Split-Dollar Spotlight: Exits, Terminations, Rollouts

This excerpt comes from *The Comprehensive Guide to Split Dollar Life Insurance*.

WHAT IS AN "EXIT," "TERMINATION" OR "ROLLOUT"?

An exit, termination, or rollout (collectively, an "exit") of any split-dollar arrangement generally refers to the unwinding of the arrangement during the insured's lifetime. The exit generally involves two components:

1. Repayment of the business's interest in the underlying policy, which is the total premiums paid, or, in non-equity arrangement, the policy's cash value, if greater
2. Release of the business's interest in the policy or a transfer of the policy, or an amount equal to the insured's interest in the policy, to the insured or other third-party owner (e.g., the insured's ILIT)

WHY ARE EXITS IMPORTANT FOR GRANDFATHERED SPLIT-DOLLAR ARRANGEMENTS?

Rising Term Costs. The term insurance cost used to measure the annual economic benefit provided by the current life insurance protection will increase each year as the insured ages. For joint policies, the annual economic benefit cost will increase significantly after the death of the first insured. Eventually, the costs to the insured, either as contributions under a contributory plan or tax on the imputed income, as well as any corresponding gift tax costs if there's an imputed gift to a third-party owner, such as an ILIT, may become too uneconomical to bear.

Reimbursement Obligation. The reimbursement amount due to the business will grow with each premium it pays, reducing the death benefit due to the insured from the policy, unless paid additions, a return of premium rider or an increasing death benefit option is used to maintain the death benefit level.

Insured's Retirement/Termination. In employment relationships, employers will often want, or the agreement will provide, for termination when the employee retires or otherwise leaves employment. Parties to the arrangement will want to ensure that there are sufficient proceeds to reimburse the business if the arrangement is terminated prior to the insured's death.

Equity Considerations. For grandfathered equity split-dollar arrangements, terminating the arrangement prior to the development of significant policy equity could avoid unfavorable income tax consequences to the insured.

WHAT ARE THE KEY FACTORS IN SELECTING AND IMPLEMENTING AN EXIT STRATEGY?

To select an appropriate strategy and timing for implementation, an advisor should analyze the following:[1]

1. **Policy Ownership.** Who owns the policy — the business (endorsement method) or the insured, his or her ILIT, or another third party (collateral assignment method)?
   a. If the business, is it a public company, C corporation, S corporation, partnership, LLC or a tax-exempt organization? And what's the relationship of the insured? Executive, key employee, shareholder, owner? The business organization and its relationship to the insured will affect the tax consequences. For example, if the business is a public company, then considerations on the prohibition of personal loans to directors and covered executives under SOX must be reviewed to see if they apply to the insured.
   b. If an ILIT, is it a grantor trust for federal income tax purposes with regard to the insured?
2. **Insurance Need.** Does the insured still have a need or desire for the insurance? Has the insured experienced a health change?
   a. If so, how much death benefit was provided under the arrangement, and based on what duration and assumptions?
   b. Is the insurance coverage amount still appropriate for the situation?
3. **Policy Performance.** Does the policy have cash value sufficient to support repayment of the business?
   a. What are the policy surrender charges?
   b. If the cash value is insufficient, how long until it will be, and on what assumptions? Can the arrangement be left intact until the insured's death?
4. **Policy Equity.** Does the policy currently have any equity? In other words, is the cash value in excess of the amount due as repayment for premium advances, and if so, by how much?
5. **Disposition of Policy Equity.** Is the grandfathered arrangement an equity arrangement (equity goes to the insured) or a non-equity arrangement (equity goes to the business)?
6. **Investment in Contract.** Does the insured (or his or her ILIT) have any basis in the policy?
7. **Modification to Product/Arrangement.** What type of product is involved? Can the premium payments or death benefits be adjusted or the product exchanged? Can the terms of the arrangement be modified, subject to the material modification issues?
   a. If the changes to the policy or any terms for the split-dollar arrangement constitute a material modification, what will the tax consequences be under the final regulations?
   b. Do the benefits of the modification outweigh these consequences?
8. **Planned Exit.** Was an exit strategy reviewed at inception? If so, which party assumed the risk that the policy wouldn't perform sufficiently to support repayment to the business from policy cash value? Does the business have the desire or flexibility to forgive part or all of its repayment right?
9. **Bonus Options.** Can or will the business and/or insured agree to switch to a bonus arrangement to support the policy? Does the insured understand that the bonus will be taxable as income and that there also will be a corresponding taxable gift of an equivalent amount if the policy is owned by an ILIT, which may raise GST tax and exemption allocation issues if the insured intends for the ILIT to be fully GST tax-exempt?
10. **ILIT Issues.** Are there fiduciary or other considerations the ILIT trustee must address in considering a modification or termination of the arrangement or the underlying policy?

WHAT ARE POTENTIAL EXIT STRATEGIES FOR A GRANDFATHERED ARRANGEMENT?

The following options may work for the typical types of grandfathered arrangements:[2]

Endorsement (Non-Equity) Arrangements. Typically, grandfathered endorsement arrangements are non-equity arrangements. Accordingly, there are no concerns related to the potential taxation of any policy equity to the insured. In these cases, the timeframe for the duration of the arrangement and the performance of the policy will determine how to proceed.

For example:

- **Maintain Arrangement.** If the arrangement will terminate at the insured's retirement (with the business, perhaps, retaining the policy and using the policy cash value to fund a SERP for the insured), the parties may want to keep the arrangement in place. If the grandfathered arrangement was entered into before Jan. 28, 2002, the parties can continue to measure the annual economic benefit using the lower insurer term rates without complying with the additional restrictions imposed by Notice 2002-8.

- **Rollout Policy.** If the arrangement was intended to remain in place until the insured's death and to provide the insured with substantial death benefits (usually payable to the insured's ILIT), the annual economic benefit may eventually become too great, even with application of the insurer term rates. In addition, if the ILIT holds the rights to the death benefit, the imputed annual gift made each year to the ILIT will also grow. In these cases, the business may want to transfer the policy to the insured (or his or her ILIT) via a distribution or a sale of the policy to the insured (or his or her ILIT).
  - A distribution of the policy will be taxed to the insured based on the relationship of the policies, with a corresponding gift to the insured's ILIT. Whether a distribution is feasible from the insured's tax perspective is highly dependent on the insured's financial circumstance and the tax environment. Some insureds may prefer to time a rollout to occur after retirement, when they anticipate less income.
  - If properly structured, a sale of the policy should avoid compensation income on distribution of the policy to the insured and a gift of the policy to the ILIT, but the insured will need to fund the ILIT with the cash needed to purchase the policy, which may require a gift. Also, if the sale is to an ILIT, the parties will want to confirm that it's a wholly owned grantor trust with regard to the insured for federal income tax purposes; otherwise, the transfer could run afoul of the transfer for value rules under IRC § 101(a)(2), resulting in taxation of the policy death benefit in excess of the consideration paid for the transfer. In addition, the ILIT trustee must ensure purchase of the policy complies with his or her fiduciary duties.

- **Cash-Out Policy.** If the policy has a sufficient cash surrender value, the business may want to surrender the policy using the cash surrender value to repay itself, and terminate the arrangement. The business may recognize income to the extent the policy cash value exceeds its investment in the contract.

COLLATERAL ASSIGNMENT EQUITY ARRANGEMENTS

Rollout of Policy with or Without Bonus. The business is either repaid or forgives its reimbursement right under the arrangement and releases the collateral assignment of the policy. Considerations:

- The business must decide if it will waive or forgive any part of the reimbursement amount due (e.g., as a bonus). The business may need to address accounting issues related to forgiving the obligation.
- Otherwise, the insured (and ILIT, if it holds the policy) must determine how to fund the business's repayment right. Assuming an ILIT holds the policy:
  - If the policy has cash value, it may be possible to access that value to repay the business (an "internal rollout"), subject to review of any income-tax consequences from such actions based on whether the policy is a modified endowment contract (MEC), is in a gain position with regard to accessing cash value, etc. Withdrawals from or loans against policy cash value also could limit the policy's ability to sustain itself or to provide a source of income going forward.
  - The use of non-policy assets may be preferable to exit the strategy (an "external rollout") based on the policy economics but requires the insured to fund the ILIT with assets other than the policy or external borrowing. This could be accomplished with taxable gifts or, if the ILIT is a grantor trust, on a leveraged basis through the use of loans from the insured to the ILIT (or an installment sale of assets to the ILIT). The insured, however, may not have sufficient assets to fund the repayment or may not wish to use them.
- If the policy has equity at rollout, the business must determine how to report and treat that equity (as compensation if the insured is an employee, a distribution to an owner, etc.) and whether it wishes to take a position that the equity isn't taxable, relying on the "no-inference" language in Notice 2002-8.
- The insured will be subject to tax on the forgiven amount and any equity reported by the business, based on the relationship of the parties (as compensation, a distribution, etc.), less any basis in the policy. If an ILIT owns the policy, there will be an imputed gift of a corresponding amount from the insured to the ILIT.
- Although the business should receive a deduction for any amount treated as compensation to an insured employee, it may face IRC §162(m) deduction limitations if the imputed compensation from any forgiven repayment obligation or equity is not "reasonable."

- Depending on the entity, if the insured is a shareholder or partner, the business may need to make equalizing distributions to the other owners.
- The business's release of its security interest under a collateral assignment arrangement shouldn't constitute a transfer for value under IRC § 101(a)(2), since the initial collateral assignment isn't a transfer for value.[3]
- Often, the policy will need additional premiums to remain in force, particularly if policy cash value was used to fund the rollout, which will now be the insured's responsibility. Possible options to assist the insured in meeting these premiums include:
  - A decrease in the policy death benefit or an exchange of the policy to reduce premiums needs. As the split-dollar arrangement is terminated, a material modification is no longer a concern, although the insured will want to make sure such changes don't adversely affect policy guarantees or other terms.
  - A possible private split-dollar arrangement between the insured and his or her ILIT, subject to the final regulations.
  - A bonus plan arrangement, if the business still wants an insured employee to have coverage and is willing to increase his or her compensation, or possibly additional split-dollar loans for future premium payments.

Switch to a Loan (Collateral Assignment Equity Arrangements Prior to Equity Buildup).[4] Prior to any equity buildup in the policy,[5] the business and insured convert all prior premium payments, less any repayments made to the business, to a loan on the first day of the year in which the election to switch to loan treatment is made. The business and insured determine the loan terms, such as length or term, interest rate, payment schedule, etc.

The insured (or, more typically, his or her ILIT) continues as the owner of the policy. The business retains a security interest in the policy, evidenced by a collateral assignment reflecting its revised interest. Considerations:[6]

- This approach won't be available for arrangements between public companies and directors and covered executives under SOX due to the prohibition against personal loans to such individuals, and may not be an option for organizations, like nonprofits, that have chosen to adopt or are otherwise subject to SOX-like policies.
- If the underlying policy hasn't yet produced equity and the insurer term rates, if they apply, remain low for purposes of calculating the annual economic benefit to the insured, the parties could delay the switch to a loan until the year before policy equity will appear and continue reporting under the rules available for grandfathered arrangements. The parties need to consider the performance of the policy, the applicable insurer term rates for determining the annual economic benefit to the insured, the current interest rates that would apply to a loan and the possibility of a rise in those rates if the loan were delayed.
- If the switch to a loan occurs when the policy has equity, it will likely trigger current taxation of that equity to the insured, with an imputed gift to the ILIT.
- Once converted, the conversion likely constitutes a material modification — and thus application of the loan regime under the final regulations.[7] Specific taxation under those rules will depend on several factors, primarily the term of the loan, the interest rate charged and the relationship between the parties.
- Where an ILIT holds the policy, the final regulations may divide the loan into two separate loans: one made by the business to the insured with a corresponding loan from the insured to the ILIT. In this case, the loan approach generally will work best if the ILIT is a grantor trust with respect to the insured, in order to avoid treating the imputed interest on the loan to the ILIT as taxable income to the insured.
- Grantor trust status may also facilitate the insured engaging in an installment sale or other loan transactions with the ILIT. This could provide funding for the ILIT to repay the loan to the borrower and/or future premium payments on the policy, avoiding the need for future loans from the business to subsidize the premiums.
- If required, future premiums on the policy can be paid by the insured (and his or her ILIT), via bonus compensation from the business, subject to the same policy review and payment options as discussed in the rollout option above, or funded through additional split-dollar loans under the final regulations.

Policy Roll-In. The insured (or his or her ILIT) transfers the policy to the business, which terminates the arrangement. If ongoing life insurance coverage is desired, the business could implement a non-equity endorsement arrangement taxed under the economic benefit regime under the final regulations. The business would endorse the desired amount of death benefit to the insured's designated beneficiary (e.g., his or her ILIT). Considerations:

- The approach may appeal in cases where a policy hasn't developed equity. Since, in an equity split-dollar arrangement, the business's reimbursement right equals the lesser of the premiums it paid or the policy's cash value, the transfer of the policy to the business should satisfy its reimbursement right.

- A transfer of the policy to the business in exchange for a release of the insured's obligation under the split-dollar agreement likely constitutes a transfer for value under IRC §101(a)(2), which would result in taxation of the policy death benefit in excess of the consideration paid for the transfer (e.g., the amount of the obligation released). If the business won't surrender the policy, it should be reviewed whether an exception to the transfer for value rule applies (e.g., transfer of the policy to a partnership or corporation in which the insured is a partner or shareholder).
- If a non-equity endorsement arrangement is implemented after the roll-in, the employee will have no access to policy equity. This may not be critical if the transferred policy was underperforming or only death benefit protection is now desired, somewhat like a death-benefit-only plan.
- The employee will have imputed income for the cost of current life insurance protection provided under the new arrangement for the duration of the plan.
- This cost will be determined similarly to the annual economic benefit under the grandfathered arrangement, except that the parties can use the insurer's term rates only if they meet the more stringent requirements imposed by Notice 2002-8. Otherwise, the Table 2001 rates must be used, which can substantially increase the annual economic benefit.
- If the policy is owned by an ILIT (as is likely), those implementing this strategy should consider any potential estate or gift tax issues resulting from a new endorsement or economic benefit arrangement, if implemented after the policy roll-in. For example, will the insured's assignment to the ILIT of the endorsed interest in the death benefit constitute a gift, potentially subject to gift tax? If so, that gift likely will subject the endorsed death benefits to the estate inclusion rule applicable to gifts of life insurance policies within three years of death (see IRC § 2035).
- The ILIT trustee must review whether a transfer of a policy to the business will comply with its fiduciary duties to the ILIT and its beneficiaries, factoring in the change in the economic benefits, if any, provided to the ILIT under a new arrangement and the potential estate tax consequences noted above.

Leave Plan Intact. Although not really an "exit," the parties can leave the arrangement in place until the death of the insured, with continued taxation on the annual economic benefit as provided under the grandfathered rules. Considerations:

- Under Notice 2002-8, there should be no current tax on any policy equity as long as the insured reports or contributes the annual economic benefit, which will be required even if no further premiums are due on the policy. It also seems that the policy equity may not be taxed if the arrangement continues until the insured's death.[9]
- Depending on the policy, if the business will defer its reimbursement right until the death of the insured, the policy cash value will not be used to repay the business and thus could be applied to support the death benefit.
- The business, however, will need to account for the discounted value of its receivable over the insured's life expectancy.
- In addition, if the insured or the ILIT accesses the policy equity through loans or withdrawals, it will likely result in immediate taxation to the extent those amounts exceed the insured's or ILIT's basis in the policy.
- Also, if terms of the split-dollar arrangement require termination of the agreement at the insured's retirement, it's possible that an extension of the arrangement until death will constitute a material modification, resulting in taxation of the annual economic benefit and the policy equity under the final regulations.

Endnotes

[1] See Brody and Ratner, "What To Do With Those Existing Split-Dollar Plans," supra note 35. See also Skeletons in the Closet: What to Do With "Grandfathered" Split-Dollar Arrangements by David Houston & Maggie Mitchell, The AALU Quarterly, Spring 2012.

[2] See discussions of these options at Brody and Ratner, "What To Do With Those Existing Split-Dollar Plans," supra note 35; Ratner and Leimberg, "A Planner's Guide to Split-Dollar After the Final Regulations," supra note 45.

[3] See Regs. § 1.101-1(b)(4).

[4] See safe harbor provided under Section VI.3 of Notice 2002-8. See also Brody and Ratner, "What To Do With Those Existing Split-Dollar Plans," supra note 35.

[5] See note 44 for a discussion of when policy equity develops.

[6] See discussion in Ratner and Leimberg, "A Planner's Guide to Split-Dollar After the Final Regulations," supra note 45.

[7] See Lawrence Brody, Michael D. Weinberg, and Myron Kove, "Practice Alert: Experts' Critical Analysis of Final Split-Dollar Regulations," Estate Planners Alert Newsletter (RIA) (Dec. 2, 2003), stating that "Prudence may suggest assuming that the new rules do apply to the switch, notwithstanding that the plan was a pre-final regs. plan." See also Ratner and Leimberg, "A Planner's Guide to Split-Dollar After the Final Regulations," supra note 45 (stating that "the IRS is likely to consider a post-9/17/03 switch from economic benefit regime to loan regime as a material modification of the contract. It's therefore likely that the final Regs. would apply from that point.").

[8] See note 85 for a review of IRC §101(a)(2).

[9] See Joshua E. Husbands and J. Alan Jensen, "Split-Dollar Life Insurance Funding: You Mean People Still Do That?" Probate & Property Magazine, May/June 2008, p. 3 (the parties to the grandfathered split-dollar arrangement "can ignore the equity if they are certain that the policy will be held until the death of the insured(s) and the proceeds paid. Because of the exclusion from income under Code § 101, the entire proceeds should be exempt from income tax and no equity in the policy should be recognized on the payment of the proceeds.").

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