VOLUME 10, ISSUE 2
Apr-Jun 2016

Shenkman

PRACTICAL PLANNER®

Martin M. Shenkman, CPA, MBA, PFS, AEP, JD

SPLIT-DOLLAR LIFE INSURANCE

Summary: A private split-dollar insurance arrangement is one in which two persons/trusts join in purchasing insurance on the life of one person. In the estate planning context, this typically, involves the insured and an irrevocable life insurance trust (ILIT). But it is not limited to this traditional approach. The two parties agree to allocate policy costs and benefits between them and the beneficiaries of the insured. There are two flavors of split-dollar: (1) the economic benefit regime under Reg. Sec. 1.61-22; and (2) the loan regime under Reg. Sec. 1.7872-15.

In a private economic benefit split-dollar arrangement, the ILIT typically pays only the term cost of the life insurance which is modest in the early years of the arrangement. Another party, such as a family member (often the insureds) or a family trust (e.g., an existing funded marital (QTIP) or dynasty trust) pays the remaining portion, which is typically the bulk of the insurance cost in the early years of the arrangement. This arrangement can substantially reduce the amount of current gifts the donor/insured is required to make to the ILIT to purchase the insurance, but nevertheless can assure that the insurance proceeds are removed from the donor/insured's taxable estate. With a $5 million inflation adjusted exemption most taxpayers will not need this reduction in current gifts, although for high net worth taxpayers, or those who have used their exemption, this will remain important. In many planning situations using a split-dollar arrangement to reduce estate value has become a sought after benefit.

Clinton 2: If Hillary Clinton wins the election and pursues President Obama's tax agenda, including a return to 2009 $3.5 million exemption and restrictions on GRATs, grantor trusts and other important estate tax planning techniques, split-dollar may become even more important to planning. If the Democratic platform feels the Bern, the evil 1% is perhaps even more likely to be subjected to estate tax restrictions. So far split-dollar has not made that agenda.

An Estate Planning Challenge: A common estate tax challenge is how to quickly reduce the taxable estate of a wealthy client, especially one that is elderly. While grantor retained annuity trusts (GRATs), grantor trusts and other techniques can shift incredible value out of your estate these techniques often take years to have a significant impact. One technique is based on the use of a split-dollar life insurance plan. "Split-dollar" is not a type of insurance but rather a method of financing the purchase of life insurance. These techniques can be incredibly valuable for ultra-high net worth clients and can be applied in a myriad of ways to accomplish unique planning goals. But split-dollar planning can be an incredible tool for more moderate sized estates as well.

Example: Jane is 88 years of age and has a taxable estate. Jane's assets are comprised almost entirely of highly appreciated stocks she has held for many decades. Jane borrows from her bank using her appreciated assets as collateral. The cash borrowed is loaned to an insurance trust for Jane's son Tom, age 48. The funds are used to purchase a permanent life insurance policy on Tom's life. The loan is structured as a split-dollar loan so that interest can be accrued until the loan

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CHECKLIST: SPENDING

Summary: Your spending rate might be the most important factor in determining your financial security. Even those who think their wealth enables them to ignore pedestrian discussions like budgets need to address this because their burn rate could be so high that even they could face a problem.

√ Longevity: You don't want to be eating cat food in your 90s so you need to consider the impact of real life expectancy not just some average life expectancy. Life expectancy is not a simple concept. The wealthy live longer so the rules of thumb you see in the consumer media are made from a different hand. The longer you live the longer you may live. So have your financial forecasts out to perhaps age 95+ unless you have a known health risk. Refine your analysis and get a real life expectancy evaluation so that your budgeting and estate planning is based on your life expectancy not some average number.

√ Get Real Budget: It is remarkable how many financial forecasts are based on guestimates or canned numbers. Don't blame the wealth manager or financial planner, most prefer doing real financial planning as the foundation of an investment plan, and using real data for the

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...Split-Dollar Life Insurance

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matures. As a split-dollar loan the loan term is not limited to the life of the lender, Jane. The split-dollar loan in fact matures when Tom dies and the life insurance policy pays off. On Jane's death her estate is reduced by the debt she owes the bank. The split-dollar loan is, however, included in Jane's estate. However, the value of that loan, which pays no interest or principal until Tom dies is worth significantly less than the face amount of the loan. No independent party would pay much for a loan made at current low interest rates that pays nothing for potentially four or more decades. The difference between the face amount of the loan and its substantially lower fair value reduces the value of the estate for tax purposes potentially providing a significant estate tax savings. If Tom had no estate planning, retirement plan or life insurance in place before this, the split-dollar plan can in a single step create a robust financial safety net for him.

Morrissette Case: A recent tax case approved the use of a split-dollar plan. C. Morrissette Est., 146 TC No. 11, CCH Dec. 60,574. The taxpayer was in her 90s and incapacitated. She created a revocable trust (the payor) that advanced funds to be used for premium payments for life insurance owned by three dynasty trusts (formed by mom's conservator), under a split-dollar arrangement. Each child had a dynasty trust and that trust used the funds received from mom's revocable trust to buy a life insurance policy on the two other siblings. The insurance was to be used as part of the succession plan for the family owned businesses, which included Interstate Van Lines. Family members entered into a buy sell/cross-purchase shareholders' agreement that required the surviving children to purchase shares held by a deceased child. Mom's revocable trust contributed approximately $10 million to each of the three dynasty trusts, for a total of $30 million. Of the $10 million received $5 million was used immediately for insurance premiums that were sufficient to cover the anticipated premium cost for the insurance for each child's lifetime. Caution: There was a non-tax reason for the split-dollar arrangement and insurance. Courts might view an arrangement that has no non-tax motives differently.

The IRS argued that the entire $30 million transfer was a taxable gift. Mom's position was only that the "economic benefit cost" was a gift each year so that the amount of taxable gift was very modest. Some of the issues considered:

Δ If the split-dollar arrangement terminated during either the life of the insured child, or at the insured child's death, the revocable trust/payor would have to receive the greater of the premiums paid or the cash value of that policy.

Δ The dynasty trusts and their beneficiaries could only receive the benefit of the life insurance protection but no other benefits, such as the benefit of the cash value. Thus, the dynasty trusts had to be prohibited from borrowing on the policy. They were. The IRS argued that by paying all premiums at one time the payor revocable trust gave a further benefit to the dynasty trusts, namely that they did not have to pay future premiums. Because the split-dollar agreement made the payor revocable trust solely responsible for premiums the dynast trusts had no obligation to pay premiums and therefore could not realize another benefit by the payment of the premiums at inception.

Δ The IRS argued that the arrangement was an impermissible reverse split-dollar agreement. The court rejected that argument.

Δ On mom's death her revocable trust/payor owned the right to receive the greater of the premiums paid or the cash value of each policy on the death of the child. The revocable trust was included in mom's estate so that right had to be valued. The estate's appraiser valued this approximately $30 million payment at $7.5 million, about a 75% discount. Unfortunately, the Court did not rule as to whether this was the correct value.

Δ Split-dollar arrangements are a creature of the tax Regulations that define them. Adherence to those Regulations, as in the Morrissette case is vital. PP

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...Checklist: Spending Rates

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budget numbers. But many clients often shun the process, or are too put out to come out with real budget numbers. Would you want your doctor using average blood results in prescribing your meds? If you don't do the real homework (like putting your finances on Quicken, Mint or something similar so you can track spending) guessing at your current and future expenses is a dangerous practice that could understate your current standard of living (which means cat food), or might even overstate it (meaning you could kick it up a notch and splurge on the Burger King regular menu instead of buying value meals).

√ **Withdrawal Rate: So you've retired and have a pot of money. What percentage of that pot can you take out every year and remain secure in your financial future. Too high a withdrawal rate could mean you run out of money. Too low a rate could mean a lower quality lifestyle then you want. William Bengen wrote an article in Financial Advisor Magazine "Is 4.5% Still Safe?" If you have $7 million you might be able to withdraw $315,000/year and remain financially secure. This can be a really useful rule of thumb for initial planning discussions. But a deeper discussion is really necessary. This rate was determined by evaluating rates of return on a portfolio since 1926 and calculating a withdrawal rate that will suffice for 30 years of post-retirement life. The safe withdrawal rate has declined over time. A retiree in the 1930s might have been able to sustain a 5.85% rate. A 4.5% rate has been sustainable for about the past 50 years, but for those retiring in 2000 or 2008, just prior to large stock market declines, the 4.5% rate might be too aggressive.**

√ **Revisit your Rate: Remember the 4.5% rate is designed to provide a maximum rate that won't run out in the worst case scenarios. If after several years of positive results you should reevaluate your withdrawal rate as it may be safe to increase it. That may be safer then gambling with a rate that might be too high and later having to cut your standard of living. Caution is in order because the analysis of safe withdrawal rates shows that those retiring in different calendar quarters can have significantly different results.**

√ **Investment Allocation: Calculation of the 4.5% withdrawal rate presumes 35% large cap stocks, 20% small cap stock and 45% intermediate government bonds. If you've invested more aggressively, or have a more diversified investment allocation, how may your results differ?**

√ **Define "Retirement": The calculation of the 4.5% withdrawal rate assumes you retire and then live without working for 30 years. 82 percent of working Americans over 50 say it is at least somewhat likely they will work in retirement. Forecast your results. A modest amount of work in retirement may suffice to swing the results for you.**

√ **Be Sensitive: Once your financial planner has created forecasts for you do some sensitivity analysis. Ask "what if" questions and see how changes impact your results. In many cases an expense that had been paid for years (e.g., an insurance policy that may no longer be needed), or an idle asset that can be sold and added to your investment pot (e.g. a vacation home that is used less frequently than that waffle maker you can't find), might swing bad results to a tolerable range.** PP

Recent Developments

■ **Watch Formalities: Mom, Esq. supposedly hired her kids to do part time work in her law practice and claimed a $29,000 deduction for their wages. She had no records, issued no W-2s, etc. Big shocker the court disallowed most of the deduction. Fisher, TC Summ. Op. 2016-10 (3/8/2016). Had Mom, Esq. been a bit careful this could have been a cool plan. You can avoid payroll taxes on paying minor kids working in your business and if the wages are less than the standard deduction amount for earned income, Junior won't owe any tax.**

■ **Executor Liability: An executor is personally liable for the estate's estate tax liability if the assets of the estate are distributed to the beneficiaries and the executor knew or should have known of the IRS's claim. CCA 201212020. In a recent case the executor was not held liable because the estate lacked assets to pay the tax and many assets were non-probate assets. Singer, TC Memo 2016-48 (3/14/2016). Before doing a happy dance executors should consider the liability they might face with new Form 8971.**

■ **Marital Residence: The IRS was able to enforce a tax lien to force the sale of a home even though only the husband, but not the wife, was delinquent on his taxes. The wife had argued that only the husband's half of the house should have been subjected to the lien. The court did not agree. U.S. v. Davis, 117 AFTR 2d ¶2016-499 (6th Cir., 3/9/2016).**

■ **LLC Tax Basis: Investors formed an LLC treated as a partnership for tax purposes. The taxpayer did not contribute any capital to the LLC but provided services without compensation. The business failed and he deducted his share of the loss. The Court held he had no tax basis from the services provided until he reported the salary in income. Hastings, TC Memo 2016-61 (4/5/2016)). Had this service partner guaranteed LLC debt he might have had at-risk basis to support the deduction.**

■ **The above tax updates courtesy of Prof. John J. Connors' Monthly Tax Update. Email John for more info or a subscription TaxesProf@msn.com.** PP

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Announcement: Melvyn H. Bergstein, Esq. has joined Shenkman Law, Of Counsel. He concentrates his practice primarily in commercial, probate, and employment litigation and is a Certified Civil Trial Lawyer, recognized by the Supreme Court of New Jersey. He is also admitted in New York.

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Planning Potpourri

■ **Revocable trusts. These trusts, not merely a will, should be the default approach to estate plans for many. Consider replacing your current will with a revocable trust and "pour-over" will. Revocable trusts have been touted for decades as a tool to avoid probate. While that might be beneficial, there are many more important uses of this document. A revocable trust, especially if combined with a trust protector and other checks and balances, can be a useful technique to protect you as you age or in the event health challenges worsen. Trusts for heirs formed under a revocable trust may be easier to move to trust friendly jurisdictions.**

■ **Special needs trusts. The provisions that are required in New Jersey differ than those required for trusts under New York because of what is known as the New Jersey trust buster provision. The trigger mechanism should be incapacity and the definition should track the definition provided under the law. If your document has not been reviewed, your special child moved to NJ, or your document silent (can anyone assure they won't have a special needs descendant), review them.**

■ **Seed Gifts: Sales of assets to grantor trusts have become a common estate planning technique for larger estates. Some commentators have long subscribed to a mythical requirement that before assets can be sold to a trust that trust should have assets/ value equal to 10% of the value of the assets to be sold. That Chimera never really comported with applicable law, but had become de rigueur as commentators kept repeating the myth. Other commentators have suggested instead that a reality of sale construct be used (whether or not the 10% seed gift is addressed). Under this approach the buyer should be able to demonstrate a reasonable likelihood that it will be able to make the payments required. There are other points to consider. Although taxpayers have had a recent victory on a note sale transaction, other techniques, such as a sale to a disregarded LLC followed by a contribution to a GRAT might warrant consideration instead. Also, with so many wealthy clients having created trusts in prior years (especially 2012) it may be feasible to engage in transactions with trusts that already have significant assets and perhaps assets unrelated to the asset being sold.** PP

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