82-145 6** .

Now **Ltr. Rul. 9745019** can be thrown into the mix. In the second section of this letter ruling involving a private split-dollar arrangement, the Service held that since the two insureds, under their split-dollar agreement with the trust that owned the policy, did not possess any of the economic benefits of ownership, as listed in the above-quoted portion of **Reg. 20.2042-1(c)(2)** , they did not hold any incidents of ownership. Their rights were limited to receipt of the cash surrender value of the policy on certain events (i.e., surrender of the policy or payment of the death benefit) that they did not control. While this ruling adds to the bulk of the authority on the favorable side of the issue, whether it adds to the weight of the authority is questionable because the holding on the other issue in the case contains a statement inconsistent with the recited facts, as discussed above.

Conclusion

Split-dollar life insurance plans are frequently recommended by planners to corporations and their top executives as a valuable supplemental form of compensation with important income tax advantages. All too often, however, the potential estate tax impact on the life insurance proceeds is overlooked. When the split-dollar plan involves a large face amount policy or an executive with sufficient net worth (including the death benefit of the policy subject to the plan) for estate taxes to be a factor, consideration should be

given to having the policy acquired by an irrevocable trust and structuring the split-dollar agreement as between the trust and the corporation.

Even if the irrevocable trust approach is used, some risk of estate taxation remains if the employee-insured is a controlling shareholder of the employer corporation. This is because of the attribution to the shareholder-insured of any incidents of ownership held by the corporation in its position as collateral assignee under the split-dollar plan. **Ltr. Rul. 9745019** , as well as two of the three earlier letter rulings on the issue, as discussed above, lend some degree of comfort that the IRS will not be inclined to regard the mere passive reimbursement right of the corporation under a collateral-assignment split-dollar arrangement as an incident of ownership.

Private letter rulings, however, cannot be cited as precedent and are binding only with respect to the specific taxpayers to whom they are issued. Thus, the IRS could in the future choose to interpret the above-quoted language of **Reg. 20.2042-1(c)(2)** more broadly by simply declaring that the right to receive a portion of either the death benefit or the cash surrender proceeds is an economic benefit in the policy.

In light of the recent holding in **Ltr. Rul. 9745019** , this seems less likely, but some element of risk remains, unless eliminated by a clarifying amendment to the regulation itself. This risk is probably not sufficiently great to inhibit the establishment or continuance of split-dollar plans in controlled corporations when the expected benefits are significant. In situations where the benefits of the split-dollar plan are marginal, however, the risk might best be avoided.

1

See Madden, "Opportunities Abound for Making Life Insurance an Executive Perk," 61 TA 85 (August 1998).

2

1964-2 CB 11.

3

Sections 671-679.

4

See **Rev. Rul. 82-145, 1982-2 CB 213** .

5

1976-2 CB 278.

6

1982-2 CB 213.

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