# PLANNING STRATEGIES IN RESPONSE TO IRS EQUITY SPLIT-DOLLAR RULING

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IRS Technical Advice Memorandum ("TAM") 9604001 holds that in an "equity" split-dollar life insurance arrangement, the employee is taxed on any cash value buildup in excess of the employer's premium payments. This article discusses a new planning technique designed to avoid this unfavorable ruling.

## Equity Split-Dollar Planning

A split-dollar arrangement is a favored device that permits business owners and executives to acquire large amounts of life insurance on their lives at little or no income tax or gift tax cost to the insured. Generally, under a typical split-dollar arrangement, the employer advances the premium payments for cash value life insurance on the executive's life. In the traditional split-dollar arrangement, known as the "endorsement method," the employer owns the life insurance policy.

By use of an endorsement (hence the name) to the policy, the employee has the right to designate the beneficiary. The beneficiary may not be changed without the executive's consent. The employer's interest in the policy is usually the greater of the premiums advanced or the cash value.

## The Collateral Assignment Method

With an equity type split-dollar plan, the cash value in excess of the premiums advanced by the employer belongs to the executive. The policy is usually owned by the executive with a collateral assignment (hence the name) to the employer to secure the advances.

## Retirement Planning and Equity Split-Dollar

The equity split-dollar arrangement is an excellent device for retirement planning. With a traditional split-dollar plan, although the executive designates the beneficiary, the employer is entitled to the greater of the premiums advanced or the cash value of the policy at the time of termination of employment or death. With the equity plan, any cash value in excess of the premiums advanced by the employer is for the benefit of the executive. This means that at retirement, the executive may use the excess cash value for retirement planning. With the traditional split-dollar, the executive is looking solely to the death benefit.

Because of the retirement feature, equity split-dollar is very popular. The equity plan means that executives and business owners are able to take more money out of their companies at, until the recent TAM, a modest income and gift tax cost.

## The Income and Gift Tax Consequences of Split-Dollar Plans

Prior to TAM 9604001, the executive was and continues to be taxed on the pure insurance costs on the amount at risk. This amount is calculated by reference to the lower of the IRS PS 58 Table rates or the insurance company's annual renewable term rate. Generally, the insurance company's term rate is significantly lower.

If the insurance policy is owned by a third party, such as an irrevocable life insurance trust ("ILIT"), the amount subject to income tax is also treated as a deemed gift to the third party. The amount of this gift is usually qualified for the annual $10,000 gift tax exclusion through the use of *Crummey* withdrawal powers in favor of descendants of the executive.

## Treatment by the Employer

Generally, the equity split-dollar arrangement has a neutral tax impact on the employer. The premium advances represent assets on the books and records of the employer. The advances are secured by the collateral assignment of the insurance policy to the employer. To the extent the cash value equals or exceeds the advances, then the employer is fully secure. The repayment of the advances at the time of termination, retirement or death is not taxable to the employer.

Initially, however, it may be several years before the cash value equals premiums. So long as the premiums are more than the cash value, the employer is unsecured and the advances may not be recognized as an asset unless the executive agrees to repay the employer for any deficiency. The loss to the employer, if the advances are repaid in full, is only the time value of money. This is insignificant when compared to the benefits provided to owners and executives who benefit from this planning.

Although the arrangement is generally tax neutral to the employer, the payment of the life insurance premiums is not tax deductible. This means that the employer will be using after tax dollars to advance the premiums. For closely held regular C corporations, this may actually be an advantage since the income tax rates on the first $100,000 of C corporation taxable income is less than the owner's or executive's tax bracket.

The tax rates for regular C corporations is 15% on the first $50,000 of taxable income or a tax of $7,500; 25% on the next $25,000 or a tax of $6,250; the total tax is $13,750 on taxable income of $75,000. The total tax on the first $100,000 of taxable income is $22,250 or an effective rate of 22.25%. This is probably one-half the

marginal rate of income tax paid by the owners and executives who participate in split-dollar plans.

### Tax Impact of TAM 9604001

TAM 9604001 changes the present tax scenario significantly. The TAM states that with respect to an equity spilt-dollar arrangement, the buildup in the cash value of the insurance policy in excess of the premiums paid by the employer constitutes a taxable benefit to the executive. Even though the excess cash value is taxable to the executive, the employer does not receive any offsetting tax deduction since the payment of life insurance premiums is not deductible.

Since the purpose of an equity split-dollar plan is to create substantial cash values for owners and executives, if the TAM is eventually accepted by the IRS as tax policy, planners will have to create alternative planning designs.

### Alternative Planning Suggestions

Planners will have to closely monitor existing and future equity split-dollar plans so as to avoid adverse tax consequences either by amending the agreement to adopt the "traditional" form or adopting a strategy known as a "rollout." A rollout means that the split-dollar arrangement is terminated and the policy is transferred to the executive at the time when the cash value buildup becomes taxable to the executive. An accurately designed policy illustration should approximate that period of time so that the parties can plan for the rollout.

Before TAM 9604001, the planned rollout contemplated the use of the "equity" format and the accumulation of unusually large policy cash values. Before the insureds reached their late seventies, the ILIT trustee would use a portion of the cash values to repay the entire premium advances. The remaining "equity" within the policy and future premiums would be sufficient to carry the policy well past the insureds' joint life expectancy. Obviously, this heavy reliance on the "equity" format renders this form of planned rollout highly susceptible to damage by the TAM in question.

### The Limited Partnership Strategy

The limited partnership is designed to solve the rollout problems created by the TAM. The strategy calls for the business owner to create a family limited partnership ("FLP") funded with sufficient assets to permit it to pay the annual insurance premiums.

The FLP purchases a life insurance policy and enters into a traditional endorsement type split-dollar arrangement with an ILIT for the benefit of the owner's descendants. The ILIT is the beneficiary of the policy. The FLP owns the policy, but the death proceeds in excess of the greater of the cash value or the premiums advanced are paid to the ILIT. The advantage of using the FLP is that the owner has a vehicle for transferring wealth to his or her children and grandchildren through gifting limited partner interests to children and grandchildren.

At the first death, the split-dollar arrangement is terminated and the FLP owns the entire interest in the life insurance policy. Using this strategy there is no need for a rollout at the time of the first death. This not only solves all of the problems associated with a rollout, but it also eliminates taxation to the executive of any excess cash value since the executive does not have an equity interest in the policy. All the equity is owned by the FLP.

Since the arrangement is a traditional endorsement type split-dollar plan, all of the cash value is preserved in the policy for the FLP. The ILIT has no equity interest in the SLI policy. Since the children own 99% of the FLP, the equity in the policy and the death proceeds will be owned by them and not the parents.

### Simultaneous Death

If both parents die simultaneously before they have had an opportunity to transfer all of the limited FLP interests to the children, the death proceeds are collected by the FLP which reimburses itself for the greater of the premiums paid or the cash value and the balance of the proceeds are paid to the ILIT. The portion paid to the ILIT is not taxable in the estate of either parent.

If, for example, the death benefit is $1 million, the cash value is $50,000 and the premiums advanced at the time of the simultaneous deaths are $100,000, then $100,000 is retained by the FLP and the balance of $900,000 is paid to the ILIT.

### Conclusion

The Family Limited Partnership strategy is designed to provide all the benefits usually associated with equity split-dollar while at the same time avoiding the need for a rollout and without the adverse income tax consequences created by the TAM.

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