

Part 1

The Side Fund Split-Dollar Solution™: A New Technique for Split-Dollar

The Side Fund Split-Dollar Solution™ is an innovative technique that—despite the split-dollar Regulations—allows clients and their families to acquire life insurance on a tax-favored basis that minimizes both income and transfer taxes.

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This article discusses an old-new technique—split-dollar life insurance. Split-dollar has fallen into disfavor in recent years as the government tightened the rules in 2003 with the issuance of the split-dollar final Regulations.¹ Nevertheless, as will be demonstrated, split-dollar in the “2005-2006 model” can be as good as (or sometimes even better than) the old split-dollar. This new technique is called the “Side Fund Split-Dollar Solution™” (“SFSDS” for short).² It is likely that there will be a renaissance of split-dollar over the coming years

as new and creative techniques are developed, because split-dollar is still an effective way to finance large life insurance purchases.

Why the Side Fund Split-Dollar Solution™?

Why use the Side Fund Split-Dollar Solution™ (and life insurance in general) in estate and business planning? Life insurance in general—and SFSDS in particular—are used for the tax-efficient funding of the following liquidity needs.

1. *Estate taxes.* The first need is the payment of estate taxes; life

insurance has traditionally been used to fund estate taxes.³

2. *Other estate liquidity needs.* These could be other liquidity needs at a client’s death, such as estate equalization among heirs and key person replacement. Funding state death taxes may be another liquidity need. Even if the federal estate tax is repealed, there may still be state death taxes. In fact, some states have increased their estate taxes to make up for the loss of the state death tax credit that used to be available against the federal estate tax. Another liquidity need that might require funding is the capital gains tax resulting from the new carryover basis regime that will likely accompany any federal estate tax repeal.

3. *Business continuity plans.* The classic continuity situation occurs when one child is active in a family business and the other children are not involved in the business. How are their respective shares made equitable? Frequently, the child in the business will own life insurance, typ-

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ically financed by split-dollar between the child and the business, to fund the purchase of the parent's shares at death. The other children will receive these sales proceeds or separate life insurance proceeds (also financed via similar split-dollar), which helps equalize their shares with those of the son or daughter who is working in the business.

4. *Buy-sell agreements.* Life insurance has long been used to fund buy-sell agreements.⁴ Split-dollar works very well here, particularly in cross-funded, cross-purchase-type agreements, where each stockholder or partner owns a policy on the life of the other, and split-dollar is used to minimize the cash flow burden on each policyowner.

5. *Charitable bequests.* If the assets in the estate are relatively illiquid, or the client does not want to leave family corporation stock or other business interests to charity, life insurance is a good funding device. Alternatively, perhaps stock in a closely held business is given to the charity, and the life insurance can be used to redeem the stock from the charity at the insured's death. If the stock redemption is from a family foundation, care is required to avoid violating the private foundation prohibited transaction rules.⁵ Whether a public or private charity, life insurance can be an effective tool for buying back stock that was given to the charity.

6. *Defective grantor trust installment notes.* Most advisors are familiar with the estate planning technique of a sale to a defective grantor trust,⁶ which has been a favored strategy for several years now. It involves the sale of an appreciating asset (usually as an asset of a discounted entity, such as a family limited partnership ("FLP") or a limited liability company ("LLC")) to a trust in exchange for an installment note. The trust is created as a grantor trust, so there is neither

capital gains tax to the grantor resulting from the sale, nor income generated by the interest the grantor receives.⁷ The installment note is later repaid from the trust. The result is that the appreciation in the property sold to the trust (in excess of the interest paid to the grantor) passes estate, gift, and generation skipping transfer ("GST") tax-free to the children and grandchildren, as beneficiaries of the trust.

If the note is outstanding at death, life insurance owned by, and payable to, the trust can be used to pay it off. Many practitioners like to have these notes paid off during the life of the grantor, to the extent the cash flow of the trust permits it.⁸ If that's the case, the trust's life insurance proceeds can be used to replace the assets that were used to repay the grantor during life—a form of "wealth replacement."

The split-dollar final Regulations

The IRS issued split-dollar final Regulations effective 9/17/03,

which can be briefly summarized as follows:

There are two mutually exclusive tax regimes for split-dollar plans entered into (or materially modified) after 9/17/03. The first regime is the economic benefit or endorsement regime, which is covered by the first section of the Regulations, Reg. 1.61-22. This approach should be familiar, since it is traditional endorsement split-dollar with a few twists. Basically, tax is imposed on the annual term cost (what used to be called the "PS-58 cost"), which is referred to in this article as the "ATC." The policy is owned by the corporation (or other business entity) in employer-employee split-dollar, or by the grantor-insured in private split-dollar.⁹ The split-dollar Regulations have actually helped private split-dollar, because this form of split-dollar was relatively untested before these Regulations were issued,¹⁰ and the final Regulations gave official IRS sanction to the concept.

¹ TD 9092, 68 Fed. Reg. 54336 (9/17/03), *corrected*, 2003ARD 219-5 TD 9092, Correction (11/10/03).

² The Side Fund Split-Dollar Solution™ is a trademark of The Weinberg Group.

³ In October 2005, there seemed to be the potential for federal estate tax repeal. This potential is certainly greater under the Bush administration than it was under the Clinton administration, and it is greater today because of House and Senate control by the Republicans. The House has voted again to repeal the estate tax after year 2010, H.R. 8 (4/13/05). Since this is the fourth time the House has passed repeal to no avail, obviously the crucial issues will be decided by the Senate. A Senate vote on repeal scheduled for September 2005 was indefinitely postponed in the aftermath of Hurricane Katrina.

⁴ The authors wrote a book comprehensively covering this subject, *The Insured Stock Purchase Agreement with Sample Forms*, for *The Insurance Counselor* primer series published by the Real Property, Probate & Trust Law Section of the American Bar Association.

⁵ See the "estate administration" exception to the self-dealing rules of IRC Section 4941 for qualifying stock redemptions from a private foundation. Reg. 53.4941(d)-1(b)(3).

⁶ Many articles have been written about the sale to a defective grantor trust technique. Generally, transactions between a grantor and a grantor trust are not recognized and are treated as a nullity for income tax purposes because the grantor is treated as transacting with himself. Rev. Rul. 85-13, 1985-1 CB

184. For two articles dealing specifically with the use of life insurance in a defective grantor trust, including split-dollar, see Jansen, "Split-Dollar Has Split—So How Do We Finance Premiums Now?," 38 *U. Miami Heckerling Inst. on Est. Plan.* ¶ 1307 (2004), and Weinberg, "Reducing Gift Tax Liability Using Intentionally Defective Irrevocable Outstanding Trusts," 4 *J. Asset Protection* 62 (Jan./Feb. 1999).

⁷ Instead, the grantor is taxed on the income, credits, or deductions generated by the assets in the trust.

⁸ Paying off the note during the grantor's life would avoid the risk that the grantor would be treated as if he had sold the policy to the trust for the balance of the note at the grantor's death when the trust ceases to be a grantor trust. For further elaboration, see Jansen, *supra* note 6, at ¶¶ 1302.2 and 1307.2.

⁹ The case study that will be discussed in Part 2 of this article is a private split-dollar case. Concerning employer-employee split-dollar, this article assumes that the types of plans discussed here (non-equity economic benefit plans providing only a death benefit and split-dollar loans bearing interest at the AFR and repayable at maturity) are not subject to the new deferred compensation rules of Section 409A. See Preamble to Section 409A Proposed Regulations, REG-158080-04, 70 Fed. Reg. 57930-57984, § II.H, pp. 51-53 (9/29/05). Concerning private split-dollar, Section 409A would not apply in any event because this Code section operates only in an employer-employee or other specified compensatory context.

The second regime treats the premiums advanced as split-dollar loans. This regime is covered by the second section of the Regulations, Reg. 1.7872-15. This approach is the current version of the former collateral assignment split-dollar plan. The old type of equity collateral assignment split-dollar¹¹ is effectively no longer available, although, as will be discussed, a collateral assignment arrangement can still be used after the Regulations.

Generally, if the employee or an irrevocable life insurance trust (“ILIT”) owns the policy, the split-dollar loan regime governs—not the economic benefit regime.¹² The Regulations now permit policy equity to belong to the employee or ILIT, but at a different tax cost. That cost is a tax on interest on the premium loans, measured by the applicable federal rate (“AFR”),¹³ rather than ATC on the insurance death benefit measured by the (presumably) lower split-dollar term rate.

Although the rules were tightened by the split-dollar final Regulations, new split-dollar plans can continue to operate within those

rules. Furthermore, the rules applicable to split-dollar were clarified, so that practitioners now know what these ground rules are.

Another major impact of the split-dollar Regulations is in determining the annual term cost attributable to the death benefit, the ATC.¹⁴ How to measure ATC is very important for split-dollar arrangements subject to the economic benefit regime.¹⁵ There are three possible methods of measuring ATC:

1. IRS Table 2001 is the first measure of term cost. This table was issued in 2001, several years before the Regulations were adopted.¹⁶ The Table 2001 term rates are provided only on an individual life basis, and, although they are lower at every age than the table of PS-58 costs which they replaced, they are quite high compared to the old carrier alternative individual term rates.

Notice 2002-8¹⁷ provides that taxpayers could apply these individual rates to survivorship insurance. A number of insurance carriers applied a formula to the Table 2001 individual rates similar to the “Greenberg to Greenberg” formula, which was previously used in extrapolating from the individual PS-58 rates to the US-38 or Table 38 rates for survivorship coverage. The resulting Table 2001-based survivorship rates, applicable while both insureds are alive, are very low. In fact, up to about age 70 for husband and wife, the Table 2001-based survivorship rates are even lower than the old carrier alternative survivorship rates in many cases. Thus, it may be advantageous to base survivorship split-dollar term rates on Table 2001 (at least while both insureds are alive).

2. The second measure of ATC is the life insurance premium factors. The split-dollar Regulations specified that these premium factors would be published in the Internal Revenue Bulletin.¹⁸ However, nothing

has been issued since September 2003, and this topic is apparently not high on the IRS’s list of priorities. Therefore, advisors are still using Table 2001 in the interim. It is thought that these premium factors, when issued, will actually be lower than the Table 2001 rates.¹⁹

3. The third measure of ATC is the lower of the Table 2001 rates or the carrier’s alternative term rates, at least until the IRS issues the life insurance premium factors discussed in the preceding paragraph. Notice 2002-8 provided grandfathered protection for alternative term rates used in pre-1/28/02 split-dollar plans.

In Notice 2002-8, the IRS also addressed permissible term rates for new arrangements. Essentially, the Service said that for split-dollar plans entered into after 1/28/02 (i.e., the effective date of the Notice), lower carrier term rates could continue to be used after 2003, so long as those rates complied with the additional requirements of the Notice. Those requirements were that the rates were made known to the insurer’s customers and applied to policies regularly sold through its normal distribution channels.²⁰ An important question was whether the Notice 2002-8 compliant carrier term rates could continue to be used for new split-dollar plans entered into after 9/17/03, the effective date of the final Regulations. This question has apparently now been answered in the affirmative.

On 4/15/05, the IRS published on its website what are known as its Executive Compensation Audit Technique Guides (“ATGs”).²¹ The Service stated in the split-dollar portion of the ATGs that carrier alternative term rates could continue to be used for new post-9/17/03 split-dollar plans, provided those rates comply with Notice 2002-8, and, additionally, the rates are published rates available to all persons who

¹⁰ See Ltr. Ruls. 9636033 and 9745019.

¹¹ “Equity” means cash value in excess of the amount necessary to repay the corporation or the grantor for their premium outlays.

¹² However, as discussed in detail in the text at note 36, *infra*, a non-equity collateral assignment arrangement between a donor and a donee, or an employer and an employee, will continue to be subject to the economic benefit regime.

¹³ Interest on these loans must be paid or accrued at the AFR appropriate to the loan term, or interest will be imputed to the borrower. Reg. 1.7872-15(e).

¹⁴ This cost used to be called the “PS-58 cost.”

¹⁵ Under the loan regime, it is not important because interest costs, instead of ATC, will determine the amount of the economic benefit.

¹⁶ Table 2001 was republished as part of Notice 2002-8, 2002-1 CB 398.

¹⁷ 2002-1 CB 398.

¹⁸ Reg. 1.61-22(d)(3)(ii).

¹⁹ The Table 2001 rates are based on the Table I group term rates under Section 79 which do not take underwriting factors into consideration. As a result, Table 2001 probably overstates ATC.

²⁰ These rates are called “compliant” carrier alternative term rates in this article.

apply for term insurance from the insurer plus meet certain other specified requirements.²² It's unclear whether compliant carrier term rates will continue to be available for split-dollar plans adopted after the IRS issues its new life insurance premium factors.

The ability to use compliant carrier alternative term rates is a major advantage because these rates are much lower than the Table 2001 rates, especially for individual insurance.²³ It isn't clear whether those rates will continue to be available for new split-dollar plans entered into after the life insurance premium factors are issued. Consequently, there may be an opportunity for using carrier alternative term rates for new plans adopted now.²⁴ Of course, it is important that an insurance carrier's alternative term rates comply with Notice 2002-8 and the ATG. If the alternative rates do not comply, the ATG states that the IRS should recompute ATC using Table 2001, which will usually result in higher annual term costs for

income, gift, and GST tax purposes. In addition, a portion of the insurance death benefit could become subject to income taxation under the split-dollar Regulations.²⁵

To conclude this discussion of ATC, why is it important to use split-dollar instead of premium loans or premium bonuses or gifts? The answer is to minimize taxes. Accordingly, an important goal of the Side Fund Split-Dollar Solution™ will be to preserve favorable ATCs for as long as possible. Income and gift taxes will be kept as low as possible if low split-dollar term costs can be preserved, as opposed to having to use higher interest costs for premium loans or the amounts of the premiums themselves for premium bonuses or gifts.

Gift tax minimization will become especially important if the federal estate tax is repealed. The reason is that under the present system, gift taxes paid during life are credited against estate taxes due at death. If gift tax is paid and the estate tax is eliminated, the gift tax will no longer serve as a "prepayment" of the estate tax (and a potential "estate freeze" transaction), because there will be no estate tax against which to offset this prepayment. Therefore, a donor's payment of gift taxes no longer would involve merely a timing difference between the time of the gift and the time of death—it would become an absolute cost. Gift taxes likely will remain in force even if estate taxes are repealed. Moreover, the present gift tax lifetime exemption remains at \$1 million per spouse, and it doesn't increase as the estate (and GST) tax exemptions do.²⁶

Implementing the Side Fund Split-Dollar Solution™

There are five steps to implementing the SFSDS.

1. The client creates an intentionally defective grantor trust (an

"IDGT"), funded with assets in addition to a life insurance policy, which will also serve as the ILIT.²⁷ The term "defective grantor trust" means that for income tax purposes, the trust is defective (so that the grantor is taxed on the trust's income, credits, and deductions), but for estate tax and gift tax purposes, the trust is effective (to keep the trust assets out of the grantor's estate). There are no income tax consequences resulting from transactions between a grantor and his grantor trust.²⁸ For example, if the grantor sells appreciated property to the trust, the built-in capital gain is not recognized.²⁹

To fund the grantor insurance trust in the case study described in Part 2 of this article, the grantors simply will use gift tax annual exclusions and lifetime exemptions, if needed. They also might have been able to employ some of the more sophisticated estate planning techniques currently available.

For example, as mentioned above, a grantor could fund a grantor insurance trust by selling appreciated stock or partnership interests (usually at a discount) to the trust in return for the trust's installment note (with interest at the AFR). All the payments of interest and principal would be non-taxable to the grantor, and the property could grow in the trust free of gift, estate, and GST taxes. Another sophisticated technique to fund the grantor insurance trust is for the grantor to simultaneously create a grantor retained annuity trust (a "GRAT") and provide that the GRAT remainder will pass to the grantor insurance trust upon termination of the GRAT.³⁰ These estate planning tools are designed to get assets into the grantor insurance trust on a gift tax-favored basis in order to fund the life insurance purchase.

2. The second step is to have the client implement a donor/donee

²¹ See <http://www.irs.gov/businesses/corporations/article/0,,id=135045,00.html>.

²² The rate must not be based on a policy with a renewal feature, the carrier's rate sheet may not use words such as "not for publication" or "internal use only," and the carrier must sell individual term policies.

²³ See the discussion in the text at note 17, *supra*, concerning survivorship insurance.

²⁴ Plans that use these rates perform as well as (and sometimes even better than) old pre-Regulation split-dollar plans.

²⁵ Reg. 1.61-22(f)(3)(i). See also, in Part 2 of this article, the discussion in "Illustration 1" of alternative designs if compliant carrier term rates are not available in a particular case.

²⁶ The estate (and GST) tax exemption is \$1.5 million in 2005, and \$2 million in 2006.

²⁷ This might be called combining an IDGT with an ILIT.

²⁸ See note 6, *supra*. For common "defects" that can be used to cause the trust to be defective, see Jansen, *supra*, note 6, at ¶ 1302.2.

²⁹ See Rev. Rul. 2004-64, 2004-27 IRB 7, holding that the grantor's payment of income tax on the grantor trust's income is not a gift to the trust.

³⁰ This assumes that the ILIT is a non-generation-skipping trust, because the grantor's GST exemption can't be allocated to the property transferred to the GRAT until the grantor's term interest ends pursuant to the "ETIP" rules of Section 2642(f)(1).

non-equity collateral assignment split-dollar plan between the grantors and the trust. In the case study, we will use a private split-dollar plan. The plan also could be a corporate non-equity, collateral assignment, split-dollar plan in which the arrangement is between the employer corporation and an employee or a grantor insurance trust created and funded by the employee. The insurance policy involved can be either individual insurance or survivorship insurance.

The concepts of “non-equity” and “collateral assignment” are both important to the SFSDS technique. An “equity” plan means that the trust owns the cash value in excess of the amount required to repay the grantor or corporation for their premium outlays. This excess is called the policy “equity,” and equity split-dollar is one of the major areas the IRS dealt with in the split-dollar Regulations.

The Regulations provide that the equity under an economic benefit or endorsement split-dollar plan is taxable if the trust has “access” to it (as broadly defined in the Regulations).³¹ The taxes involved may be gift taxes in the case of private split-dollar, or both income and gift taxes in the case of corporate split-dollar. Depending on the structure of the plan, the equity could be taxable as it accrues,³² or at the time

of repayment of the grantor or corporation for their premium outlays.³³ Therefore, SFSDS contemplates a donor/donee or corporation/employee collateral assignment non-equity plan,³⁴ to avoid these potentially adverse tax results.

Next, a collateral assignment is executed by the trust in favor of the grantor or corporation and filed with the insurance carrier. Generally under the economic benefit split-dollar regime of the Regulations, the grantor or corporation owns the policy.³⁵ However, in non-equity arrangements, the Regulations also permit the trust to own the policy and collaterally assign a security interest in the policy to the grantor or corporation in order to secure their premium outlays.³⁶ This arrangement will still be treated as economic benefit split-dollar, and not as a split-dollar loan, provided that the plan is a non-equity plan, and if the only benefit provided to the trust is current life insurance protection—i.e., an interest in the policy death benefit.³⁷ This technique is sometimes called “collateral endorsement” split-dollar.

A possible reason that the government permits this nominal ownership in the trust and securing the grantor’s or corporation’s policy interest via a collateral assignment is to allow the grantor/insured to avoid estate taxable incidents of ownership where the insured is the premium provider (as typically he or she will be) in private split-dollar, or where the insured is a majority stockholder of the corporation in corporate split-dollar. Accordingly, estate taxation of the life insurance can be avoided with a properly drawn “limited rights” (a/k/a “bare bones”) collateral assignment,³⁸ which will—at the same time—fit within the economic benefit regime. In addition, since, by definition, the arrangement is non-equity, there is no risk of tax-

ation of policy equity if the trust owns the policy.

3. Ultimately, the grantor or the corporation will be repaid for their split-dollar advances from the trust side fund, if the arrangement terminates during the insured’s lifetime, because this trust is going to be funded and will have assets in it. This is very different from an old type of split-dollar plan. In the old split-dollar technique, sufficient premiums were paid so that the policy could be both rolled out (i.e., the grantor or corporation would be repaid their split-dollar advances from the policy cash value), and then continued without further premium payments by applying the remaining policy cash value equity. This old technique required large premiums to generate sufficient cash value to carry out the rollout, which can be avoided with the new SFSDS technique.

If there are sufficient assets in the trust to repay the grantor at the planned rollout time, the trust will transfer these assets to him.³⁹ It is very important to make the repayment in a year in which there is no policy equity. If there is policy equity at that time, payment of the equity to the grantor or corporation would result in unnecessarily repaying them more than their premium outlay and perhaps could trigger adverse tax consequences to the



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³¹ Reg. 1.61-22(d)(1).

³² Regs. 1.61-22(d)(2)(ii) and 1.61-22(d)(4).

³³ Regs. 1.61-22(c)(1)(ii)(B)(2) and 1.61-22(g).

³⁴ In such a plan, the premium provider is entitled to the greater of the premiums advanced or the policy’s cash value (ignoring surrender or similar charges).

³⁵ See the text accompanying note 9, *supra*.

³⁶ This is the case in either donor/donee or employer/employee arrangements.

³⁷ Reg. 1.61-22(c)(1)(ii)(A).

³⁸ See Rev. Rul. 76-274, 1976-2 CB 278, *modified* by Rev. Rul. 82-145, 1982-2 CB 213; Rev. Rul. 79-129, 1979-1 CB 306; Ltr. Ruls. 9511046, 9651017, 9651030, 9709027, 9746004, 9746006, and 9848011.

³⁹ In a corporate context, the assets usually will have to be converted to cash, which will be used to repay the corporation, generating taxable gain or loss for the grantor.

recipient.⁴⁰ Alternatively, if the plan is then modified to give the equity to the trust, this transfer of equity would be a taxable transaction.⁴¹

In private split-dollar, any taxable equity transferred to the trust would be a gift from the grantor to the trust. In corporate split-dollar, such taxable equity would be both income to the employee and a gift by the employee to the trust. If there aren't sufficient assets in the trust to repay the grantor or corporation at the time of planned rollout, then a switch to a loan can be made at that time, and the rollout will be accomplished by a note. Rollout via a note needs to be done in a year in which there is no policy equity.

4. Annual term costs will also be paid to the grantor or the corporation from the trust side fund or, if a switch to a loan occurs, annual interest will be paid from the side fund.⁴² This is again different from the old split-dollar where the trust was unfunded, and the grantor made annual gifts of the term cost to the trust. In our case example (in Part 2 of this article), in order to fund the trust, the gifts will be annual exclusion gifts made by the grantors. Also, in old split-dollar, once rollout occurred, premium payments usually did not continue. This may not be true with SFSDS. If there are continuing premiums after rollout, they will also be paid from the trust side fund, and if there are insufficient assets to pay these continuing pre-

miums, they can be paid with additional loans from the grantor or the corporation.

5. Finally, if there are any loans outstanding, incurred either at rollout or from continuing premium payments after rollout, these also will be repaid from the side fund during the insured's life or from the insurance proceeds at the insured's death.⁴³

Other options

There are several other plans that may be considered as alternatives to SFSDS. Generally, SFSDS is designed for the large insurance case in order to minimize income, gift, and GST taxation.⁴⁴ For smaller insurance purchases, the following alternatives may suffice.

1. The first option is a collateral endorsement "switch-dollar" plan. As with SFSDS, the idea behind this technique is to start in split-dollar to capture low term costs, and then switch to a loan at the appropriate time. The plan is a non-equity endorsement-type plan, the ILIT is the nominal owner of the policy, and a collateral assignment is used to secure the premium outlays of the premium payer (the grantor or corporation).

Unlike SFSDS, the ILIT is typically unfunded, similar to old split-dollar plans. However, just before equity accrues, the plan switches to a loan—hence the term "switch-dollar." The loan switch prior to equity is necessary to avoid taxation of the equity. With this technique, interest costs are incurred at some point, replacing the lower term costs—which is the disadvantage of the technique. Nevertheless, it may work quite well in a specific case, especially where the premiums are more modest, and therefore the interest costs after the switch are not unduly burdensome.

2. A second possibility is a non-equity endorsement-type plan for the insured's life (which could be

in the collateral endorsement format). This plan remains available under the split-dollar Regulations, as it was before the Regulations. The problem is that as the insured ages, the annual term costs continue to increase, and at some point, these costs will exceed the premium (even with survivorship insurance). So, this may not be such a great plan, especially if your client has to be told that he or she has to die early in order to make the plan work! The technique may be realistic for a relatively small policy, but not for the large case.

3. A third alternative is to use split-dollar premium loans from the outset. Interest costs at the AFR may be higher than ATC, although not necessarily always, especially if the insured in a single life policy arrangement is older, and current Table 2001 individual term rates are applied. Furthermore, inasmuch as each premium payment is con-

⁴⁰ However, there would not be tax consequences to the grantor in a private split-dollar situation because of the interplay of the grantor trust rules and the holding of Rev. Rul. 85-13.

⁴¹ See note 33, *supra*.

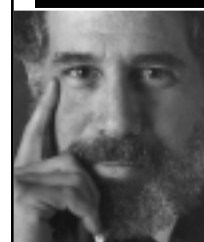
⁴² A contributory arrangement in a corporate context would be income to the corporation under the Regulations (Reg. 1.61-22(f)(2)(ii)), but would not be income to the grantor in a private context because of the interplay of the grantor trust rules and Rev. Rul. 85-13.

⁴³ Interest on all these loans should be at the AFR. See note 13, *supra*.

⁴⁴ A "large" insurance case is typically a case where the annual premium is \$100,000 or more. Below that amount, the premium usually can be covered by gift tax annual exclusions and lifetime exemptions, if needed.

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Practice Notes

The Side Fund Split-Dollar Solution™ contemplates combining a funded defective grantor trust with split-dollar life insurance—private or corporate—to produce outstanding tax results.

sidered as a separate loan under the Regulations,⁴⁵ future interest costs are less predictable than term costs, which can be determined up front at the plan's inception.⁴⁶

4. Another alternative is premium gifts (in a private arrangement) or bonuses (in a corporate arrangement). For larger amounts of insurance, though, the tax costs of premium gifts or bonuses are just too great. That's why split-dollar is used in large cases—to minimize the tax costs.

5. Financed life insurance is another option, including financing from outside sources, such as a bank or other lending institution. Here, an entirely additional set of considerations come into play, which are generally beyond the scope of this article. Split-dollar can be considered as an inside or self-financing technique, because the insured or his corporation finances the premiums. This results in considerable control over the arrangement, within the limits of the split-dollar Regulations.

On the other hand, with an outside creditor, there are additional risks. Typically, the client will lack control over interest rates and therefore, will lack control over gifts to the trust to pay that interest; the loan term generally will be limited in duration with no guarantee of renewal; the insured will usually have to pledge collateral or personally guarantee the loan; policy performance may deteriorate and thereby adversely affect loan collateral requirements; a lifetime exit strategy may not have been contemplated; and the loan agreement

will be decidedly in favor of the creditor and usually will involve excessive paperwork. In short, the risk level is increased with outside financing compared to the inside financing available with split-dollar.

Nevertheless, if a client is interested in outside financing, the insured or corporation can step in and undertake the premium loans with the creditor and then turn around and effect split-dollar (or split-dollar loans) with the ILIT—a “back-to-back” financing arrangement. The reason for this extra step is to leverage the difference between interest paid to the outside lender and the low term rates possible with split-dollar, so that the tax consequences are governed by these lower rates.

Generally, the Side Fund Split-Dollar Solution™ is designed for the large insurance case in order to minimize income, gift, and GST taxation.

Outside financing has recently gotten much more expensive. The typical premium financing deal is the LIBOR rate plus a spread of 150 to 200 basis points—let's say 175 basis points for a reference point. In October 2004, the one-month LIBOR was 1.91%. In October 2005, it was 4%, so the current loan interest for an outside premium loan could exceed 5-3/4% (subject to periodic adjustments as interest rates rise or fall). Consequently, ATC under split-dollar, or even interest at the AFR on split-dollar premium loans, will usually be lower than interest paid to an outside creditor.

6. Finally, the old technique of death benefit-only (“DBO”) plans is a possibility. In this technique, the employer owns and is the ben-

eficiary of the life insurance policy, and at death, the insured employee's beneficiaries get paid a death benefit by the employer, in an amount equal to the insurance proceeds. The employer receives these proceeds income tax-free under Section 101(a)(1); however, the death benefit payments the employer makes to the employee's beneficiaries are subject to ordinary income taxation, as income in respect of a decedent. The result is that otherwise income tax-free life insurance proceeds are effectively converted into taxable income when received by the beneficiaries. Accordingly, this usually is not a very satisfactory type of plan when large amounts of life insurance are involved.

A final thought about plan alternatives: it is virtually impossible to assess different premium payment plans on a conceptual or theoretical basis. Detailed computer modeling is required to analyze and quantify the alternatives, usually applying net present value cost (“NPV”) and rate of return (“ROR”) methodology. Part 2 of this article, which will appear in the next issue of ESTATE PLANNING, will present a case study using the Side Fund Split-Dollar Solution™. This case study is based on split-dollar modeling programs developed by The Weinberg Group for use with their clients and advisors.

Nothing contained in this article is to be considered as providing investment, legal, or tax advice. Each person is responsible for consulting his or her own professional advisors concerning the ideas and techniques discussed. ■

⁴⁵ Regs. 1.7872-15(a)(2)(i) and 1.7872-15(a)(2)(iv), Example 1.

⁴⁶ In an appropriate case, lending many or all of the premiums planned to be paid under the plan up front would allow the interest rate to be fixed for the term of the loan at the AFR when the loan was made.

Part 2

How an Innovative New Technique for Split-Dollar Life Insurance Works

This second part of a two-part article presents a case study using the Side Fund Split-Dollar Solution™—an innovative technique that combines a funded defective grantor trust with split-dollar life insurance to produce excellent tax results.

LAWRENCE BRODY AND MICHAEL D. WEINBERG, ATTORNEYS

This article analyzes a new split-dollar life insurance technique called the “Side Fund Split-Dollar Solution™” (“SFSDS” for short).¹ The first part of this two-part article examined the background of this strategy.² This second part of the article focuses on a case study in which SFSDS is used.

Case study—The facts

Mort and Mollie Berg are the clients and the insureds in this case. Mort is age 65, Mollie is 60, and they both are nonsmokers and in good health. The insurance policy on their lives will be a \$10 million survivorship, guaranteed no-lapse, universal life policy (sometimes called a “guaranteed universal life” or “GUL” policy). A guaranteed no-lapse universal life policy (either survivorship or individual) is a popular newer species of UL policy.³ This type of policy provides for a death benefit guaranteed by the issuing insurance company so long as the specified premium is timely

paid, and no loans or withdrawals are made from the policy. If these requirements are met, the policy will remain in force even though the cash value drops to zero, a very different result compared with the

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traditional UL policy. Another feature of the SFSDS technique is that it is expressly designed for use with guaranteed no-lapse policies because of their unique cash value characteristics (discussed more later).

The plan is a non-equity collateral assignment split-dollar plan. As previously discussed,⁴ the plan is non-equity to avoid taxation of the equity, and it can use a collateral assignment with the trust as nominal owner and still be considered an economic benefit (endorsement) type of plan because it is non-equity. A limited rights collateral assignment will be used to avoid incidents of ownership in the insureds.⁵ Finally, the grantor insurance trust created by the Bergs is the applicant, owner, and beneficiary of the policy.

Case study—The plan

The SFSDS plan for Mort and Mollie Berg operates over four relevant time periods:

1. During the split-dollar period,
2. At rollout,
3. During the loan period (if any), and
4. At death.

Exhibit 1—During the split-dollar period. The Bergs create the grantor insurance trust and fund it with annual exclusion gifts and lifetime exemption gifts if necessary.⁶ The insurance is a survivorship policy on the lives of both the Bergs. Since this is private split-dollar, the split-dollar agreement is between them and the trust.⁷ This is a “contributory” split-dollar plan, and each year, the trust pays the annual term cost (“ATC”) to the Bergs. While the Regulations provide that term cost contributions are normally taxable as income to the recipient (unlike the prior rules),⁸ that would not be the case here, because the trust is a grantor trust, and transactions between the grantors and their trust are disregarded for income tax purposes.⁹ Of course, the Bergs will be taxable on the trust income, if any, earned from trust investments. If the recipient of the term contributions had been a corporation, as in employer/employee split-dollar, the term

EXHIBIT 1 During Split-Dollar Period

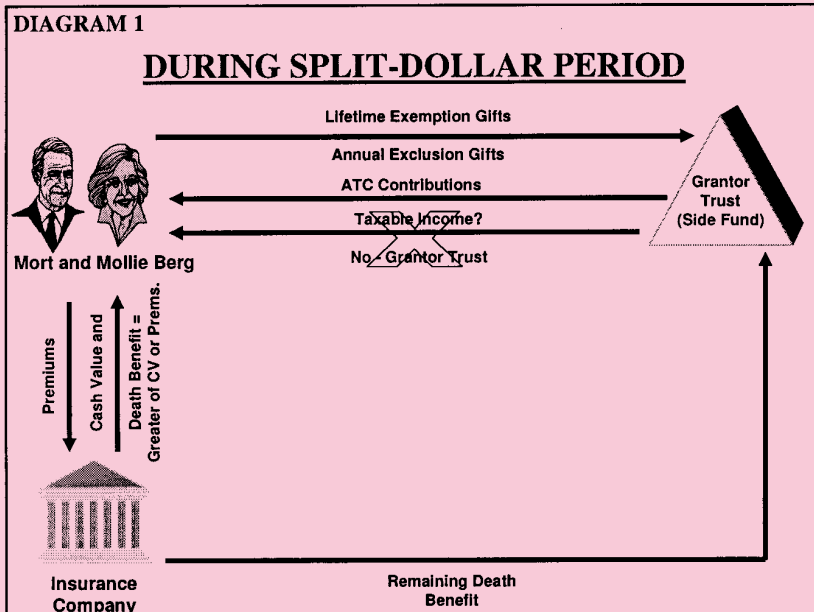
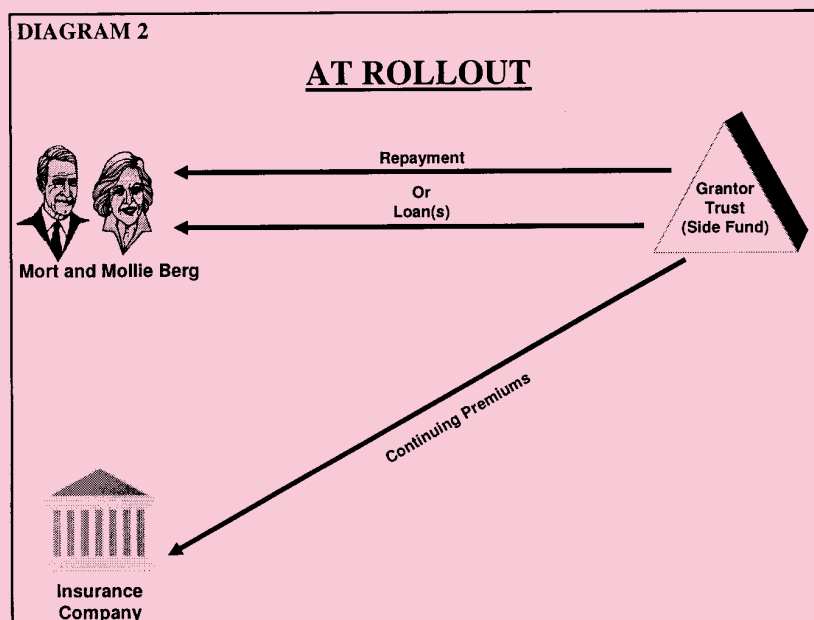


EXHIBIT 2 At Rollout



¹ The Side Fund Split-Dollar Solution™ is a trademark of The Weinberg Group.

² See Brody and Weinberg, “The Side Fund Split-Dollar Solution™: A New Technique for Split-Dollar,” 33 ETPL 3 (Jan. 2006) (hereinafter, “Brody and Weinberg, Part 1”).

³ For two excellent recent articles about this type of policy, see Malarkey and Leimberg, “Innovative Planning With ‘No-lapse Guarantee’ Life Insurance,” 32 ETPL 3 (July 2005), and Rybka and Jones, “Guesses, Projections, Promises, and Guarantees,” 59 J. Financial Service Professionals 50 (July 2005).

⁴ See Brody and Weinberg, Part 1, *supra* note 2.

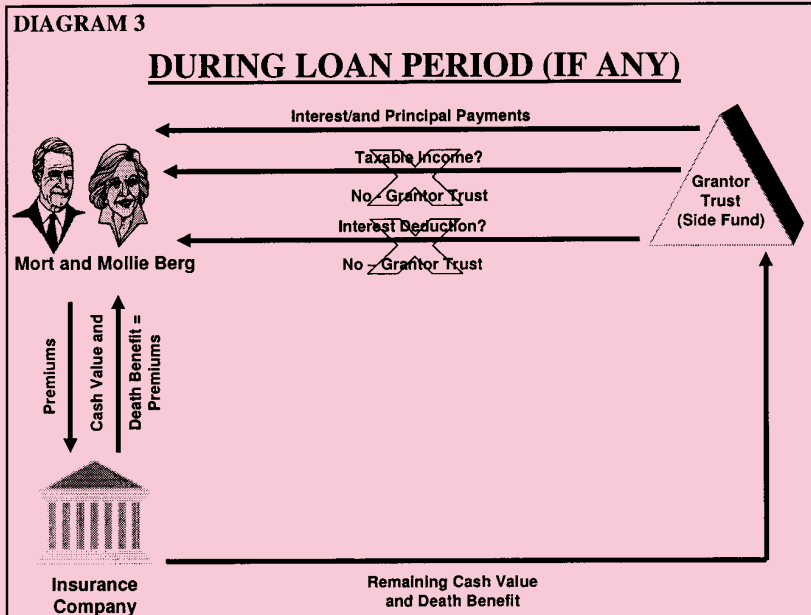
⁵ See Rev. Rul. 76-274, 1976-2 CB 278, modified by Rev. Rul. 82-145, 1982-2 CB 213; Rev. Rul. 79-129, 1979-1 CB 306; Ltr. Ruls. 9511046, 9651017, 9651030, 9709027, 9746004, 9746006, and 9848011.

⁶ It turns out that only annual exclusion gifts are necessary in this case.

⁷ The plan is a non-equity collateral assignment arrangement, which is treated as economic benefit split-dollar even though the trust nominally owns the policy.

⁸ Reg. 1.61-22(f)(2)(ii).

EXHIBIT 3 During Loan Period (If Any)

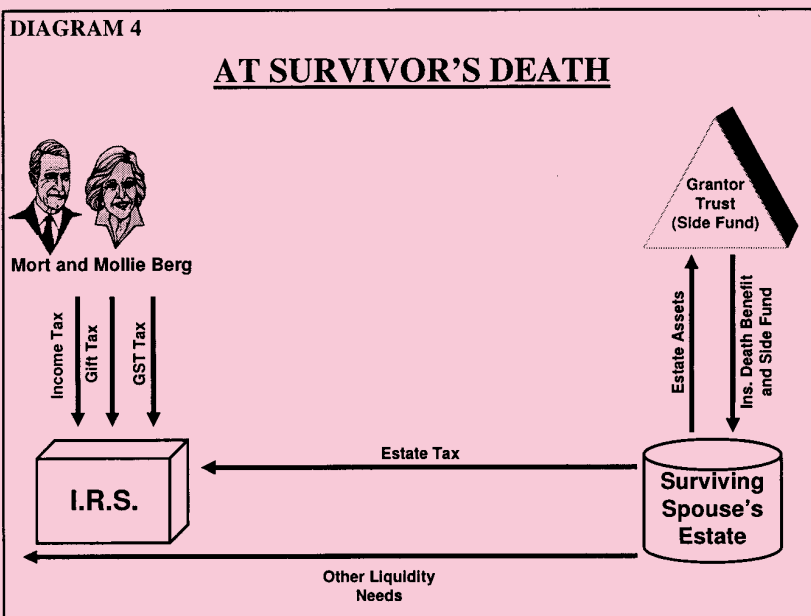


costs would have been income taxable to the corporation under the Regulations.

Premiums are paid by the Bergs to the insurance company, and they take back a restricted collateral assignment from the trust to secure their premium outlays. Because this is a non-equity split-dollar plan, the Berg's security interest in the cash value and death benefit of the policy equals the *greater* of the cash value (ignoring surrender charges) or premiums paid, and the trust is entitled to the balance of the death benefit. A limited rights (bare bones) collateral assignment is used here to avoid the possession of

⁹ With a survivorship policy, as in this case, an interesting question is who should be the grantor—husband, wife, or both? Here, both spouses are the grantors, for several reasons. First, the annual term cost ("ATC") and interest payments to the co-grantor spouses from the trust would be nontaxable under the grantor trust rules, and, following the death of the first spouse, these payments to the surviving grantor-spouse should continue to be nontaxable (at least in part). Second, a roll-out (discussed in the text at note 11, *infra*) may effectively be considered as a transfer of the policy from the grantors (or surviving grantor) to the trust, raising the issue of transfer for value under Section 101(a)(2), which would subject the insurance death benefit to income tax. Consequently, as a precaution, it is important that both spouses (or at least the surviving spouse) be considered the grantor at the time of rollout to come within the exception provided by Section 101(a)(2)(B) for a transfer to the insured pursuant to the doctrine of *Swanson*. *Swanson*, 518 F.2d 59, 36 AFTR2d 75-5159 (CA-8, 1975). In any event, such a policy transfer should be ignored for income tax purposes and therefore not be considered a transfer for value. See Ltr. Ruls. 200120007, 200228019, and 200247006, all involving transfers of survivorship policies to grantor trusts. Finally, on this point, conservative advisors may want to use a "belt and suspenders" approach and also structure a rollout to come within another exception to the transfer-for-value rule, such as the partner/partnership exception of Section 101(a)(2)(B), especially where the rollout is by a surviving grantor, who might not be considered the grantor of the entire trust. Jansen, "Split-Dollar Has Split—So How Do We Finance Premiums Now?," 38 *U. Miami Heckerling Inst. on Est. Plan.* ¶¶ 1306.5 and 1307 (2004), and Weinberg, "Reducing Gift Tax Liability Using Intentionally Defective Irrevocable Outstanding Trusts," 4 *J. Asset Protection* 62 (Jan./Feb. 1999). For more about the transfer-for-value rule, see Brody and Leimberg, "Avoiding the Tax Trap of the Transfer-for-Value Rule," 32 *ETPL* 3 (Oct. 2005), and Brody and Leimberg, "Using a Transactional Analysis to Avoid the Transfer for Value Rule," 32 *ETPL* 3 (Nov. 2005).

EXHIBIT 4 At Survivor's Death



estate taxable incidents of ownership by the Bergs.¹⁰

Exhibit 2—At rollout. At the designated time, the policy will “roll out,” meaning the trust will repay the grantors their cumulative premium outlay (or the cash value—ignoring surrender charges—if greater) from the trust side fund assets.¹¹ If there are insufficient assets in the trust to repay the grantors at rollout, the deficiency will be made up by a loan from them to the trust. In other words, the plan will switch at that point from economic benefit to split-dollar loan.¹²

So long as there is no policy equity at the time of repayment or loan switch, there will be no adverse tax consequences from the rollout.¹³ One of the challenges of SFSDS is to design the plan to make certain that policy equity does not exist at the time of rollout. Once rollout occurs and the split-dollar plan ends, future equity can accrue to the trust, and the trust thereafter can have an interest in both cash value and death benefit without adverse tax consequences.¹⁴ Finally, any continuing premiums following rollout also will be paid from the trust side fund or by additional loans if there are insufficient trust assets to pay the continuing premiums.

Exhibit 3—During the loan period (if any). Loans could exist between the grantors and their trust, either because trust assets are

¹⁰ See note 5, *supra*.

¹¹ If the grantors both died before rollout, the trust would repay this amount to the survivor's estate from the policy death benefit.

¹² Referred to as “switch-dollar” in Brody and Weinberg, Part 1, *supra* note 2.

¹³ In a corporate context, the assets usually will have to be converted to cash, which will be used to repay the corporation, generating taxable gain or loss for the grantor.

¹⁴ See Reg. 1.61-22(g)(4) and Reg. 1.61-22(h), Example 5.

EXHIBIT 5 Policy Information

ILLUSTRATION 1

- THIS IS A SAMPLE CASE TO BE USED FOR EDUCATIONAL PURPOSES ONLY -

H's Age	W's Age	Year	Policy Information				Grantor Outlays and Benefits				
			(1) Annual Policy Premium	(2) Policy Cash Value (Net of Policy Loans)	(3) Policy Cash Surr. Value (Net of Policy Loans)	(4) Policy Death Benefit (Net of Policy Loans)	(5) Annual Trust ATC/Premium Contribution Received (a.)	(6) Beginning Loan Balance	(7) Annual Loan	(8) Loan Repayment	(9) Ending Loan Balance (Col. 6-7+8)
65	60	1 2004	\$126,500	\$67,599	\$0	\$15,000,000	(\$1,190)	\$0	\$0	\$0	\$0
79	74	15 2018	126,500	2,060,222	2,060,222	10,000,000	(4,764)	0	0	0	0
80	75	16 2019	0	2,109,072	2,109,072	10,000,000	(5,524)	0	0	0	0
81	76	17 2020	0	2,145,662	2,145,662	10,000,000	(6,598)	0	0	0	0
82	77	18 2021	0	2,164,739	2,164,739	10,000,000	(7,914)	0	0	0	0
83	78	19 2022	0	2,164,577	2,164,577	10,000,000	(68,717)	0	0	0	0
88	83	24 2027	248,033	1,826,051	1,826,051	10,000,000	(126,124)	0	0	0	0
89	84	25 2028	248,033	1,807,715	1,807,715	10,000,000	(142,710)	0	0	0	0
90	85	26 2029	248,033	1,730,177	1,730,177	10,000,000	(162,667)	0	0	0	0
94	89	30 2033	248,033	825,819	825,819	10,000,000	(270,404)	0	0	0	0
95	90	31 2034	248,033	446,003	446,003	10,000,000	0	0	0	0	0
96	91	32 2035	248,033	13,514	13,514	10,000,000	0	0	0	0	0
104	99	40 2043	248,033	0	0	10,000,000	0	0	0	0	0
			\$6,114,061				(\$1,830,279)		\$0	\$0	

EXHIBIT 6 Grantor Outlays and Benefits

ILLUSTRATION 2

- THIS IS A SAMPLE CASE TO BE USED FOR EDUCATIONAL PURPOSES ONLY -

H's Age	W's Age	Year	Grantor Outlays and Benefits							
			(10) Annual ATC Received (a.) (Col. 5*-3)	(11) Annual Interest @ AFR Received (b.) (Col. 9*AFR)	(12) Annual Int. @ AFR and ATC Received (Col. 10+11)	(13) I/T on Ann. Int. and ATC Rcvd (c.) (Col. 12*0.00)	(14) Annual Insurance Outlay (Col. 1 Unit Repayment +5 - Repayment 6)	(15) Cumulative Insurance Outlay	(16) Cash Value Recovery	(17) Death Benefit Recovery
65	60	1 2004	\$1,190	\$0	\$1,190	\$0	\$125,310	\$125,310	\$67,599	\$125,310
79	74	15 2018	4,764	0	4,764	0	127,346	1,858,329	2,060,222	2,060,222
80	75	16 2019	5,524	0	5,524	0	(4,524)	1,852,805	2,109,072	2,109,072
81	76	17 2020	6,598	0	6,598	0	(6,598)	1,846,207	2,145,662	2,145,662
82	77	18 2021	7,914	0	7,914	0	(7,914)	1,838,294	2,164,739	2,164,739
83	78	19 2022	68,717	0	68,717	0	(68,717)	1,769,577	2,164,577	2,164,577
88	83	24 2027	126,124	0	126,124	0	126,124	1,520,553	1,826,051	1,826,051
89	84	25 2028	142,710	0	142,710	0	142,710	1,625,877	1,807,715	1,807,715
90	85	26 2029	162,667	0	162,667	0	162,667	1,711,242	1,730,177	1,730,177
94	89	30 2033	270,404	0	270,404	0	270,404	1,803,452	825,819	1,803,452
95	90	31 2034	0	0	0	0	(1,803,452)	0	0	0
96	91	32 2035	0	0	0	0	0	0	0	0
104	99	40 2043	0	0	0	0	0	0	0	0
			\$1,830,279	\$0	\$1,830,279	\$0	\$0			

**EXHIBIT 7
Trust Outlays and Benefits**

ILLUSTRATION 3

- THIS IS A SAMPLE CASE TO BE USED FOR EDUCATIONAL PURPOSES ONLY -

			Trust Outlays and Benefits									
H's Age	W's Age	Year	(18)	(19)	(20)	(21)	(22)	(23)	(24)	(25)	(26)	(27)
			Annual Interest Gift To Trust (d.)	Annual ATC Premium Gift To Trust (a.)	Taxable Policy Equity Gift To Trust (f.)	Lifetime Exemption/Annual Excl. Gift to Trust (e.)	Total Annual Gifts To Trust (Col. 18-21 +20+21)	Annual G/T Cost (g.)	Repayment of Grantor During Life (h.)	Net Cash Value After GR Recovery (Col. 2-16)	Net Cash Surrender Value After GR Recovery (Col. 3-16) if > 0	Net Ins. Death Benefit After GR Recovery (Col. 4-17)
65	60	1 2004	\$0	\$0	\$0	\$110,000	\$110,000	\$0	\$0	\$0	\$0	\$14,874,690
79	74	15 2018	0	0	0	110,000	110,000	0	0	0	0	7,939,778
80	75	16 2019	0	0	0	110,000	110,000	0	0	0	0	7,890,928
81	76	17 2020	0	0	0	110,000	110,000	0	0	0	0	7,854,338
82	77	18 2021	0	0	0	110,000	110,000	0	0	0	0	7,835,261
83	78	19 2022	0	0	0	55,000	55,000	0	0	0	0	7,835,423
88	83	24 2027	0	0	0	55,000	55,000	0	0	0	0	8,173,949
89	84	25 2028	0	0	0	55,000	55,000	0	0	0	0	8,192,285
90	85	26 2029	0	0	0	55,000	55,000	0	0	0	0	8,269,823
94	89	30 2033	0	0	0	55,000	55,000	0	0	0	0	8,196,548
95	90	31 2034	0	0	0	55,000	55,000	0	(1,803,452)	446,003	446,003	10,000,000
96	91	32 2035	0	0	0	55,000	55,000	0	0	13,514	13,514	10,000,000
104	99	40 2043	0	0	0	55,000	55,000	0	0	0	0	10,000,000
			\$0	\$0	\$0	\$3,190,000	\$3,190,000	\$0	(\$1,803,452)	0	0	10,000,000

insufficient to repay the grantors at rollout or because additional premium payments are required following rollout, or both. Interest will have to be charged on these loans at the applicable federal rate ("AFR") to avoid the imputed interest rules of the split-dollar loan Regulations.¹⁵ The diagram in Exhibit 3 illustrates that interest (like the ATC) paid by the trust to the grantors would not be income taxed to them because of the grantor trust rules.¹⁶ Furthermore, interest payments would not be deductible by the trust for several reasons—e.g., the grantor trust rules, the personal interest rules under Section 163(h), and the non-qualifying interest rules under Section 264(a).¹⁷

If a switch to a loan occurs at rollout, the grantors' security interest in both cash value and death benefit thereafter can be limited to their premium outlays (assuming there was no equity at the time of the switch). Consequently, future equity can accrue to the trust after the loan switch.¹⁸ The cost is that now the trust must pay AFR interest, rather than ATC, presumably a higher cost. Finally, the loan(s) from the grantors will be repaid by the trust at such time as the side fund has grown sufficiently to permit the repayment or from the policy death proceeds, if the grantors die before then.

**EXHIBIT 8
Trust Assets, Including Side Fund**

ILLUSTRATION 4

- THIS IS A SAMPLE CASE TO BE USED FOR EDUCATIONAL PURPOSES ONLY -

			Trust Assets Including Side Fund										
H's Age	W's Age	Year	(28)	(29)	(30)	(31)	(32)	(33)	(34)	(35)	(36)	(37)	(38)
			Total Annual G/Ts to Trust (Col. 22)	Net AT Value of Side Fund After Total Annual G/Ts (Col. 29 + Col. 28)	Annual Income on Side Fund (Col. 29 * 0.06)	Annual UT on Income (Col. 30 * 0.00)	Net Annual Income After UT (Col. 30 - 31)	Net Value of Side Fund After UT (Col. 29 - 32)	Repayment of Grantor During Life (h.) (Col. 24)	Annual ATC/Interest/Premium Payments (Col. 12)	Net AT Value of Side Fund After Total Annual G/Ts (Col. 29 + Col. 35)	Net Ins. Death Benefit After GR Recovery (Col. 3-17)	Net Trust Assets (Col. 34-37)
65	60	1 2004	\$110,000	\$110,000	\$6,600	\$0	\$6,600	\$116,600	\$0	(\$1,190)	\$115,410	\$14,874,690	\$14,990,100
79	74	15 2018	110,000	2,512,531	150,752	0	150,752	2,663,283	0	(4,764)	2,658,519	7,939,778	10,598,297
80	75	16 2019	110,000	2,768,519	166,111	0	166,111	2,934,630	0	(5,524)	2,929,106	7,890,928	10,820,034
81	76	17 2020	110,000	3,039,108	182,346	0	182,346	3,221,453	0	(6,599)	3,214,855	7,854,338	11,069,193
82	77	18 2021	110,000	3,324,855	199,491	0	199,491	3,524,346	0	(7,914)	3,516,433	7,835,261	11,351,694
83	78	19 2022	55,000	3,571,433	214,286	0	214,286	3,785,719	0	(68,717)	3,717,002	7,835,423	11,552,425
88	83	24 2027	55,000	4,600,801	276,048	0	276,048	4,876,849	0	(126,124)	4,750,725	8,173,949	12,924,874
89	84	25 2028	55,000	4,805,725	289,343	0	289,343	5,094,058	0	(142,710)	4,951,359	8,192,285	13,143,644
90	85	26 2029	55,000	5,096,359	300,382	0	300,382	5,306,740	0	(162,567)	5,144,073	8,269,823	13,413,896
94	89	30 2033	55,000	5,702,498	342,150	0	342,150	5,644,648	0	(270,404)	5,774,244	8,196,548	13,979,792
95	90	31 2034	55,000	5,829,244	349,755	0	349,755	6,178,959	(1,803,452)	(248,033)	4,127,514	10,000,000	14,127,514
96	91	32 2035	55,000	4,182,514	250,951	0	250,951	4,433,465	0	(248,033)	4,185,432	10,000,000	14,185,432
104	99	40 2043	55,000	4,755,754	286,345	0	286,345	5,041,099	0	(248,033)	4,793,066	10,000,000	14,793,066
			\$3,190,000	\$7,717,127	\$0	\$7,717,127	\$1,803,452	(\$4,310,609)	0	0	0	10,000,000	14,793,066

Exhibit 4—At death. The diagram in Exhibit 4 carries through to the surviving spouse's death, the time at which estate taxes will be imposed on the Bergs' estate.

¹⁵ Interest on these loans must be paid or accrued at the AFR appropriate to the loan term, or interest will be imputed to the borrower. Reg. 1.7872-15(e).
¹⁶ ATC and interest paid by the trust to a corporation in a corporate arrangement would be income to the corporation.
¹⁷ Reg. 1.7872-15(c), but see Reg. 1.7872-15(e)(2)(iii).
¹⁸ See note 14, *supra*.

To review, we've looked at the income tax consequences of this plan during the Bergs' lifetimes. Essentially there are none, because in private split-dollar, transactions between the grantors and their grantor trust are nontaxable events for income tax purposes. We have also looked at the gift tax consequences of the plan. In this case study, the only gifts required to adequately fund the trust are annual exclusion gifts. Therefore, the gifts to the trust are totally free of gift tax.

The generation-skipping transfer ("GST") tax issues associated with this trust need to be addressed because we'll assume the grantor insurance trust created by the Bergs is a generation-skipping trust. Typically, the amount of the gifts to the trust is also the measure of the GST transfers, and GST exemptions are allocated against those amounts. The GST exemption is the same as the estate tax exemption, which is \$2 million per spouse in 2006, and \$3.5 million in 2009.¹⁹ With a generation-skipping trust, gifts to the trust must be within the grantors' available GST exemptions, as well as their gift tax exclusions and exemptions. In the case study, the Bergs' gifts to the trust are covered by their GST exemptions, which will be allocated to each gift to the trust on a gift tax return, to produce a zero inclusion ratio for the trust.²⁰

At the surviving spouse's death, estate assets are purchased by the insurance trust with the trust life insurance proceeds and side fund; that's how the required cash is injected into the estate—via the

EXHIBIT 9 Gift Tax Comparisons

ILLUSTRATION 5

- THIS IS A SAMPLE CASE TO BE USED FOR EDUCATIONAL PURPOSES ONLY -

Gift Tax Comparisons

H's Age	W's Age	Year	Trust Outlays and Benefits					Policy Information				
			(18) Annual Interest Gift To Trust (d.)	(19) Annual ATC/Premium Gift To Trust (e.) (Col. 17 Int.)	(20) Taxable Policy Equity Gift To Trust (f.)	(21) Lifetime Exemption/Annual Excl. Gift to Trust	(22) Total Annual Gifts To Trust	(1) Annual Policy Premium	(2) Policy Cash Value (Net of Policy Loans)	(3) Policy Cash Surre. Value (Net of Policy Loans)	(4) Policy Death Benefit (Net of Policy Loans)	
65	60	1	2004	\$0	\$0	\$0	\$110,000	\$110,000	\$126,500	\$67,599	\$0	\$15,000,000
79	74	15	2018	0	0	0	110,000	110,000	126,500	2,060,222	2,060,222	10,000,000
80	75	16	2019	0	0	0	110,000	110,000	0	2,109,072	2,109,072	10,000,000
81	76	17	2020	0	0	0	110,000	110,000	0	2,145,662	2,145,662	10,000,000
82	77	18	2021	0	0	0	110,000	110,000	0	2,164,739	2,164,739	10,000,000
83	78	19	2022	0	0	0	55,000	55,000	0	2,164,577	2,164,577	10,000,000
88	83	24	2027	0	0	0	55,000	55,000	248,033	825,819	825,819	10,000,000
89	84	25	2028	0	0	0	55,000	55,000	248,033	446,033	446,033	10,000,000
90	85	26	2029	0	0	0	55,000	55,000	248,033	1,730,177	1,730,177	10,000,000
94	89	30	2033	0	0	0	55,000	55,000	248,033	825,819	825,819	10,000,000
95	90	31	2034	0	0	0	55,000	55,000	248,033	446,033	446,033	10,000,000
96	91	32	2035	0	0	0	55,000	55,000	248,033	13,514	13,514	10,000,000
104	99	40	2043	0	0	0	55,000	55,000	248,033	0	0	10,000,000
				\$0	\$0	\$0	\$3,190,000	\$3,190,000	\$6,114,061			

LE/AE GIFT PREMIUM GIFT

EXHIBIT 10 Total Return on Insurance Death Benefit

ILLUSTRATION 6

- THIS IS A SAMPLE CASE TO BE USED FOR EDUCATIONAL PURPOSES ONLY -

TOTAL RETURN ON INSURANCE DEATH BENEFIT

H's Age	W's Age	Year	(1)	(2)	(3)	(4)	(5)	(6)	
			Cumulative Outlay Prior to Current Plan Year	Annual Policy Premium (Pg. 1, Col. 1) - 1033 Amount (if any)	Repayment of Grantor (h.) (Pg. 4, Col. 34)*-1 If Paid From Policy Values	Annual Insurance Outlay (Col. 1 + 2 - 3)	Policy Death Benefit (Pg. 1, Col. 4)	A/T ROR on Policy Death Benefit	
65	60	1	2004	\$0	\$126,500	\$0	\$126,500	\$15,000,000	11757.71%
79	74	15	2018	0	126,500	0	126,500	10,000,000	19.03%
80	75	16	2019	0	0	0	0	10,000,000	17.29%
81	76	17	2020	0	0	0	0	10,000,000	15.82%
82	77	18	2021	0	0	0	0	10,000,000	14.56%
83	78	19	2022	0	0	0	0	10,000,000	13.48%
88	83	24	2027	0	248,033	0	248,033	10,000,000	9.59%
89	84	25	2028	0	248,033	0	248,033	10,000,000	8.44%
90	85	26	2029	0	248,033	0	248,033	10,000,000	8.28%
94	89	30	2033	0	248,033	0	248,033	10,000,000	6.17%
95	90	31	2034	0	248,033	0	248,033	10,000,000	5.73%
96	91	32	2035	0	248,033	0	248,033	10,000,000	5.31%
104	99	40	2043	0	248,033	0	248,033	10,000,000	2.70%
Projected Jt. L.E.				\$0	\$6,114,061	\$0	\$6,114,061		

TOTAL ROR

¹⁹ The GST exemption is tied to the increasing estate tax exemption, and is not limited to the \$1 million per spouse gift tax exemption.

²⁰ Alternatively, the Bergs could rely on the automatic allocation rules of Sections 2632(b) and 2632(c).

EXHIBIT 11
Trust-Only Return on Net Trust Assets

ILLUSTRATION 7
- THIS IS A SAMPLE CASE TO BE USED FOR EDUCATIONAL PURPOSES ONLY -

TRUST-ONLY RETURN ON NET TRUST ASSETS AT DEATH

H's Age	W's Age	Year	(1) Cumulative Gifts to Trust Prior to Current Plan Year <small>(Pg. 3, Col. 22)</small>	(2) Total Annual Gifts to Trust <small>(Pg. 3, Col. 22)</small>	(3) Cumulative Gift Tax Cost Prior to Current Plan Year	(4) Annual GT Cost <small>(Pg. 3, Col. 23)</small>	(5) Total Outlay <small>(Col. 1+2+3+4)</small>	(6) Net Trust Assets <small>(Page 4, Col. 38)</small>	(7) A/T ROR on Net Trust Assets	(8) Equivalent B/T ROR on Net Trust Assets
65	60	1 2004	\$0	\$110,000	\$0	\$0	\$110,000	\$14,990,100	1352.73%	40.40%
79	74	15 2018	0	110,000	0	0	110,000	10,598,297	2.18%	64.18%
80	75	16 2019	0	110,000	0	0	110,000	10,820,034	19.30%	50.33%
81	76	17 2020	0	110,000	0	0	110,000	11,069,193	11.00%	50.84%
82	77	18 2021	0	110,000	0	0	110,000	11,351,694	17.80%	49.89%
83	78	19 2022	0	55,000	0	0	55,000	11,552,425	16.55%	46.47%
88	83	24 2027	0	55,000	0	0	55,000	12,924,674	11.47%	31.76%
89	84	25 2028	0	55,000	0	0	55,000	13,143,644	10.64%	28.99%
90	85	26 2029	0	55,000	0	0	55,000	13,413,896	10.40%	31.50%
94	89	30 2033	0	55,000	0	0	55,000	13,970,792	8.61%	28.99%
95	90	31 2034	0	55,000	0	0	55,000	14,127,514	8.26%	25.02%
98	91	32 2035	0	55,000	0	0	55,000	14,185,432	7.90%	23.94%
104	99	40 2043	0	55,000	0	0	55,000	14,793,066	5.83%	17.67%
Projected Jt. L.E.			\$0	\$3,190,000	\$0	\$0	\$3,190,000			
L.E.			NPV @5.00% int:	\$1,666,011		\$0	\$1,666,011			

purchase of assets from the estate.²¹ The estate will then use this cash to pay estate taxes and for other estate liquidity needs.

Case study—Illustrations

So far, we've described in text and diagrams how the Side Fund Split-Dollar Solution™ works. This final section explains how the numbers work through a series of easily understood illustrations.

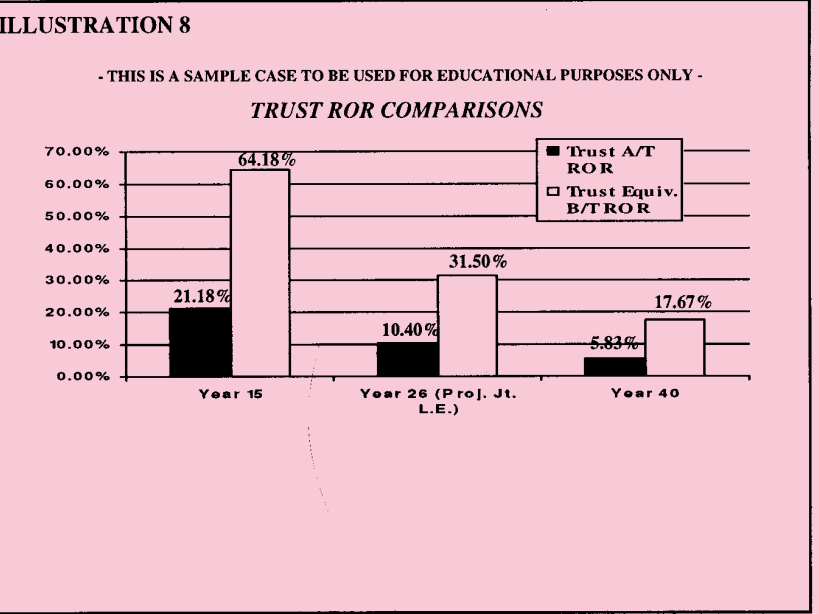
Illustration 1—Policy information.

This illustration appears in Exhibit 5. Column 1 is the annual policy premium. This premium is \$126,500 payable for 15 years, ceasing for the next eight years, and then resuming at a higher level, \$248,033, for the rest of the insureds' lives. The premium payment scenario is part of the plan design and requires insurance expertise in determining the optimum premium flow.

Column 2 of this illustration is the policy cash value (sometimes called the "account value" or "accumulation value"). Notice the bell-shaped curve of this cash value. It starts low, increases to \$2+ million, then decreases, and ultimately reduces to zero by age 99. This is a fairly typical premium pattern for a guaranteed no-lapse UL policy (quite different from a traditional UL or whole life policy where the cash value can be expected to increase over the life of the policy). This cash value characteristic of the policy will be important in the SFSDS design, because it will permit a rollout in a later year when there is no equity.

Column 3 is the policy cash surrender value. This is the policy cash value from Column 2, minus sur-

EXHIBIT 12
Trust ROR Comparisons



²¹ Except in any year in which the carryover basis regime is in effect (currently year 2010), the estate's basis step-up to fair market value at death under Section 1014 will avoid recognition of gain on the sale.

render charges. In determining whether there is policy equity, cash value—prior to surrender charges—is the relevant value.

On 2/13/04, the IRS issued Proposed Regulations about how to value life insurance policies for various purposes. These Proposed Regulations were issued in final form on 8/26/05. Companion safe harbor procedures were also issued, the most recent in April 2005.²² The life insurance valuation Regulations generally appear to be consistent with the split-dollar Regulations. In fact, the Preamble to the final valuation Regulations states: “These final regulations also amend (Regs.) § 1.83-3(e) generally to apply the definition of property for split-dollar life insurance arrangements to all situations involving the transfer of a life insurance contract....” However, these policy valuation rules apply in the employer/employee (or other compensatory) context, and presumably private split-dollar (such as our case study) won’t be affected.²³

The policy death benefit in Column 4 of Illustration 1 is a level \$10 million.²⁴ The insurance death benefit could have been structured as an increasing death benefit (typically used in old split-dollar arrangements) sufficient to pay back the grantors and then net the trust a death benefit of \$10 million. That isn’t done here because the premiums would have been higher, and all that the client really

wants is for the trust side fund plus the insurance to equal \$10 million (which it will, as subsequent Illustration 4 demonstrates).

Column 5 is the annual trust contribution. This is the ATC (annual term cost), calculated here at the lower of the Table 2001²⁵-based term rates and the carrier’s compliant alternative term rates, as previously discussed.²⁶ In year 19, the term cost jumps to \$68,717, from \$7,914 in year 18. What happens here? The illustration assumes that the husband dies at his projected life expectancy in year 18, and that the term cost increases the next year from the survivorship term cost,²⁷ a substantial difference in cost.²⁸ The remaining columns in Illustration 1 refer to loans, which proved unnecessary in this case.

An important observation about the term costs in our model is this: Even though this model incorporates compliant carrier alternative term rates, The Weinberg Group has developed other SFSDS models where these rates are not available—e.g., the particular carrier does not offer such rates. These alternative models include using Table 2001 term rates (or Table 2001-based term rates in the case of survivorship life), starting with split-dollar loans from the outset, or starting in split-dollar and then switching to a loan at the appropriate time using the switch-dollar technique. We found that all these

alternative designs produce excellent results. Therefore, the utility of SDSFS does not depend on the use of compliant carrier term rates, and the technique works well with other designs.

Illustration 2—Grantor premium outlays and benefits. Illustration 2, which appears in Exhibit 6, sets forth the grantors’ premium outlays and benefits. Column 10 is a repeat of the ATC received, already discussed. Column 11 reflects any interest received by the grantors on premium loans if loans had been required to repay the grantors at rollout.²⁹ Column 13 indicates that the grantors paid no income tax on the trust’s ATC contributions. The reason, of course, is that the trust is a grantor trust.

Column 14 is the grantors’ annual insurance outlay, which is the annual premium less the trust’s ATC contribution (the negative numbers in years 16-23 represent positive cash flows to the grantors in years premiums are not paid by them). Column 15 is the grantors’ cumulative insurance outlay, summing up the outlays in column 14. These are two important columns because they illustrate the rollout. The rollout occurs at the beginning of year 31, which is the time the grantors are repaid their cumulative outlay of \$1,803,452 from the trust. At that time, the collateral assignment is released, and substantive policy ownership is acquired by the trust.

Selecting the proper time for rollout is part of the design expertise with SFSDS. We chose the beginning of year 31 because at the end of year 30, ATC slightly exceeds the then-annual premium (\$270,404 vs. \$248,033), and we thought it advisable to cut off the increasing ATC at this point. Furthermore, it is important to make sure that there is no equity trans-

²² TD 9223 (8/26/05), finalizing REG-126967-03, 69 Fed. Reg. 7384 (2/13/04), and Rev. Proc. 2005-25, 2005-17 IRB 962, modifying and superseding Rev. Proc. 2004-16, 2004-10 IRB 559. The final Regulations are substantially similar to the Proposed Regulations and are effective for policy transfers made on or after 2/13/04, the same effective date provided for in the Proposed Regulations.

²³ See Reg. 25.2512-6—the “interpolated terminal reserve” approximation of the replacement value of a policy for gift tax valuation purposes. See also Rev. Proc. 2005-25, *supra*, note 22, and the Preamble to the final Regulations, both warning that this method is appropriate only where the reserve reflects all relevant features of the policy.

²⁴ Actually, in the first four years, the policy death benefit is \$15 million because this particular carrier provides an extra death benefit to cover possible estate inclusion under Section 2035(a) if both insureds die within three years of policy inception.

²⁵ Table 2001 was republished as part of Notice 2002-8, 2002-1 CB 398.

²⁶ See Brody and Weinberg, Part 1, *supra* note 2.

²⁷ The survivorship rates are available only while both insureds are alive.

²⁸ This model permits assuming the husband’s death in any specified year—here, his projected life expectancy was chosen.

²⁹ As noted, loans were unnecessary in this case.

ferred to the trust in the rollout year to avoid subjecting that equity to gift taxation.³⁰ There is no equity at the beginning of year 31 because the cash value at the end of year 30 of \$825,819 in column 16 is less than the grantor outlay at that time of \$1,803,452 in columns 14 and 15; equity is the *excess* of cash value (excluding surrender charges) over premium outlay, which obviously doesn't exist here.

The cash value bell-shaped curve for the guaranteed no-lapse UL policy is what makes it possible to accomplish the rollout in a year in which there is no policy equity. Equity does exist in earlier years (years 15-26), so a rollout in those years could have been costly. The SFSDS technique is expressly designed to capitalize on this cash value characteristic of a GUL policy.

This raises an interesting possibility. Could the grantors be repaid just the \$825,819 cash value at rollout time, rather than their full outlay of \$1,803,452? The split-dollar Regulations seemingly permit the payback of just the cash value. In essence, the Regulations provide that a substantive change of policy ownership to the trust is a modification of the arrangement which is treated as a transfer of the policy, and so long as the grantors receive the then fair market value of the policy, defined as the cash value, there does not appear to be any taxable transaction.³¹ Obviously, this is a more aggressive position, and we would need a client who understands the risk of rolling out for the lower cash value. This risk is that the client could be making an unintended gift of almost \$1 million, the difference between the \$1.8 million grantor outlay and the \$825,000 cash value.

The last column in Illustration 2, column 17, is the grantors' death benefit recovery which the surviv-

ing spouse's estate will receive if she dies prior to lifetime repayment at rollout. The amounts in this column simply match the grantors' cumulative insurance outlay in column 15 or the cash value recovery in column 16, whichever is greater.

Illustration 3—Trust outlays and benefits. Illustration 3 is shown in Exhibit 7. As columns 21 and 22 of this illustration indicate, the trust in this case will be entirely funded by Mr. and Mrs. Berg's gift tax annual exclusions, and it is unnecessary to use their lifetime gift tax exemptions. In this case, assume that the Bergs, a couple in their 60s, have a total of five children and grandchildren, and each of these beneficiaries has Crummey withdrawal powers. Because each spouse has annual exclusions of \$11,000 per donee in 2005 (the year of this illustration),³² the Bergs can make annual gifts to the trust of \$22,000 per donee, a total of \$110,000 a year. However, that's while they're both alive. Once one of them dies, only the surviving spouse's annual exclusions remain available. In this illustration, assume that Mr. Berg dies at his projected life expectancy in year 18, and only Mrs. Berg's annual exclusions are used thereafter.

The last column in Illustration 3, column 27, is the trust's net insurance death benefit after the grantors' recovery. Because the total insurance death benefit is a level \$10 million (\$15 million in the first four years), the trust's portion of that death benefit decreases as the grantors' portion increases (shown in column 17 on prior Illustration 2) until the time that the grantors are repaid their outlay at rollout. Alternatively, the total insurance death benefit could have been designed as an increasing death benefit that includes the amount

necessary to repay the grantors. The result would have been a net level death benefit of \$10 million for the trust.

Illustration 4—Trust assets including side fund. Illustration 4, which appears in Exhibit 8, shows the various additions and subtractions pertaining to the trust assets, including the side fund. Most of these items are self-explanatory, so our comments will be limited to select columns.

Column 30 is the annual income earned on the trust side fund.³³ We used a conservative 6% income assumption in this model. Column 31 indicates that the trust is not taxed on the side fund income because it's a grantor trust. In essence, the income earned by the trust on its assets is both a before- and after-income-tax number, and this is shown in column 32.³⁴

Column 34 shows the \$1.8 million repayment of the grantors at rollout in year 31. Column 35 is all the other disbursements from the side fund, including ATC, interest, if any, and continuing premium payments after rollout.

Column 37 is the trust's net insurance death benefit after the grantors' recovery of their outlays. And, finally, Column 38 is the net trust assets, including both insurance proceeds and side fund, at the surviving grantor's death. The net trust assets exceed \$10 million in every year, which meets the clients' goal of at least \$10 million in the

³⁰ This would apply for both income taxation and gift taxation in the case of employer/employee split-dollar.

³¹ See Regs. 1.61-22(c)(1)(ii)(B)(2) and 1.61-22(g). It may be that the split-dollar agreement at inception would have to provide for such a cash value rollout.

³² The gift tax annual exclusion, which is indexed for inflation, increased to \$12,000 in 2006.

³³ This column reflects both current income and asset appreciation.

³⁴ See Rev. Rul. 2004-64, 2004-27 IRB 7.

trust at all times following both grantors' deaths.

Illustration 5—Gift tax comparisons. Illustration 5, which is shown in Exhibit 9, compares the gift tax consequences of the SFSDS plan vs. outright gifts of the premiums by the Bergs. With the SFSDS plan, total gifts could go as high as \$3.1 million. However, all those gifts qualify for gift tax annual exclusions through the use of Crummey powers. Consequently, the Bergs do not have to pay any gift tax or even consume any of their \$1 million gift tax lifetime exemptions.

Alternatively, if the Bergs had made outright premium gifts, the total gifts could have exceeded \$6.1 million. Using the same amount of potential gift tax annual exclusions as under the SFSDS plan (\$3.1 million), the Bergs could have exhausted both of their lifetime exemptions and additionally made taxable gifts of almost \$1 million. This example illustrates the tax leverage available by using split-dollar vs. gifting the entire premiums.

Illustration 6—Total return on insurance death benefit. Illustration 6 appears in Exhibit 10. Column 6 of this illustration reflects the annual rate of return ("ROR") on the total insurance death benefit. At the grantors' death at projected joint life expectancy in year 26, the annual ROR exceeds 8%, and this is a *guaranteed* rate of return because the policy is a GUL policy. In today's market environment, 8% for life is a respectable overall rate of return, especially on a guaranteed basis.³⁵

Illustration 7—Trust-only return on net trust assets at death. Illustration 7, which appears in Exhibit 11, shows the annual rate of return on the grantors' outlays to the trust—that is, their gifts to the trust, compared with the net trust assets at death, both insurance and side fund. Focusing on just the trust ROR is an important and legitimate inquiry because it demonstrates the benefits and leverage of split-dollar. In essence, the grantors in private split-dollar (and the corporation in employer/employee split-dollar) forego the use of their money used to pay premiums for a period of time in order to generate all the income, gift, estate and GST tax advantages to the trust for the benefit of the insureds' family.

Column 5 of this illustration is the grantors' gifts to the trust, and column 6 is the net trust assets. Column 7 is the after-tax trust ROR on net trust assets at death based on these cash flows. This column illustrates the annual trust ROR for each year from the present through year 40 (which is Mrs. Berg's age 99). At the grantors' projected joint life expectancy in year 26, the trust annual ROR on net trust assets at death is 10.4% after tax. The insurance portion of this ROR calculation is guaranteed, and the side fund portion incorporates a conservative 6% annual return.

But, that's not quite the whole story. Column 7 shows rates of return *after* income and estate taxes. Column 8 shows the equivalent *before-tax* rates of return on net trust assets at death by grossing up the after-tax RORs for income and estate taxes (40% income tax rate and 45% estate tax rate in this model). At the grantors' projected joint life expectancy in year 26, the equivalent annual

before-tax ROR on net trust assets at death is 31.5%. In other words, the trust would have had to earn 31.5% per year before income and estate taxes to match this benefit. Most clients would be unable to achieve this ROR on their other investments, and this illustration demonstrates again the outstanding tax leverage of SFSDS.³⁶

Illustration 8—Trust ROR comparisons. Illustration 8 is shown in Exhibit 12. These graphs compare trust RORs on net trust assets at death at three points in time: early death in year 15, death at projected joint life expectancy in year 26 (just discussed), and late death in year 40. The black bars represent the after-tax rates of return and the gray bars the equivalent before-tax rates of return. Even at late death in year 40, when Mrs. Berg (the assumed surviving spouse) is age 99, the after-tax ROR on net trust assets is 5.83%, and the equivalent before-tax ROR is 17.67%. These are respectable rates of return even at that advanced age.

Conclusion

Split-dollar life insurance is alive and well in the post-Regulations environment. Using such advanced techniques as the Side Fund Split-Dollar SolutionTM, clients and their families can continue to acquire life insurance on a tax-favored basis that minimizes both income and transfer taxes. While this article mainly discusses private split-dollar, corporate split-dollar in the employer/employee context using this concept works equally well.

Nothing contained in this article is to be considered as providing investment, legal, or tax advice. Each person is responsible for consulting his or her own professional advisors concerning the ideas and techniques discussed. ■

³⁵ Life expectancies are based on IRS Table 90 CM, the mortality table used by the IRS for valuation purposes.

³⁶ Factoring in GST taxes would have further increased the equivalent before-tax RORs.