PACIFIC LIFE

Advanced Designs Professional Guide

ESTATE PLANNING AND LIFE INSURANCE FOR THE YOUNG & WEALTHY

Pacific Life
Insurance Company

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OVERVIEW

Need for Estate Planning

Estate planning is rarely a top priority for younger individuals in their twenties, thirties, forties or early fifties. However, these individuals have a unique opportunity to maximize the wealth they transfer to heirs. The earlier an individual engages in a gifting strategy, the more he or she may be able to transfer to loved ones. Unfortunately, without proper planning, the same wealthy individual may diminish his or her estate by as much as 40 percent in estate taxes,[1] depending on the year of death.

A young individual can take advantage of years of annual tax-free gift transfers to his or her heirs by making annual exclusion gifts[2] that may otherwise be wasted if they fail to plan. Additionally, they may be able to employ techniques that "freeze" the value of property early in life so that the growth and appreciation are outside their taxable estate and in the hands of heirs. Finally, life insurance may be a useful tool to incorporate in one's estate plan, as it may provide the individual's loved ones with death benefit protection in the event of a premature death.[3]

Fear of the Future

A young individual may have serious concerns with gifting hard-earned assets because the individual may lose the economic benefits associated with the transferred property when the property is gifted to heirs. While they may have sufficient wealth today to provide for their future, change is foreseeable; businesses fail, creditors attach assets and medical emergencies deplete fortunes. Moreover, given the continued uncertainty surrounding the federal estate tax, a young individual may be even more reluctant to engage in planning that would cause them to lose access to transferred property.

On the other hand, if a young individual is willing to part with the economic benefits of gifted property, he or she still may not be willing to part with control over the property. This is particularly true if the individual has not yet "settled down." Assuming a trust is established and administered properly, assets held by an irrevocable trust should pass to the trust beneficiaries and should not be included in the individual's estate. This, however, means that the individual must give up their rights to alter, amend or revoke the trust.[4] If an individual is single or does not have children, he or she may reasonably, but erroneously, believe that they must wait until marriage or children to begin planning. Even if the individual is married with children, they may be reluctant to make gifts to an irrevocable trust if they are unable to predict the beneficiaries' eventual maturity, spending habits and financial needs.

The techniques described in this professional guide may help address some of these concerns and may be particularly appropriate for a young individual or couple concerned with losing access to a trust-owned policy's cash value. This professional guide will discuss the following strategies: spousal lifetime access trusts, irrevocable life insurance trust (ILIT) loans, wait-and-see planning, and private financing (private split-dollar and intra-family loans).

[1] According to the Tax Cuts and Jobs Act of 2017, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $10,000,000 per person (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%. In 2026, the federal estate, gift and generation-skipping transfer (GST) tax exemption amounts are scheduled to revert to $5,000,000 per person (indexed for inflation for tax years after 2011).

[2] As of January 1 2025, the annual gift tax exclusion is $19,000 per donee (as indexed for inflation. For gifts made to spouses who are not US Citizens, the annual exclusion has increased to $190,000.

[3] Life insurance is subject to underwriting and approval of the application and will incur monthly policy charges.

[4] IRC Sec. 2038.

SPOUSAL LIFETIME ACCESS TRUST

Overview of Arrangement

A spousal lifetime access trust (SLAT) may be an ideal variation of an irrevocable life insurance trust (ILIT) for a young and wealthy married couple. This type of trust is particularly appropriate for a young couple because it is designed to keep life insurance policy proceeds outside of the couple's taxable estates while providing the couple with indirect access to the policy's available cash value. A SLAT may also be particularly useful for couples that need some flexibility in the event of a change to the transfer and estate tax laws.

An example will best illustrate the potential usefulness of a SLAT. Assume Ryan and Erin, both 45 years of age, are married with three young children. Ryan recently inherited a beachfront home in Hawaii worth $15,000,000 dollars. Ryan and Erin have no other significant assets. As an attorney, Ryan is familiar with the gift and estate tax system. He realizes that if he and Erin spend their salaries for living expenses and allow the property to appreciate, if they die in 40 years, they may have significant estate tax exposure after both of them pass away.[5]

Ryan and Erin decide to purchase life insurance to provide liquidity for their estates so that their children will not be forced to sell the beachfront property. The couple, however, has two main concerns. First, they want to make sure the life insurance policy's death benefit proceeds are excluded from their estates. Second, even though Ryan and Erin are willing to pay the life insurance premiums, they are concerned about losing control and would prefer to retain some access to the life insurance policy's available cash value in the event of an emergency.

To address these two concerns, Ryan and Erin, with the help of their estate planning attorney, consider establishing an ILIT to own life insurance. While an ILIT, if set up properly, will address Ryan and Erin's concerns over estate inclusion, they discover that an ILIT may not address their concerns about access to the life insurance policy's cash value. In other words, with a traditional ILIT, Ryan and Erin may not have access to the life insurance policy's cash value if they need it. Thus, they opt, instead, to establish a SLAT to own the life insurance policy so they may retain indirect access to the life insurance policy's cash value.

Ryan names an appropriate trustee,[6] names his wife (Erin) as the beneficiary of the SLAT during Erin's lifetime, and the children as the remainder beneficiaries. Ryan, the "grantor spouse," then gifts enough of his separate property to the SLAT so that the trustee may purchase a life insurance policy. This gift may be subject to gift taxes depending on Ryan's use of his annual exclusion gifts and/or lifetime gift tax exemption amount.[1,2] The SLAT trustee uses Ryan's gift to purchase a life insurance policy. The SLAT becomes the owner and beneficiary of the life insurance policy.

The SLAT is drafted to include certain provisions that give the trustee the discretion to take loans and withdrawals from the life insurance policy's available cash value and to distribute them to Erin, the "non-grantor spouse," during her lifetime. These loans and withdrawals may be income tax-free[7] if within limits and up to basis. After Ryan's death, the remaining assets in the trust should pass to the SLAT beneficiaries, according to the terms of the SLAT, free of estate[1] and income[8] tax.

By using the SLAT technique, the couple provides Erin with indirect access to the policy's cash value, if necessary, at the trustee's discretion. Assuming the trustee exercises his or her discretion and makes distributions to Erin, she may then utilize the unlimited marital deduction[9] to give Ryan the distributions free of gift tax.[2] Even though Ryan and Erin have indirect access to the policy's cash value, the trust's proceeds should pass to their children, free from estate tax.[1] Thus, the SLAT addresses both of Ryan and Erin's main concerns.

Features of a SLAT Arrangement Include the Following:

1. **The couple should have indirect access to the trust-owned life insurance policy's cash value.**

   The terms of the SLAT provide the trustee with discretion to distribute principal to one designated spouse, referred to as the "non-grantor spouse," during his or her lifetime. The non-grantor spouse is the spouse who neither

[5]This discussion assumes that Ryan and Erin die in 40 years.

[6]The trustee appointed should not be the insured or the insured's life insurance producer. A life insurance producer who is paid a commission on the sale of a life insurance policy represents both his or her personal interest and the interests of the trust, creating a conflict of interest.

[7]For federal income tax purposes, tax-free income assumes, among other things: (1) withdrawals do not exceed tax basis (generally, premiums paid less prior withdrawals); (2) policy remains in force until death (any outstanding policy debt at time of lapse or surrender that exceeds the tax basis will be subject to tax); (3) withdrawals taken during the first 15 policy years do not cause, occur at the time of, or during the two years prior to, any reduction in benefits; and (4) the policy does not become a modified endowment contract. See IRC §§ 72, 7702(f)(7)(B), 7702A. Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.

[8]For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e., the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

[9]The unlimited marital deduction permits gifts of any size to a U.S. citizen spouse during life or at death without tax consequences. IRC Sec. 2056.

created nor funded the trust. Accordingly, if and when the family needs funds, the trustee has the discretion to take income tax-free withdrawals and loans[7] from the policy's available cash value and make distributions to the non-grantor spouse.[10] The SLAT thus provides the couple with indirect access to the policy's cash value.[11]

2. The life insurance policy's death benefit should pass to the SLAT free from estate tax.

In the typical situation, an insured maintains ownership of a policy if they want access to the policy's cash value. Unfortunately, this form of ownership would subject the life insurance policy's death benefit to estate tax.[1]

If a policy is instead owned by a SLAT, the couple should have indirect access to the policy's available cash value without subjecting the policy's death benefit to the possibility of estate tax. This statement is true if the trust is properly drafted[12] and properly funded with the grantor spouse's separate property.[13] By excluding the policy's death benefit from both spouses' estates, the couple's estate may pass to their heirs without further augmenting the estate by the amount of the death benefit proceeds.

Disadvantages of a SLAT Arrangement Include the Following:

1. Depending on SLAT drafting, the grantor spouse may lose indirect access to the life insurance policy's cash value.

Depending on the way in which the SLAT is drafted, the grantor spouse may lose indirect access to the life insurance policy's cash value. This issue typically arises when the trust is narrowly drafted to benefit only the non-grantor spouse and the couple's marriage ends (i.e., divorce or dissolution of marriage) or the non-grantor spouse predeceases the grantor spouse.

This issue may be addressed with proper drafting as attorneys usually draft SLATs to broadly benefit the spouse who is living and currently married to the grantor of the trust. With this type of drafting, the non-grantor spouse would ordinarily lose their status as the beneficiary of the SLAT when they die or if the marriage ends.[14] In addition to creating a floating spouse provision, you might consider giving a trust protector the power to remove beneficences including the surviving spouse. This would stop difficult conversations at the creation of the trust. If the grantor spouse remarries, his or her new spouse would then become the SLAT beneficiary, thereby providing the grantor spouse with the same indirect access to the life insurance policy's cash value that the former spouse had upon creation of the SLAT. With this type of drafting, the grantor spouse may not lose access to the life insurance policy's cash value upon the death or divorce of his or her spouse.[15] In addition to remarriage, the trust could be created in Domestic Asset Jurisdiction which would allow a trust protector to add the grantor as discretionary upon divorce. This issue may also potentially be addressed by including a provision in the SLAT that gives the trustee the discretion to make arm's-length loans to the grantor spouse *(see discussion of ILIT Loan Technique on page 8)*.

2. A SLAT should not be created by an unmarried couple.

SLATs are designed to provide indirect access to married couples.[16] This is the case because the non-grantor spouse is able to take advantage of the unlimited marital deduction[9] and can gift his or her distributions from the SLAT to the grantor spouse free of gift tax.[2] If the couple establishing a SLAT is unmarried, they do not have the advantage of using the unlimited marital deduction. Thus, any gifts made by the non-grantor to the grantor may be subject to gift taxes depending on the non-grantor's use of his or her annual exclusion and/or lifetime gift tax exemption amount.[1,2]

[10]Please note that the reduction in the face amount of the life insurance policy may have additional tax consequences. A reduction in the face amount will not necessarily result in a proportionate reduction of all associated policy fees and charges. The life insurance policy may need to be retested under the 7-pay test for Modified Endowment Contract (MEC) purposes. Prior to authorizing the reduction in the face amount, consult your life insurance producer and tax advisor as a reduction may cause the policy to become a MEC.

[11]The insured should not have a pre-existing arrangement to share such funds prior to the insured's creation of the SLAT or trust proceeds could be included in the insured's estate. Treas. Reg. 20.2036-1(a).

[12]Proper drafting of the SLAT should prevent the grantor and the non-grantor spouse from retaining any prohibited power or benefit over the trust or policy that would cause the trust property to be included in either spouse's estate. IRC Secs. 2036, 2038, 2041 and 2042. The Internal Revenue Service has privately ruled that the proceeds of an irrevocable life insurance trust holding a survivor life policy were not includable in wife's estate under Sections 2036, 2038 or 2042 even though the trustee had the discretion to take withdrawals and loans from the policy's cash value and make distributions to wife. Priv. Ltr. Rul. 97-48-029 (Aug. 29, 1997). Private letter rulings are only binding upon the Internal Revenue Service as to the individuals and facts specifically set forth in the rulings, yet such rulings are generally indicative of the Internal Revenue Service's view as to certain tax situations. A key element to proper drafting is including language prohibiting the trustee from discharging the grantor of any legal obligation to support the non-grantor spouse. If the distributions to the non-grantor spouse discharge the grantor spouse of his or her legal obligation to support his spouse, some or all of the trust property would be subject to tax at the grantor spouse's death. Treas. Reg. Sec. 20.2036-1(b)(2).

[13]Proper funding of the trust with the grantor's separate property should prevent the non-grantor spouse from becoming a grantor of the trust. It is important that the non-grantor spouse not be considered to be a grantor of the trust because being a grantor and beneficiary of the trust causes inclusion of trust property in a beneficiary's estate. IRC Sec. 2036. In Private Letter Ruling 97-48-029, the Internal Revenue Service reasoned that Section 2036 did not apply to cause inclusion of the trust property in wife's estate because wife had not made any contributions to the trust. Priv. Ltr. Rul. 97-48-029 (Aug. 29, 1997).

[14]If a court determines that the insured funded the trust with community or marital property, the court may conclude that the non-grantor spouse has some rights in the trust property.

[15]Even if the grantor spouse does not remarry, he or she may still have indirect access to the life insurance policy's cash value because most trusts provide the trustee with the discretion to make loans to the grantor. For more information on this loan strategy, please refer to Section III of this professional guide discussing ILIT Loans.

[16]This includes married same-sex couples.

Common Questions

1. Who can serve as trustee of the SLAT?

Any competent adult, other than an insured,[17] can serve as trustee of the SLAT. The trustee appointed should not be the insured or the insured's life insurance producer. A life insurance producer who is paid a commission on the sale of a life insurance policy represents both his or her personal interest and the interests of the trust, creating a conflict of interest. The SLAT document typically appoints an adult child or family friend of the couple to serve as trustee.

If the policy purchased by the SLAT is a single life policy insuring one spouse, it is possible, but not typically recommended for the non-grantor spouse to serve as trustee of the SLAT. As trustee, the non-grantor spouse's ability to access the policy's cash value would be limited to access based upon an ascertainable standard of distributions for health, education, support and maintenance; otherwise, the non-grantor spouse's powers over the SLAT would subject the trust property to inclusion in his or her gross estate.[18] To prevent limitations on distributions to the non-grantor spouse, the grantor may choose to appoint an adult child, family friend or third party trustee to serve as trustee of the SLAT and provide the trustee with the unlimited discretion to distribute trust property to the non-grantor spouse.

2. Why must the grantor spouse fund the SLAT with separate property?

Proper funding of the SLAT is vital to preventing the trust property from being subject to estate tax[1] at the non-grantor spouse's death. The non-grantor spouse should not purposefully or inadvertently fund the trust. The non-grantor spouse could inadvertently fund the trust if the grantor spouse transfers community property[19] or joint funds to the trust. If he or she does so, the non-grantor spouse is now deemed a grantor. This dual status as a grantor and beneficiary of the SLAT will cause trust assets to be includable in the non-grantor spouse's estate at his or her death and, therefore, be subject to estate tax at death.[20]

Accordingly, prior to making the transfer, the grantor spouse should be sure that the funds he or she transfers to the SLAT are separate property. In community property jurisdiction, a severance may needed to convert community to separate property.[21] Similarly, if the grantor spouse is contemplating transferring an existing life insurance policy to the SLAT, the non-grantor spouse should be certain he or she gifts any interest he or she owns in the policy to the grantor spouse before the life insurance policy is transferred to the SLAT.[22]

3. Can each spouse establish a SLAT for the other spouse?

Traditionally, a married couple would only establish one SLAT. If each spouse establishes a SLAT for the other spouse, the IRS may apply the "reciprocal trust doctrine." Under the reciprocal trust doctrine, two identical or substantially similar SLATs created for the benefit of a married couple may be ignored for federal tax purposes. This means that if the SLATs were determined to be reciprocal, all of the assets in the trusts, including the life insurance policies, could be included in the couple's taxable estate. If this doctrine is applied, each spouse is treated as establishing a trust for his or her own benefit, causing assets in the trust to be included in each spouse's estate at death.[23]

The clients' tax and legal advisors must carefully consider the reciprocal trust doctrine when contemplating the use of the *His and Her SLAT* structure. In some cases, the following items may keep the trusts from being considered reciprocal: different beneficiaries of the two SLATs, different powers of appointment, different trustees or trustee discretionary powers, or substantially different dates for the two SLATs.

4. Can the trust be drafted to provide for future children?

An attorney can draft a SLAT broadly to provide benefits to the couple's future children, if any. This means that a young couple can begin reducing their estate by gifting today, regardless of whether they anticipate having future children.

In addition, the SLAT may provide the trustee with a limited power of appointment allowing the trustee to change the time and manner of trust distributions to the couple's children. This flexibility may be particularly important to a couple with young children or who plan on having children in the future. This power may allow a trustee to withhold or accelerate trust distributions depending upon the child's maturity, spending habits or needs.

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[17] An insured should not serve as trustee because his/her powers as trustee would constitute an incident of ownership causing inclusion of the insurance policy proceeds in the insured's gross estate. IRC Sec. 2042.

[18] Broader access to trust property would constitute a general power of appointment causing inclusion of trust property in the non-grantor spouse's estate. IRC Sec. 2041.

[19] As of the date of this publication, the community property states are currently: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin.

[20] IRC Sec. 2036.

[21] A client's attorney can determine the appropriate manner of transmuting community property funds to separate property funds.

[22] The non-grantor spouse's gift of his or her interest in the policy, if any, to the grantor, should occur well before (and independent of) the policy's transferred to the SLAT. Failure to do so may result in the application of the "step-transaction" doctrine which may cause the non-grantor spouse to be considered a co-grantor of the trust.

[23] *Lehman v. Comm'r.,* 109 F.2d 99 (2d Cir. 1940), cert. denied; *United States v. Estate of Grace,* 395 U.S. 316 (1969).

5. How does a SLAT that owns a second-to-die life insurance policy pay for the policy premiums at the death of the grantor spouse?

If the SLAT owns a second-to-die life insurance policy and premiums are still due at the death of the grantor spouse, the trust will need funds to continue to pay the life insurance policy premiums.

One potential solution is for the non-grantor spouse to loan funds to the SLAT. As mentioned previously, the non-grantor spouse should not become a grantor of the trust because his or her status as a grantor and beneficiary of the trust will cause trust property to be subject to estate tax at the non-grantor spouse's death.[24] If the loan is structured properly and bears interest at the applicable federal rate (AFR) set forth in IRC Section 1274(d), a loan by the non-grantor spouse to the trust should not cause the non-grantor spouse to become a grantor of the trust.

Additionally, the couple may plan ahead when purchasing a second-to-die life insurance policy in a SLAT to help ensure that there will be sufficient funds in the SLAT to pay future premiums upon the death of the grantor spouse. First, a shorter planned premium schedule[25] could be used to shorten the time period the premiums are paid. Second, the grantor spouse could pre-fund the SLAT. For example, if there is a spread between the life insurance premium amount and the amount that the grantor spouse could gift to the trust by making annual exclusion gifts, the grantor spouse could gift the entire amount to pre-fund the SLAT. These gifts may provide the SLAT with the requisite funds to pay any future premiums. Third, a separate term life insurance policy could be purchased in the SLAT on the life of the grantor spouse if underwriting requirements are met. The term policy death benefit proceeds payable on the death of the grantor spouse may provide the SLAT with the requisite funds to pay off any future premiums.

Life Insurance Applications

A married couple considering establishing a SLAT may choose any cash value policy that fits their needs. The type of policy the individual selects depends on whether the primary goal in establishing the SLAT is: (1) to obtain death benefit protection with potential access to the policy's cash value in emergency situations; and/or (2) to accumulate funds for supplemental retirement needs without inclusion of that policy's death benefit in either spouse's estate. While many policies can be designed to accommodate both goals, certain policy designs favor potential cash value accumulation over potential death benefit. Please consult with your life insurance producer for more information on the life insurance product that best fits your needs.

ILIT LOAN TECHNIQUE

Overview of Arrangement

Most ILITs are drafted to give the trustee the discretion to loan assets/funds to the grantor/insured. Accordingly, an ILIT may provide the grantor/insured with access to a life insurance policy's cash value, at the trustee's discretion, and pass life insurance policy proceeds estate tax-free[1] to heirs. When the grantor/insured needs funds for retirement or other family purposes, the trustee may take income tax-free withdrawals and loans[7] from the policy's available cash value, within policy limits and up to basis, and thereafter lend such funds to the insured.

An example will illustrate the usefulness of the ILIT loan technique. Assume Patrick is a 40-year-old bachelor who owns and operates a successful chain of grocery stores worth $15,000,000. Patrick is anticipating marrying and having children with Shelby and has designated Shelby as the primary beneficiary of his estate. Patrick's friend, an estate planning attorney, is encouraging him to purchase a life insurance policy to provide Patrick's estate with liquidity so that Shelby will not need to liquidate the business to pay the estate taxes due at his death. While Patrick understands that he cannot personally own the life insurance policy if he wants the death benefit proceeds to pass outside of his estate, he is reluctant to give up access to the policy's cash value. Patrick is concerned because there is a chance, however small, that his business could have future financial difficulties. To solve his concern over losing access to cash value, Patrick's attorney drafts an ILIT so that Shelby, as trustee, has the discretion to borrow from the life insurance policy's available cash value and loan the funds to Patrick.

[24] IRC Sec. 2036.

[25] It is important to keep in mind that a planned premium schedule is oftentimes based on non-guaranteed elements (such as a non-guaranteed rate of return or earnings rate).

Features of an ILIT Loan Arrangement Include the Following:

1. **The ILIT loan technique may provide the grantor/insured with indirect access to the trust-owned life insurance policy's cash value.**

   A grantor/insured must give up ownership of a life insurance policy to exclude the policy's death benefit proceeds from his or her estate. This may be a troublesome realization for a young individual who is considering having a trust-owned policy but desires access to the policy's cash value. With an ILIT loan technique, the trustee may, in his or her discretion, provide the grantor/insured with indirect access to the policy's cash value. Despite this access, after the grantor/insured's death, the death benefit proceeds should pass to the ILIT free from estate[1] and income[26] taxes.

   If the grantor/insured needs funds for retirement or other family purposes, the trustee of the ILIT can take income tax-free withdrawals,[7] within policy limits and up to basis, and make loans to the grantor/insured. While the grantor/insured can seek a loan from the trust at any time, the terms of a properly drafted ILIT should provide that the trustee may only loan trust property to the grantor/insured if he or she can adequately secure the loan.[27]

2. **The life insurance policy's death benefit proceeds may pass to the ILIT free from estate tax.**

   The death benefit from a life insurance policy purchased and owned by an ILIT may pass to the trust beneficiaries free from estate tax. As with any ILIT, this is true provided that an individual's estate planning attorney drafts the trust agreement properly to avoid providing the grantor/insured with any prohibited powers or benefits over the trust or trust-owned policy.[28] If the ILIT is not properly drafted and structured, a loan to the grantor/insured from the ILIT (even if indirect and bearing adequate interest) may cause the grantor/insured to have incidents of ownership resulting in estate inclusion of the life insurance death benefit proceeds.[29]

Disadvantages of an ILIT Loan Arrangement Include the Following:

1. **The grantor/insured's estate may be increased if he or she dies with unspent loan funds.**

   The grantor/insured's estate will include the value of any unspent funds borrowed from the ILIT loan.[30] If, for example, the ILIT trustee lends $250,000 to the grantor/insured and he or she spends $100,000 of the loan proceeds during his or her life, the grantor/insured's estate will include the unspent $150,000 at his or her death. The grantor/insured's estate should, however, receive an estate tax deduction equal to the outstanding balance due on the note, even if the balance exceeds the value of the unspent funds, provided that debt is a bona fide claim against the grantor/insured's estate.[31]

2. **The ILIT may not have sufficient funds to make a loan to the grantor/insured.**

   Depending on the size of the trust and the performance of the assets in the trusts, the ILIT trustee may not have sufficient funds to lend money to the grantor/insured. This type of situation may arise if, for example, the life insurance policy does not perform well and the cash value of the life insurance policy is insufficient to permit the trustee to make loans to the grantor. It is important to remember that any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits. If the trust does not have any other assets from which to make loans, the grantor/insured may lose his or her access to the assets in the trust.

Common Questions

1. **Is it difficult to properly draft an ILIT to permit loans to the grantor/insured?**

   Any competent estate planning attorney should be able to draft an ILIT to permit the trustee to make loans to the grantor/insured. With the ILIT loan technique, however, the attorney must pay careful attention to the manner in which the grantor/insured obtains loans from the trust.

   The ILIT should be drafted to provide the trustee with the discretion to make loans to the grantor/insured (as opposed to providing the grantor/insured with the right to borrow from the trust). A *right* to borrow money from

[26]For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e., the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

[27]If the trust does not require the grantor/insured to post adequate security for a loan from the trust, the IRS may determine that the grantor/insured never made a completed gift to the trust or maintained some benefit over the trust that causes the policy proceeds to be includible in his or her estate and, thus, subject to estate tax. Inadequate security may also prevent the IRS from finding that the loan was an estate tax deductible bona fide claim against the grantor/insured's estate. IRC Sec. 2053(a)(3).

[28]IRC Secs. 2036, 2038 and 2042.

[29]See section titled *"1. Is it difficult to properly draft an ILIT to permit loans to the grantor/insured?"*, infra.

[30]IRC Sec. 2031(a).

[31]IRC Sec. 2053(a)(3).

a life policy inside an ILIT is considered an "incident of ownership" that may cause the policy's entire death benefit proceed to be includable in the grantor/insured's estate at his or her death (and may, thus, be subject to estate tax[1] at the grantor/insured's death).[32] In other words, if the grantor/insured has the right to borrow from the ILIT, this right may cause the life insurance policy proceeds to be subject to estate taxation because the right to borrow from the trust may be construed as control over the trust. If, however, the ILIT provides the trustee with the *discretion* to lend to the grantor/insured, the life insurance policy's death benefit may pass to the ILIT free from estate tax because the grantor/insured was not given the right to borrow from the ILIT or the life insurance policy.

2. What interest rate should the ILIT charge on loans to the grantor/insured?

Any loan from the ILIT to the grantor/insured should bear interest at least equal to the applicable federal rate (AFR) found in Section 1274(d) – short-term, mid-term or long-term, depending upon the term of the promissory note. If the interest the grantor/insured pays to the ILIT exceeds the AFR, the IRS may conclude that the payment of interest in excess of that which would be required constitutes a gift from the grantor/insured to the beneficiaries of the ILIT. Alternatively, if the interest the grantor/insured pays to the trust is less than the AFR, the IRS could argue that the grantor/insured retained some benefit over the trust that could cause property in the ILIT to be included in the grantor/insured's estate at his or her death.[33] In general, the terms of the loan should reflect the terms for a loan made in an arm's length transaction or it may be scrutinized by the IRS.

3. Will the ILIT have taxable income as a result of the interest payable on the loan to the grantor/insured?

If the attorney drafts the ILIT as a defective grantor trust for income tax purposes, the trust should not have taxable income from the interest payable on the loan because transactions between the grantor/insured and a grantor trust are ignored for income tax purposes.[34] This means that the grantor/insured recognizes all the ILIT's income even though it is paid to the beneficiaries or accumulated in the ILIT. The ILIT property thus grows without a reduction to pay income taxes. The grantor/insured's payment of income tax attributed to the ILIT is not considered a gift to the ILIT because the grantor/insured is obligated to recognize the ILIT's income as his or her own income.[35] Thus, the grantor/insured's recognition of the ILIT's income resembles a tax-free gift to the ILIT each year equal to the income tax liability of the ILIT. This tax-free transfer of additional wealth to the ILIT may be particularly important if an individual is using his or her annual exclusion gifts for other purposes and has exhausted his or her applicable lifetime gift tax exemption amount.[1,2]

4. Who can serve as trustee of the ILIT when the ILIT loan technique is used?

A corporate trustee[6] or any competent adult, other than the grantor/insured, can serve as trustee of the ILIT.[17] Given that the ILIT loan technique trust provides the trustee with the *discretion* to make loans to the grantor/insured, most individuals prefer to appoint a family member or friend to serve as the trustee.

5. Can the ILIT be drafted to provide for future children?

An attorney can draft the ILIT broadly to provide benefits to a grantor/insured's future children, if any. This means that a young individual can begin reducing his or her estate by gifting today, regardless of whether he or she anticipates having additional children.

In addition, the ILIT can provide the trustee or other third party with a limited power of appointment that allows the trustee or designated third party to change the time and manner of trust distributions to the grantor/insured's children. This flexibility may be particularly important to an individual with young or unborn children. This power may allow a trustee or designated third party to withhold or accelerate trust distributions to a child depending upon the child's maturity, spending habits or needs.

Life Insurance Applications

A grantor/insured that is considering establishing an ILIT to permit the ILIT loan technique can select any cash value single life or second-to-die life insurance policy. The type of policy the grantors/insureds choose depends upon whether the primary goal in establishing the ILIT is: (1) the accumulation of funds for retirement purposes without subjecting the policy proceeds to estate tax[1]; or, (2) the attainment of a substantial death benefit with potential access to the policy's cash value in emergency situations. While most policies can be designed to accommodate both goals, certain policy designs favor potential cash value accumulation over potential death benefit.

[32]Treas. Reg. Sec. 20.2042-1(c)(2).

[33]IRC Sec. 2036.

[34]Rev. Rul. 85-13, 1985-1 C.B. 184. An attorney can draft the ILIT Loan Technique trust as a grantor trust by intentionally implicating one or more of the grantor trust rules that yields grantor status for income tax, but not estate tax purposes. IRC Sec. 671 et. seq.

[35]Rev. Rul. 2004-64, IRB 7; Priv. Ltr. Rul. 95-43-049 (Aug. 3, 1995).

WAIT-AND-SEE IRREVOCABLE LIFE INSURANCE TRUST

Overview of Arrangement

A Wait-and-See Irrevocable Life Insurance Trust is an irrevocable trust designed to own a second-to-die life insurance policy some time before the death of the surviving spouse. This type of trust may own the policy from inception and be made irrevocable at some time before the survivor's death; or alternatively, it may be drafted as an irrevocable trust some time before the death of the surviving spouse when the insureds or surviving spouse is willing to transfer ownership of the policy.

For example, assume Jeff and Irene are a young couple in their early thirties with two toddlers and a net worth of $22,000,000. Jeff is a financial planner and realizes that the proceeds of the second-to-die policy they are about to purchase may be subject to estate tax[1] if they personally own the policy. Jeff and Irene would like to establish an ILIT to own the policy but cannot decide how and when the trust proceeds should be distributed to their children upon the death of the survivor. While Irene is scheduled to receive a large distribution from a family trust in five years, she is concerned about losing access to the life insurance policy's cash value because they might need funds in the immediate future. To help solve the family's concerns, Jeff and Irene decide to engage in wait-and-see planning and transfer the policy to an irrevocable trust in five years. The couple believes that they will be financially secure and have a better idea of how to structure the trust terms controlling distributions to their children at that time. Provided that the survivor of Jeff and Irene lives three years beyond the date of their irrevocable gift of the life insurance policy to the trust, the policy's death benefit should pass to ILIT beneficiaries free from estate tax.

Features of a Wait-and-See Arrangement Include the Following:

1. **A young married couple can retain access to the life insurance policy's cash value until the first insured's death.**

   A young married couple cannot personally own a life insurance policy insuring their lives if they want to pass the proceeds to their heirs free from the possibility of federal estate tax.[1] This is a troublesome realization for a young couple who desire access to the policy's cash value. Wait-and-see planning may allow the couple to retain access to the life insurance policy's cash value until they are confident that they can financially afford to relinquish economic rights over the policy. Provided that the couple or surviving insured parts with all incidents of ownership over the policy more than three years before the surviving spouse's death, the life insurance proceeds should pass to the ILIT free from estate tax.[36]

2. **A young married couple can retain the ability to change beneficiaries and the time and manner in which beneficiaries receive the policy's death benefit.**

   Life insurance policy proceeds will only pass to the trust beneficiaries free of estate taxes if the trust is irrevocable. Accordingly, a young married couple will need to give up their right to alter, amend or revoke the trust if they want to pass the life insurance policy proceeds free of estate taxes.[37] Even if they are willing to part with the economic benefits of the policy, the couple may not be willing to give up the ability to designate who receives the life insurance policy proceeds and in what fashion. A couple with young children may be reluctant to irrevocably designate the terms of a trust.

   With wait-and-see planning, the young couple does not need to irrevocably designate the terms of the trust until they are fairly confident with the terms of distribution to their heirs. For an extra degree of comfort, they can also work with their attorney to provide the trustee with a limited power of appointment to change the time and manner of trust distributions to the insureds' children even after the insureds irrevocably transfer ownership of the policy.

3. **The life insurance policy death benefit payable upon the survivor's death should pass estate tax-free to the ILIT.**

   With the help of an attorney, a married couple interested in wait-and-see life insurance trust planning will create a revocable life insurance trust to own the life insurance policy from inception, which is made irrevocable at some time before the survivor's death. Alternatively, the couple may choose to create an ILIT some time before the death of the surviving spouse. Provided that the couple or surviving spouse parts with all incidents of ownership over the policy more than three years before the surviving spouse's death, the life insurance death benefit proceeds should pass to the ILIT estate tax-free.[38] The ILIT trustee may then make distributions to the ILIT beneficiaries per the trust terms.

[36]This statement is true provided that the ILIT is properly drafted so that, among other things, the surviving spouse does not retain any prohibited power or benefit over the trust or policy that would cause trust property to be included in his or her estate. IRC Secs. 2036, 2038, 2041 and 2042.

[37]IRC Sec. 2038.

[38]This statement is true if the trust is properly drafted so that, among other things, the surviving spouse does not retain any prohibited power or benefit over the trust or policy that would cause trust property to be included in her estate. IRC Secs. 2036, 2038 and 2042.

Disadvantages of a Wait-and-See Arrangement Include the Following:

1. **The life insurance policy's cash value may be included in the estate of the first spouse to die.**

   If the insureds transfer ownership of the policy to an ILIT and the policy is transferred to the ILIT more than three years before the first death, no portion of the life insurance policy's cash value should be included in the first spouse to die's estate.[39]

   If, on the other hand, the insureds fail to transfer ownership of the policy to an ILIT or the policy is transferred to an ILIT within three years of the first death, the cash value of the portion of the life insurance policy owned by the deceased spouse will be includable in his or her estate at death.[40] Assuming, however, that portion of the policy passes to the surviving spouse at the deceased spouse's death, the unlimited marital deduction should shelter the transfer to the surviving spouse from transfer taxes.[41]

2. **Gift taxes may be due when the life insurance policy is gifted to the irrevocable trust.**

   With a wait-and-see trust, the life insurance policy must be transferred to the ILIT at some point in time so that the death benefit proceeds pass outside the insureds' estate. This is typically accomplished by gifting the life insurance policy from the insureds (or the surviving spouse) to the ILIT. When gifting a life insurance policy to an ILIT, there may be gift taxes due if the value of the gift exceeds the couple's annual exclusion and/or lifetime gift tax exemption amount.[2] For a detailed discussion on the value of the gift to the ILIT, please refer to the proceeding question *"1. What is the value of the gift when the trust is made irrevocable or when the life insurance policy is transferred to the irrevocable trust?"*

3. **Failure to timely implement a wait-and-see arrangement may result in estate inclusion.**

   If a young couple personally owns a life insurance policy insuring their lives, they will be deemed to have incidents of ownership over the policy that causes the policy to be includable in their estate. This, in turn, will increase the value of the couple's estate and may result in possible estate taxes.[1] If a couple waits too long or fails to properly implement the wait-and-see strategy, they may be subject to estate taxes as the life insurance will cause the value of their estate to increase by the amount of the death benefit. In other words, a personally owned $6,000,000 life insurance policy will increase the value of the owner's estate by $6,000,000 and may subject him or her to estate taxes.

Common Questions

1. **What is the value of the gift of the life insurance policy when the trust is made irrevocable or when the life policy is transferred to the trust?**

   Assuming the life insurance policy has been in force for some time and that future premiums are to be made, the value of the gift when the trust is made irrevocable or when the life insurance policy is transferred to the trust is typically its fair market value (FMV). Generally, the FMV of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.[42] The FMV for a life insurance policy is not generally easily ascertainable;[43] therefore, the IRS indicated that the value of a life insurance policy (for estate and gift tax purposes) is based on the cost of a hypothetical "comparable contract." There are, however, some instances where the gift tax[2] value of the life insurance policy will be measured differently.

   a) For newly issued (contracts transferred immediately after purchase or those within their first year) policies, the FMV is the "cost" of the policy.[44]

   b) For policies which are "single premium[45]" (one in which one premium, paid on the date the policy is issued, is intended to fund the contract completely for the life of the insured) or "paid-up" (one in which no further planned premiums remain to be paid), the value is the single premium which the issuing company would charge currently for a comparable contract of the same amount on the life of a person the insured's age at the time of the transfer.[46]

[39] Id.
[40] IRC Sec. 2033.
[41] IRC Sec. 2056.
[42] See *United States v. Cartwright,* 411 U.S. 546, 551, 93 S.Ct. 1713, 36 L.Ed.2d 528 (1973).
[43] Treas. Reg. 20.2031-8 and 25.2512-6.
[44] Treas. Regs. Sec. 25-2512-6(a) (Ex. 1).
[45] Many single premiums today fall into category 3 below because premiums are often being suspended and further premiums may be required in the future depending on policy performance.
[46] Treas. Reg. Sec. 25.2512-6(a), example 3.

c) When a policy has been in force for some time, and on which further premiums are being made, FMV can be approximated by using the Interpolated Terminal Reserve (ITR) plus unearned premiums to date.[47] The regulations, however, state that if "because of the unusual nature of the contract" the ITR is not "reasonably close to the full value," it may not be used (e.g., the insured is terminally ill).[48]

The insureds may want to gift the policy to the trust or make the trust irrevocable before the value of the policy exceeds the amount that they are able to shield from gift tax through the use of annual exclusion gifts[2] or the couple's respective applicable exclusion amounts.

2. When are wait-and-see trusts created?

A married couple interested in wait-and-see life insurance trust planning can choose to create a revocable life insurance trust to own the policy from inception. The revocable trust may be made irrevocable at some time before the survivor's death. Alternatively, the couple may choose to create an irrevocable trust some time before the death of the surviving spouse when the insured or surviving spouse is willing to relinquish control of the life insurance policy.

Working with an attorney, a married couple may choose to draft the trust to own the life insurance policy from inception as part of their initial estate plan. This may minimize the cost and burden of drafting another trust at some time in the future. Most couples interested in wait-and-see planning will, however, choose to forgo drafting the trust until they are ready to make an irrevocable gift of the policy to the trust beneficiaries.

The law, testamentary desires, and financial circumstances could drastically change over time before they would make the trust irrevocable. Even though a revocable wait-and-see trust is amendable, the amendment to the trust may be just as costly as creating a new irrevocable trust. Given that most insureds will wait years before deciding to irrevocably gift the existing policy to a trust, they are generally unwilling to spend the extra time and money to draft a wait-and-see trust today.

3. Who typically serves as trustee of the wait-and-see trust?

Either or both insureds typically serve as the trustee of the trust if the insureds choose to structure their wait-and-see planning as a revocable trust that owns the policy from inception. As trustees, the insureds can take income tax-free withdrawals and loans from the policy and distribute such funds to themselves at their discretion.[49]

Once the trust is made irrevocable or if the trust is being drafted as an irrevocable trust from inception, the goal is to pass the life insurance policy proceeds to the trust (and the trust beneficiaries) free from federal estate tax.[1] The insureds cannot serve as trustees of the irrevocable trust after this point, or they will possess incidents of ownership[50] over the policy that will cause the policy proceeds to be subject to estate tax.[1] Accordingly, any competent adult, other than an insured, can serve as trustee of the irrevocable trust.[6,17]

Life Insurance Applications

A married couple considering wait-and-see trust planning can select any cash value second-to-die policy. The type of policy the couple selects depends upon whether the primary goal when purchasing the policy is: (1) the accumulation of funds for retirement purposes without subjecting the policy proceeds to estate tax; or, (2) the attainment of a substantial death benefit with potential access to the policy's cash value in emergency situations. While most policies can be designed to accommodate both goals, certain policy designs favor potential cash value accumulation over potential death benefit.

[47] Treas. Reg. Sec. 25-2512-6(a) (Ex. 4).

[48] Treas. Reg. Sec. 25-2512-6(a).

[49] If the insureds take loans from the policy, they need to carefully analyze the income tax ramifications of transferring a policy with existing loans to an irrevocable life insurance trust. The policy proceeds may lose their income tax-exempt status if the policy loans exceed the transferors' income tax basis in the policy at the time they transfer the policy to the irrevocable trust. IRC Sec. 101(a)(2).

[50] IRC Sec. 2042.

PRIVATE FINANCING: PRIVATE SPLIT-DOLLAR – SINGLE LIFE PRIVATE SPLIT-DOLLAR WITH A MARRIED INSURED

Overview of Arrangement

A private split-dollar arrangement is a life insurance premium sharing arrangement used by individuals who wish to purchase a life insurance policy for estate liquidity purposes but want to minimize the gift tax[1] consequences of funding the life insurance policy. With a single life private split-dollar arrangement involving a married insured, the premium sharing arrangement is between the non-insured spouse (the premium payor) and the trustee of an ILIT. Married individuals may enter into this type of private split-dollar arrangement to minimize the gift tax consequences of funding the ILIT and can also have some access to the trust-owned policy's cash value.

An example will best illustrate the function of this type of split-dollar arrangement. Assume the Tuckers are a wealthy couple in their mid-forties with two children. Given their age and financial situation, the Tuckers anticipate needing $13,000,000 in life insurance death benefit to cover future possible estate tax liquidity. The premiums for such a large policy exceed the couple's annual exclusion amount.[2] The Tuckers want the policy death benefit proceeds to be excluded from their estate and are, therefore, considering establishing an ILIT to own the policy. Nonetheless, the Tuckers have two concerns with the concept of a trust-owned policy: 1) they have already exhausted their lifetime gift tax exemption amount and want to minimize gift taxes;[1] and, 2) they are reluctant to give up complete access to the policy's cash value because they fear a change in their future economic situation.

To solve the gift tax and access to cash value concerns, the Tuckers take the following actions: Mr. Tucker, with the help of an attorney, establishes an ILIT, naming his brother, James, as trustee. James, as trustee, enters into a split-dollar agreement with Mrs. Tucker. Mrs. Tucker agrees to pay the premiums from her separate funds in exchange for a collateral assignment in the life insurance policy equal to the policy's cash value.[51] As trustee, James agrees to pay an amount equal to the value of current life insurance protection (also commonly referred to as the reportable economic benefit or REB) on the death benefit payable to the ILIT.[52] James, as trustee, then purchases a single life policy insuring Mr. Tucker's life. The ILIT is the owner and beneficiary of this life insurance policy.

Although the premium payments themselves are not gifts, Mr. Tucker may still wish to make gifts to the ILIT. The ILIT may use a portion of these gifts to pay the REB to Mrs. Tucker. In the early years of a split-dollar arrangement, the REB is a fraction of the total premium. Accordingly, the split-dollar arrangement allows the ILIT to obtain the insurance the Tuckers need while minimizing the gift taxes[1] needed to finance the policy. The split-dollar arrangement also solves the Tucker's concern over access to the trust-owned policy's cash value: the collateral assignment agreement provides Mrs. Tucker with access to the policy's cash value. In order to avoid estate inclusion, however, there should be no agreement, express or implied, that Mr. and Mrs. Tucker will share the funds. At Mr. Tucker's death, the death benefit proceeds payable to the ILIT should pass to the ILIT free from federal estate tax,[1] regardless of the year of death.

Features of a Split-Dollar Arrangement Include the Following:

1. **The insured can minimize the gift tax cost to finance a trust-owned policy.**

   The insured may drastically reduce the gift he or she makes to finance a trust-owned policy and therefore reduce or avoid the payment of gift tax if the trustee of an ILIT enters into a split-dollar arrangement with the insured's spouse. The agreement between the trustee and the non-insured spouse/premium payor would require the trustee[6] to pay premium equal to the value of the current life insurance protection (or REB) on the death benefit payable to the trust and require the insured's spouse to pay the balance of the premium. As a result, the insured spouse only needs to gift a relatively small amount of funds to the ILIT to finance the life insurance policy because the rates used to value the current life insurance protection or REB are relatively small compared to the total policy premium (until the insured attains a certain age).

[51]The premium payor (Mrs. Tucker) must be assigned the entire cash value to qualify under the split-dollar economic benefit regime as defined in Treas. Reg. Sec. 1.61-22(c)(1)(ii)(A)(2). The split-dollar regulations provide that cash value is determined by disregarding surrender charges or other similar charges or reductions and no artifice or device may be used to understate the cash value. The client's independent tax advisor should be consulted for help determining the appropriate measure of the cash value.

[52]Final Split-Dollar Regulations (Treas. Reg. 1.61-22(d)(3)(ii)) reserved the issue of the cost of current life insurance protection for future guidance. Until such guidance is issued, Notice 2002-8 states that taxpayers may continue to use the insurance carrier's published one year term rates or the Table 2001 rates for arrangements entered into prior to January 28, 2002. For arrangements entered into after that date, taxpayers are generally limited to the Table 2001 rates.

2. **The non-insured spouse/premium payor can access the trust-owned policy's cash value.**

   When a non-insured spouse/premium payor enters into a private split-dollar arrangement with the trustee of the ILIT, the split-dollar and collateral assignment agreements may provide the non-insured spouse/premium payor with access to the policy's cash value. At retirement or in the event the family needs funds, the non-insured spouse/premium payor may take income tax-free withdrawals and loans[7] from the policy's available cash value by exercising his or her rights set forth in the split-dollar and collateral assignment agreements.

   While access to cash value may be an important benefit, it should not be the sole reason for establishing a private split-dollar arrangement. Rather, reducing the gift amount that finances a life insurance policy owned outside of the insured's estate is the primary reason for most private split-dollar arrangements. Additionally, indirect access to cash value may be obtained through other relatively simpler drafting techniques such as SLATs.

3. **The ILIT's portion of the life insurance policy's death benefit should pass to the ILIT free from federal estate tax.**

   The ILIT's portion of the death benefit proceeds should pass to the ILIT free from estate tax,[1] regardless of the year of death, provided that the ILIT and split-dollar agreements are properly drafted. The ILIT trustee may then, in turn, make distributions to the ILIT beneficiaries per the terms of the trust. Assuming proper drafting and funding, this means the life insurance policy proceeds should not be includable in the insured's estate because he or she did not retain any prohibited power or benefit over the trust or any incident of ownership over the policy.[53]

   Incomplete (or improper) estate planning could cause the death benefit proceeds to be included in the insured's estate. The non-insured spouse/premium payor's contractual rights under the split-dollar arrangement include rights that could cause the entire death benefit proceeds to be included in the insured's estate if held by the insured at or within three years of the insured's death.[54] Accordingly, the non-insured spouse/premium payor's contractual interests must not pass to the insured at his or her death. Rather, the non-insured spouse/premium payor should bequeath his or her interest to anyone other than the insured (e.g., children or grandchildren) in a will or living trust. Additionally, if the insured is the executor of the will or the trustee[6] of the trust (that distributes the non-insured spouse/premium payor's contractual interest), the non-insured spouse/premium payor's will or trust should designate a special executor or trustee to take all actions with respect to his or her contractual interest. Otherwise the insured will possess rights over the policy that could cause the entire policy proceeds to be included in his or her estate.[55]

Disadvantages of a Private Split-Dollar Arrangement Include the Following:

1. **Failure to terminate the split-dollar arrangement at the appropriate time may result in prohibitively high gifting.**

   The cost of current life insurance protection (REB) increases as the insured get older. From a gift tax perspective, the private split-dollar arrangement should be terminated (or "rolled out") before the value of current life insurance protection exceeds the actual premium cost (the "cross over point"). If the split-dollar arrangement is not terminated at the cross over point, the insured spouse may be gifting more to the ILIT to fund the life insurance policy with the private split-dollar arrangement than he or she would without the arrangement.

   If the parties to the arrangement fail to plan in advance, gifting concerns may force a rollout that could strip the life insurance policy of its cash value and result in little or no insurance death benefit payable to the ILIT. This may be the case because the non-insured spouse/premium payor is entitled to the entire cash value of the policy.[56] It is, therefore, important for the parties and their advisors to plan in advance by implementing a rollout strategy.

[53]IRC Secs. 2036, 2038 and 2042.

[54]IRC Sec. 2042.

[55]Treas. Reg. Sec.1.7872-15(a)(1).

[56]The final split-dollar regulations provide that the term "cash value" shall mean the cash value of the policy, determined disregarding surrender charges or other similar charges or reductions. Treas. Reg. Sec. 1.61-22(d)(4)(i). Presumably, this means the assignee spouse's interest must be at least as great as the accumulated value of the policy. The split-dollar regulations also state that no artifice or device may be used to understate the cash value. Treas. Reg. Sec. 1.61-22(d)(5)(iii). If the Flexible Duration No-Lapse Guarantee Rider is chosen, the assignee spouse's interest may be the greater of the accumulated value or the net no-lapse guaranteed value. Taxpayers should consult their independent tax advisor for help determining the appropriate measure of the assignee spouse's interest.

2. The cash value of a life insurance policy is includible in the premium payor's estate.

Upon the death of the non-insured spouse/premium payor, the amount currently owed to him or her pursuant to the split-dollar agreement (i.e., the entire cash value) is included in his or her estate.[57] The portion of the life insurance death benefit proceeds ultimately payable to the ILIT should not be included in the insured's estate.[58]

Common Questions

1. Can a private split-dollar arrangement provide access to cash value to an insured?

Providing access of the cash value to an insured of the life insurance policy may constitute an "incident of ownership" and may cause inclusion of the death benefit proceeds in the insured's estate.[59] If an insured is the premium payor and assignee (*i.e.* a single life private split-dollar arrangement for a single insured or a second-to-die private split-dollar arrangement), the insured(s) should *not* be given any rights over the life insurance policy. This restriction may be accomplished by using a restricted collateral assignment agreement and form.

2. Can the ILIT trustee[6] have access to the life insurance policy's cash value?

The split-dollar regulations provide that the ILIT must not have any access to the life insurance policy's cash value.[60] Pursuant to the final regulations, in order for the economic benefit regime to apply, the only economic benefit provided under the arrangement by the donor must be the current life insurance protection.[61] A private split-dollar arrangement should, therefore, provide the ILIT with no access to the cash value.

3. Can the value of current life insurance protection be imputed rather than actually paid?

The value of the current life insurance protection provided to the ILIT may be imputed as a taxable gift[1] by the non-insured/premium payor rather than actually paid by the ILIT. This imputed gift would not qualify for the annual gift tax exclusion[2] because it would not be a present interest gift.[62] In order to qualify for the annual gift tax exclusion, cash equal to the value of the current life insurance protection is gifted to the ILIT and the proper Crummey power provisions are followed. The ILIT then pays that amount to the insured's spouse as premium payor. The imputed gift would, therefore, require the use of the non-insured/premium payor's remaining lifetime exemption amount[1] and/or payment of gift taxes. Given that private split-dollar is used to minimize the gift tax consequences of funding a trust-owned policy, the imputed gift approach may not achieve the desired result.

4. Is the value of current life insurance protection income taxable to the non-insured spouse/premium payor?

Pursuant to the split-dollar final regulations, the value of current life insurance protection actually paid by the ILIT will be income taxable to the non-insured spouse/premium payor for any split-dollar arrangements entered into after September 17, 2003.[63] Establishing the ILIT as a defective grantor trust as to the non-insured spouse/premium payor may be considered by the individual's legal and tax advisors to possibly avoid the income taxation of the REB.[64] It is unclear, however, whether or not the use of a defective grantor trust will effectively avoid the income taxation of the REB in a private split-dollar arrangement given the language contained in the final regulations. Individuals should consult their tax advisors on this issue. If the trust is drafted as a grantor trust to the non-insured spouse/premium payor, he or she should not be a beneficiary of the ILIT. If the non-insured spouse/premium payor is also the beneficiary of the ILIT, the death benefit proceeds may be includible in his or her estate at death.[65]

5. How does divorce or separation affect the private split-dollar arrangement?

Divorce or separation does not diminish or alter the non-insured spouse/premium payor's right to reimbursement or access to the life insurance policy's cash value. Accordingly, the non-insured spouse/premium payor would retain access to the policy's cash value even after the couple divorces or separates. This issue should be discussed with the legal and tax advisors before entering into a private split-dollar arrangement.

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[57] IRC Sec. 2033.

[58] Priv. Ltr. Rul. 96-36-033 (March 12, 1996).

[59] Rev. Rul. 79-129, 1979-1, C.B. 306.

[60] Treas. Reg. Sec. 1.61-22(d). The final regulations provide that the non-owner must take into account the full value of all economic benefits provided by the owner. The value of economic benefits includes the amount of policy cash value to which the non-owner has current access. Treas. Reg. Sec. 1.61-22(d)(2)(ii).

[61] Treas. Reg. Sec. 1.61-22(c)(1)(ii)(2).

[62] A donee is given a present interest if he or she receives an unrestricted right to the immediate use, possession, or enjoyment of the transferred property. Treas. Reg. Sec. 25.2503-3(b).

[63] Treas. Reg. Sec. 1.61-22(f)(2)(ii).

[64] IRC Sec. 671 et seq.

[65] IRC Sec. 2036.

PRIVATE FINANCING: INTRA-FAMILY LOANS – ILIT-OWNED SINGLE LIFE POLICY PURCHASED WITH INTRA-FAMILY DEMAND LOANS – MARRIED INSURED

Overview of Arrangement

This type of private split-dollar design is a demand loan arrangement between the insured's spouse and the trustee of the ILIT. Married individuals may enter into this type of split-dollar arrangement to minimize the gift tax[1] consequences of funding an ILIT and to have indirect access to the ILIT-owned policy's cash value.

An example best illustrates the function of this type of private financing arrangement. Assume the Wilsons are a wealthy couple in their late forties with three teenage children. The Wilsons are already making direct gifts of $19,000 per year to each child in order to reduce the size of their estate. Given their age and financial situation, however, the Wilsons anticipate needing $13,000,000 in life insurance proceeds to cover their future estate tax[1] liability. The Wilsons want the life insurance policy death benefit proceeds to be excluded from their estates. They are, therefore, considering purchasing a life insurance policy in an ILIT and continuing their annual gifts to the ILIT rather than making gifts directly to their children. Despite this, the Wilsons have two concerns: 1) they already exhausted their gift tax exemption amount[1,2] and are reluctant to pay gift tax on the transfers to fund the policy; and, 2) they are reluctant to give up complete access to the life insurance policy's cash value because they fear a change in their future economic situation.

To solve the potential access to cash value and gift tax concerns, the Wilsons take the following actions: with the help of an attorney, Mr. Wilson establishes an ILIT, naming his brother, Brad, as trustee.[6] Mr. Wilson makes gifts to the ILIT using his annual exclusion gift and/or lifetime gift tax exemption amount. Brad purchases a life insurance policy insuring the life of Mr. Wilson. The ILIT is the owner and beneficiary of the life insurance policy. Brad then enters into a demand loan agreement with Mrs. Wilson whereby Mrs. Wilson agrees to lend all or most of the life insurance premiums to the ILIT.

By using a demand loan, Mrs. Wilson may demand loan repayment from the ILIT at any time. The ILIT then collaterally assigns a portion of the life insurance policy death benefit proceeds and cash value to Mrs. Wilson. As trustee, Brad agrees to pay the loan interest to Mrs. Wilson annually. If the ILIT already had assets, Brad may use funds in the ILIT to pay the loan interest. In this instance, the ILIT is newly created so Brad must use some of the funds that Mr. Wilson gifts to the ILIT in order to repay the loan interest to Mrs. Wilson.

Given that Mrs. Wilson has lent the premiums to the ILIT, the premium payments are not considered gifts to the ILIT. The loan arrangement allows the ILIT to purchase the life insurance the Wilsons need with minimal gifting to the ILIT. The demand loan arrangement also helps the Wilsons with their second concern: access to the ILIT-owned policy's cash value. The loan agreement and the collateral assignment provide Mrs. Wilson, as lender, with the right to demand repayment at any time. If she needs to access the cash value, she can demand repayment of the loan which may be satisfied from the cash value. At Mr. Wilson's death, the proceeds payable to the ILIT should pass to the ILIT free from estate tax[1] regardless of the year of death. The loan balance (if any), however, will be included in Mrs. Wilson's estate at her death.[66]

Features of an Intra-Family Loan Arrangement Include the Following:

1. **The insured can minimize the gift to finance an ILIT-owned policy.**

   If the trustee of an ILIT enters into a loan arrangement with the insured's spouse (the lender), the insured may drastically reduce the gift he or she makes to finance an ILIT-owned life insurance policy and therefore reduce or avoid the payment of gift tax. This is the case because the premiums paid by the insured's spouse are a loan to the ILIT – not a gift. Given that the loan agreement charges the ILIT an interest rate, the ILIT needs to use either existing funds to pay the interest or use funds gifted into the ILIT by the insured to make the interest payments to the non-insured/lender spouse.

2. **The non-insured/lender spouse can access the ILIT-owned policy's cash value.**

   When a non-insured/lender spouse enters into a demand loan arrangement with the trustee of an ILIT, the loan agreement gives the non-insured/lender spouse the right to demand repayment of the loan at any time. At retirement or in the event the family needs funds, the non-insured/lender spouse can demand repayment of the loan. The life insurance policy's available cash value, if any, may then be used to repay the loan.

[66] *Caveat:* Structuring an intra-family loan transaction under IRC Section 7872 can be complex. This professional guide is not intended as a complete discussion of all the issues. It is important that individuals considering entering into an intra-family loan arrangement consult their tax and legal advisors on all issues. Some lenders, such as broker-dealers and financial institutions, must satisfy additional lending requirements such as, but not limited to, per 12 C.F.R. 200 (Reg. T) and per 12 C.F.R. 221 (Reg. U). Lenders should seek the advice of their tax and legal advisors before making such loans.

While access to cash value may be an important benefit to this particular type of private financing arrangement, it should not be the primary reason for establishing an intra-family loan. The primary reason for most intra-family loan arrangements is to reduce the gift amount to fund a life insurance policy owned outside of the insured's estate. Indirect access to cash value may be obtained through other, relatively simpler, drafting techniques (such as SLATs).

3. **The ILIT's portion of the life insurance policy's death benefit proceeds should pass to the ILIT free from estate tax.**

   Assuming the ILIT is set up properly, its portion of the life insurance death benefit proceeds should pass to the ILIT free from estate tax,[1] regardless of the insured's year of death. This statement is true provided that the trust and agreements to effectuate the intra-family loan are properly drafted so that the insured does not retain any prohibited power or benefit over the ILIT or any incident of ownership over the life insurance policy that may cause the proceeds to be included in his or her estate.[67]

   Incomplete or improper estate planning may cause the ILIT's portion of the life insurance death benefit proceeds to be included in the insured's estate. The non-insured/lender spouse's contractual rights under the intra-family loan arrangement include rights that may cause the entire life insurance policy death benefit proceeds to be included in the insured's estate if held by the insured at or within three years of his or her death.[68] Accordingly, the non-insured/lender spouse's contractual interest must not pass to the insured. The non-insured/lender spouse should bequeath his or her interest to anyone other than the insured (such as his or her children) in a will or living trust. In addition, if the insured is the executor of the will or the trustee of the trust that distributes the non-insured/lender spouse's contractual interest, the non-insured/lender spouse's will or trust should designate a special executor or trustee to take all actions with respect to his or her contractual interest. Failure to do so may cause the entire policy death benefit proceeds to be included in the insured's estate.[69]

Disadvantages of an Intra-Family Loan Arrangement Include the Following:

1. **The loan interest payments are income taxable to the non-insured/lender spouse.**

   Loan interest payments from the ILIT to the non-insured/lender spouse are income to that spouse. Establishing the ILIT as a defective grantor trust as to the non-insured/lender spouse may be considered by the couple's legal and tax advisors to possibly avoid the income taxation of the loan interest. If the trust ILIT is drafted as a defective grantor trust as to the non-insured/lender spouse, he or she should not be a beneficiary of the ILIT and should not hold any prohibited powers that may cause inclusion.

2. **The amount owed to the non-insured/lender spouse is includible in his or her estate.**

   Upon the death of the non-insured/lender spouse, the amount currently owed to him or her (if any) pursuant to the loan agreement would be included in his or her estate.[70] The portion of the life insurance death benefit proceeds ultimately payable to the ILIT should pass to the ILIT and to the trust beneficiaries free from estate tax[1] regardless of the year of death. This statement is true provided that the insured does not retain any prohibited power or benefit over the trust ILIT or any incidents of ownership over the policy.[71]

Common Questions

1. **Can an insured lend money to an ILIT pursuant to an intra-family loan**

   An insured may lend money to an ILIT but demand loans should not be used where the insured is also the lender because the insured/lender's right to demand loan repayment may be deemed an incident of ownership in the life insurance policy causing inclusion of the death benefit proceeds in the insured's estate.[72] Demand loans should only be used if someone other than the insured, such as the non-insured spouse, is the lender.

2. **What is the interest rate used for testing the sufficiency of interest on a demand loan?**

   The loan interest prescribed for a demand loan must be no lower than the short term blended annual rate for the year.[73] The blended annual rates are published in the

[67] IRC Secs. 2036, 2038 and 2042.
[68] IRC Sec. 2042.
[69] Id.
[70] IRC Sec. 2033.
[71] IRC Secs. 2036, 2038, 2042 and 2512(b). In Priv. Ltr. Rul. 9809032, the IRS ruled that the lending of premium payments by the insured to a trust he created did not create incidents of ownership in the policy.
[72] IRC Sec. 2042. Where the lender is also the insured, an intra-family term loan arrangement can be used in conjunction with a restricted collateral assignment form.
[73] Treas. Reg. Sec. 1.7872-15(e)(3)(ii).

Internal Revenue Bulletin in July of each year.[74] If the loan interest is lower than the blended annual rate, the loan is a below-market loan and the foregone interest is treated (a) as gifted by the lender to the ILIT; and, b) as retransferred as interest by the ILIT to the lender on the last day of the calendar year. The foregone interest is the excess of the amount of interest that would have been payable on the loan for the calendar year if interest accrued at the blended annual rate minus any interest that accrued on the loan during the year.[75]

3. Can the lender spouse gift an amount equal to the loan interest to the ILIT to pay the loan interest to the lender?

IRC Section 7872 governs below-market loans. Those loans bearing sufficient loan interest, on the other hand, are taxed under general rules for debt instruments.[55] The split-dollar final regulations, however, provide that interest provisions will be disregarded "if a split-dollar loan provides for the payment of interest and all or a portion of the interest is to be paid directly or indirectly by the lender (or a person related to the lender[76])." As an example, the regulations provide that if an employer and employee set up a deferred compensation plan as part of the split-dollar loan arrangement that provides for the lender to pay an amount equal to the loan interest to the employee, that loan interest will be disregarded. It is unclear whether this provision prohibits a donor lender or donor lender's spouse from gifting to the ILIT an amount equal to the loan interest each year because the lender would be "indirectly" paying the loan interest. The final regulations provide that "all of the facts and circumstances determine whether a payment to be made by the lender (or a person related to the lender) is sufficiently independent from the split-dollar loan for the payment not to be an indirect payment of the interest (or a portion thereof) by the lender (or a person related to the lender)."[77]

In order to avoid the argument that the gift of money or assets to the ILIT by the lender or lender's spouse is an indirect payment of the loan interest by the lender, the gifting should be structured independently from the ILIT's requirements to pay the loan interest. For example, if the annual gifting to the ILIT constitutes an amount equal to the loan interest due rather than gifting the same amount to the ILIT each year irrespective of the loan interest, the facts and circumstances may indicate that the gifting and the payment of loan interest are not independent of each other and therefore disregarded. A less formal arrangement where a donor makes gifts to the ILIT in an amount irrespective of the loan interest amount may be more desirable. The individual's tax and legal advisors should be consulted on this issue prior to implementing such a gifting program.

4. Can the loan transaction be re-characterized as a transfer with a retained interest?

With other techniques involving note transactions between an ILIT and a grantor, there are concerns that an ILIT's promise to make note payments may be deemed illusory and that the transaction be deemed a transfer to a trust with a retained interest if the trust is underfunded. Accordingly, with those techniques, most commentators and advisors recommend that the clients gift cash prior to the note transaction to "seed" the trust. It is unclear if this also applies to intra-family loans under Section 7872 made to a newly-created ILIT that only owns a life insurance policy. Arguably, the payment of the Section 7872 applicable federal interest rate is a safe harbor and, therefore, there is no gift unless there is foregone interest. On the other hand, some may argue that Section 7872 is silent on this issue and the IRS could raise the argument. If the client's attorney is concerned about this issue, one approach may be to follow the approach used with other note transactions and to "seed" the ILIT prior to the lending of the funds.[78]

5. How is the intra-family loan arrangement documented?

To create an intra-family loan, the trustee[6] of the ILIT and the lender spouse execute a private intra-family loan arrangement and submit a collateral assignment to the life insurance company. The written loan agreement should set forth the rights and obligations of the trustee and the lender to prevent the IRS from arguing that the lender's payments of premiums were gifts to the ILIT beneficiaries.

[74]The annual blended rate can be found on the IRS website at www.irs.gov.

[75]Treas. Reg. Sec. 1.7872-15(e)(3)(ii).

[76]Treas. Reg. Sec. 1.7872-15(a)(4).

[77]Id.

[78]Some commentators suggest that 10 to 15 percent of the total value of the property that will be loaned is sufficient to Seed the trust in an installment note transaction between a trust and a grantor.

If the loan arrangement is established as non-recourse[79] to the borrower, an additional written representation may be needed because the split-dollar final regulations treat a non-recourse loan as a loan that provides for contingent payments, thereby complicating the calculation of the tax consequences and testing for adequacy of interest.[80] The regulations provide that contingent payments will not apply to a non-recourse loan if the parties to the arrangement represent, in writing, that a reasonable person would expect that all payments under the loan would be made.[81] The regulations provide that the Commissioner may prescribe the time and manner for providing the written representation. Until the Commissioner prescribes otherwise, in order to avoid the treatment of the loan as one that provides for contingent payments, both the borrower and lender must sign such a representation no later than the last day for filing the federal income tax return of the borrower or lender (whichever is earlier) for the year in which the lender makes the first loan under the arrangement. The representation must include the names, addresses and taxpayer identification numbers of the borrower and lender. A copy of the representation should be attached to each party's federal tax return for such year.[82]

6. Are there other ways to structure an intra-family loan?

There are generally two ways to structure an intra-family loan: a term loan and a demand loan. A term loan[83] is a loan for a specified term of years; each premium is borrowed as it becomes due. A demand loan[84] usually permits the lender to demand repayment of the outstanding loan balance at any time. The appropriateness of each technique depends on the individual's circumstances and objectives. Generally, if an insured is also the lender, a term loan should be used instead of a demand loan. If the insured is the lender and a demand loan is used, there may be incidents of ownership attributed to the insured. These incidents of ownership may cause the life insurance death benefit proceeds to be included in the insured's estate at his or her death.

[79]The term "non-recourse" is not defined in the regulations. It is unclear whether a recourse loan to an ILIT with no assets other than the life insurance policy would be treated as *non-recourse* for this purpose. One alternative to avoid that treatment when using a recourse loan with a newly-created ILIT may be to fund (or *"Seed"*) the trust with additional funds that can be used as collateral in addition to the life insurance policy's cash value.

[80]Treas. Reg. Sec. 1.7872-15(d) and (j).

[81]Treas. Reg. Sec. 1.7872-15(d)(2)(i).

[82]IRC Sec. 7872(c)(2)-(3).

[83]For a term loan, the applicable federal rates are based on the following terms: short term (0-3 years); mid-term (3-9 years); and long term (9+ years). Treas. Reg. Sec. 1.7872-15(e)(4)(ii).

[84]For a discussion on the interest rate charged for a demand loan, see the previous discussion titled *"2. What is the interest rate used for testing the sufficiency of interest on a demand loan?"*.

For additional questions, feel free to contact Pacific Life's Advanced Designs Unit at 800.800.7681 x3690 or Advanced.Designs@PacificLife.com.