Life Insurance:
Your Blueprint for Wealth Transfer Planning

Producer Guide to Private Split Dollar Arrangements

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Private Split Dollar Arrangements

The New Generation of Split Dollar Benefits

2003 marked the beginning of a new era in split dollar arrangements. After nearly three years of intensive review, the IRS issued new split dollar tax rules. The final regulations cover new arrangements created after September 17, 2003 and older split dollar arrangements that are "materially modified" after September 17, 2003. See Appendix I for more information.

Split dollar arrangements are categorized as either employment-related or family-related. This Guide covers family-related split dollar arrangements, often called Private Split Dollar (PSD) arrangements. A PSD arrangement is usually between two family members or between a family member and a trust created to benefit family members. These types of arrangements can also be between individuals who have a personal relationship but are not related by blood or marriage where there is an insurable interest.

What Is a Private Split Dollar Arrangement?

A private split dollar arrangement is an agreement between two parties to share the costs and benefits of a life insurance policy. A PSD arrangement does not involve compensation and is not related to employment. In fact, it is most often used in family situations where one family member has a need for life insurance and another family member has the money and willingness to pay the premiums.

Often, a parent or grandparent acts as both the premium payor and the insured while the children, grandchildren or an ILIT for their benefit are usually the policy owner and beneficiary.

In a PSD arrangement, the ILIT or child purchases the policy, and the parent or grandparent pays the premiums and is entitled to recover the greater of the policy's cash value or the total premiums advanced when the arrangement terminates. Termination can occur at the insured's death or at any other time specified in the PSD arrangement. If the insured dies while the arrangement is still in place, death benefits are first used to repay the premium payor the greater of cash values or premiums advanced. The remaining death benefits are paid to the policy beneficiary.

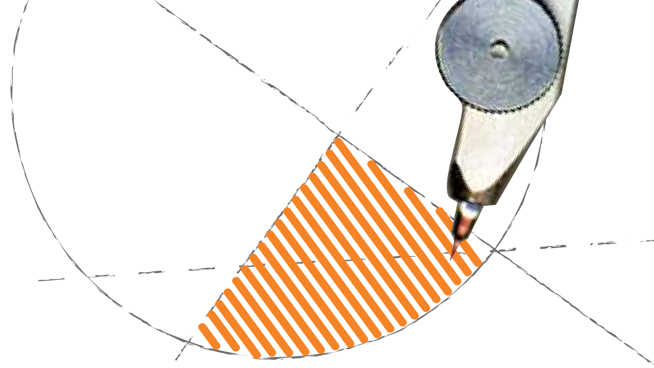
Split Dollar Arrangements – Two Regimes

The split dollar regulations finalized in 2003 permit participants in a split dollar arrangement to use either the "economic benefit regime" or the "loan regime" to determine how they will be income taxed. Because PSD arrangements are designed to deliver death benefits, the income tax consequences of the economic benefit regime are often more beneficial than those of the loan regime. Thus, at least initially, the participants will usually choose the economic benefit regime for PSD arrangements. Here is an explanation of both regimes:

The Economic Benefit Regime

The premium payor's gift tax consequences are based on the value of the life insurance protection (known as the "economic benefit"). Some of the more important factors in determining the economic benefit are:

1. The current age of the insured, and
2. The amount of death benefit that would be paid to the policy beneficiary if the insured died during the current tax year.



The premium payor (usually the parent or grandparent) receives death benefits equal to the greater of the cash values or premiums paid; all remaining death benefits are paid to the policy beneficiary (usually the children, grandchildren or a trust for their benefit). The premiums paid into the policy are not a part of the economic benefit calculation. In the economic benefit regime life insurance policies can be owned in two ways:

Endorsement Arrangements

The premium payor owns the life insurance policy. The death benefit is split to permit the premium payor to recover the greater of the policy cash values or the premiums paid; any remaining death benefits are paid to the non-premium payor's beneficiary.

Because the death benefits would be fully included in the premium payor's taxable estate, this method is seldom used in PSD arrangements.

Non-Equity Collateral Assignment Arrangements

In this arrangement, the non-premium payor (children, grandchildren or a trust for their benefit) owns the policy and assigns back to the premium payor an interest in the policy equal to the greater of the policy cash values or the total premiums paid. If the insured dies, death benefits are first used to pay the greater of the cash values or premiums paid to the premium payor or his/her estate and the remaining death benefits are paid to the policy owner's beneficiary.

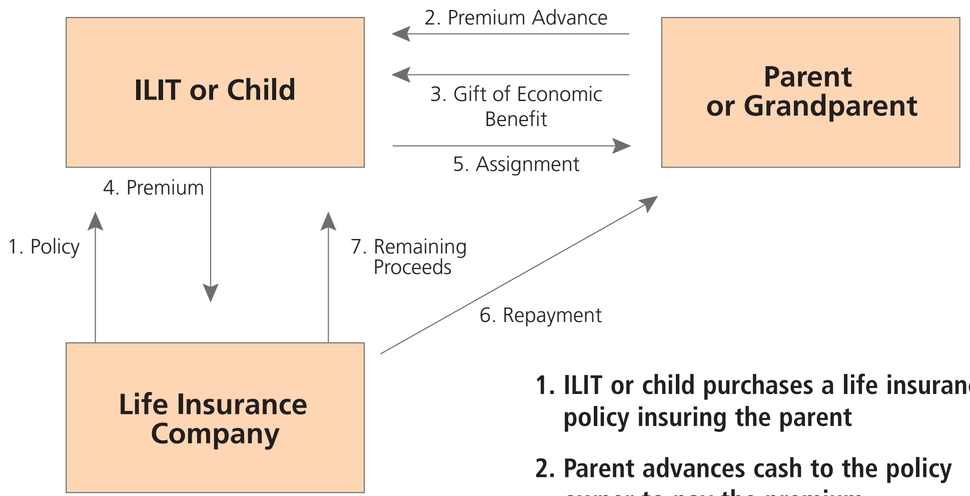
In PSD arrangements, this ownership method is most often used. The balance of the discussion in this Guide will assume the Non-Equity Collateral Assignment Arrangement is being used.

The Loan Regime

Death benefits that are generally income tax free may also be available under the loan regime. A loan arrangement usually provides income tax-free death benefits to the borrower (children, grandchildren or a trust for their benefit) after the loan balance is repaid. However, the borrower's cost for that protection is usually greater than under non-equity collateral assignment split dollar. That's because the interest costs of a loan arrangement are generally higher than the economic benefit in the economic benefit regime. This can change over time as the insured ages.

How Private Split Dollar Arrangements Work

A private split dollar arrangement typically includes the following steps:



1. **ILIT or child purchases a life insurance policy insuring the parent**
2. **Parent advances cash to the policy owner to pay the premium**
3. **Parent is deemed to make a gift of the economic benefit value annually**
4. **ILIT or child uses parent's cash advance to pay the policy premiums**
5. **ILIT or child collaterally assigns policy to parent according to the terms of the split dollar agreement**
6. **At parent's death, parent's estate receives a portion of the policy death proceeds equal to the greater of all premiums advanced or the policy's cash value**
7. **ILIT or child receives the remaining policy death benefit proceeds**

When Does a PSD Arrangement Make Sense?

PSD arrangements are normally used in three situations:

- First, PSD arrangements can be used as a way to enhance the transfer of family wealth while minimizing gift and estate taxes. In these cases a parent or grandparent establishes an ILIT to benefit children or grandchildren. The ILIT purchases the policy under a PSD agreement with the parent/grandparent. The value of the gift to the ILIT is the economic benefit, not the amount the parent/grandparent advances to pay premiums. Note: Any direct or indirect transfer or distribution to a grandchild may be subject to generation skipping transfer tax.
- Second, PSD arrangements can be appropriate when a parent/grandparent wants to increase the wealth that can be passed on to younger family members while still retaining the ability to recover some or all of their money if their personal circumstances, personal objectives or tax laws change. A PSD arrangement may be revoked or terminated; if it is, the parent/grandparent may be entitled to recover the greater of the policy's cash values or the premiums paid.
- Third, PSD arrangements can be established to temporarily pay life insurance premiums for coverage to benefit a family member. A good example is when a child gets married or has children. Let's assume, for example, a daughter marries in her early twenties. The husband is young and not well established financially. The daughter needs life insurance coverage on the husband, but they have no money to pay the premiums. PSD can solve this problem. Under a PSD arrangement, a parent can pay the premiums so the daughter can have life insurance coverage on her husband.

PSD Advantages

Private split dollar arrangements have several attractive advantages:

1. **Gift Tax Leverage—**Life insurance policies have the potential to provide wealth transfer leverage because the death benefits usually exceed the premiums paid. In PSD arrangements the leverage can be magnified because the gift that creates the death benefit is measured by the economic benefit value, not the premiums actually paid. Economic benefit values may be less than the policy premium for many years.
2. **Premium Payor Retains Some Control—**PSD arrangements are usually drafted so that they can be terminated prior to the death of the insured. The ability to terminate the agreement gives the premium payor the potential to recover policy cash values if personal circumstances or objectives change.
3. **A Parent/Grandparent Can Act Alone—**The PSD strategy does not require the participation of a spouse or any other person. One parent/grandparent can establish the ILIT, pay the premiums and be the insured. Several other estate planning strategies (e.g., the Flexible ILIT and the Standby Trust) require two people to participate. In a PSD arrangement, one individual can set up and fund the arrangement.

PSD Disadvantages

Some of the disadvantages of PSD arrangements are:

1. **Complexity—**PSD arrangements are complicated and can be difficult for people who are not familiar with life insurance and wealth transfer planning to understand.
2. **Expensive to Implement—**PSD arrangements can be expensive to establish and implement. Legal fees will be required to draft three documents: the irrevocable life insurance trust (ILIT) that will own the policy, the private split dollar agreement itself, and the collateral assignment that secures the premium payor's right to be repaid.
3. **Estate Taxation—**For estate tax purposes, the parent/grandparent's recovery of the greater of policy cash values or premiums paid at death is part of their taxable estate.
4. **Annual Administration Required—**The economic benefit (which is the measure of the annual gift to the children/grandchildren) increases each year. There needs to be a method in place to calculate and report this economic benefit; if there are other gifts, it may be necessary to coordinate them with the PSD gift so the parent/grandparent doesn't exceed available gifting limits.
5. **Economic Benefit Value Grows Annually—**The economic benefit values increase each year as the insured ages. It continues to grow and must be considered annually for tax purposes regardless of whether new premiums are paid into the policy during that year. If the insured continues to live, at some point in time the economic benefit value will exceed the policy's annual premium. Thus, there may be a need for an exit strategy from the PSD arrangement if economic benefit value gets too high.

Types of Life Insurance Policies That Are Appropriate for Private Split Dollar Arrangements

PSD arrangements are primarily designed to provide death benefits. If cash value accumulation is important, a different strategy may be more appropriate. Life insurance policies that have low premiums relative to the death benefits delivered or which may include secondary death benefit guarantees from the insurer are often used.

Survivorship policies that insure the lives of two people and pay death benefits at the second death are often used in PSD arrangements. These policies should be considered when it makes sense to receive the death benefit at the death of the second insured to die. There are two reasons why survivorship policies are often more attractive:

1. Premiums are generally lower than a single life policy paying the same amount of death benefit.
2. The economic benefit value is generally lower in a survivorship life insurance policy while both insureds are alive. In survivorship policies the economic benefit value is based on the likelihood of both insureds dying in the same year.

Rates for Determining Economic Benefit Value

IRS Notice 2002-8 and the final split dollar regulations permit the participants in a split dollar plan to use the rates in IRS Table 2001 to calculate economic benefit values. The participants in post-September 17, 2003 split dollar arrangements may also potentially use the issuing insurance company's rates if certain conditions are satisfied. Several ING member life insurance companies offer one year term life insurance products which could potentially qualify to be used to calculate economic benefit values.*

See Appendix I for more information about when an insurance company's rates may potentially be used as an alternative to the Table 2001 rates.

See Appendix II for information on the rates of one year term insurance policies offered by several ING member companies. The ING Life Companies that have issued these products cannot say with certainty whether they qualify to be used as alternatives to the Table 2001 rates in calculating economic benefit values for split dollar arrangements.

* ING One-Year Term, policy form #1311-01/09, and ING Survivorship One-Year Term, policy form #1312-01/09, may vary by state and may not be available in all states, are issued by Security Life of Denver Insurance Company. ING One-Year Term NY, policy form #3311-01/09, and ING Survivorship One-Year Term NY, policy form # 3312-01/09, are issued by ReliaStar Life Insurance Company of New York. Within the state of New York, only ReliaStar Life Insurance Company of New York is admitted and its products issued. Both companies are members of the ING family of companies.

Documenting a PSD Arrangement

Every PSD transaction should be in writing. The required documents include:

1. The PSD agreement itself (this document sets forth the rights and duties of both the premium payor and the policy owner).
2. Because the life insurance policy will serve as security for repayment of the premium payor’s advances, a collateral assignment from the policy owner to the premium payor should be filed with the insurer. This collateral assignment needs to be carefully drafted. In most PSD situations, the premium payor may also be an insured and does not want the entire policy death benefit to be taxed in his or her estate at death. To limit estate tax exposure to the greater of cash values or premiums paid, the premium payor should not have an incident of ownership in the policy as described in IRC Section 2042. Standard collateral assignments may contain language that constitutes an incident of ownership in the policy; it may also give the premium payor the right to take over ownership of the policy. This could be an expensive mistake. The collateral assignment should be limited; it should exclude rights that could be an incident of ownership. The premium payor should consult with his or her legal counsel for advice.

How Can a PSD Arrangement Be Terminated?

Planning should always consider the possibility that a PSD arrangement may need to end before the death of the insured. For this reason, it is often wise to create an exit strategy when the arrangement is originally created.

A PSD arrangement may need to end early for these reasons:

1. The premium payor has a financial crisis and needs funds fast.
2. Tax laws have changed making the PSD arrangement unnecessary or obsolete.
3. The premium payor's objectives have changed.
4. The economic benefit value has become too high.
5. One of the insureds in a survivorship policy has died and the new economic benefit value (based on the surviving insured's age) has become too high.

There are several ways to terminate a PSD arrangement. The first step is to review the agreement. It may include specific provisions for ending the arrangement. PSD agreements often give the premium payor the right to terminate the agreement at any time. Even if the agreement does not specifically address termination, the premium payor may release his/her rights under the agreement. In this case, the collateral assignment should also be released. When this happens, the release is usually considered a taxable gift from the premium payor to the policy owner.

If the PSD agreement was originally designed so that the premium payor never had an "incident of ownership" in the policy as defined by IRC Section 2042, then this release of rights should not trigger estate inclusion under the three-year rule of IRC Section 2035. However, if the premium payor did have an incident of ownership in the policy, then he/she would usually have to survive for at least three years following the date of the release in order for the policy death benefits to be estate tax free. If the policy is a survivorship policy, estate tax inclusion may be avoided as long as one of the insureds survives for at least three years after the date of the release.

If a termination is being considered because the economic benefit value is getting too high, it may be worthwhile to consider converting the arrangement from a PSD arrangement to a private loan. This may make sense when the economic benefit value gets too high or in a survivorship policy when one of the insureds dies. The option to convert to a loan arrangement may be specifically provided in the agreement. If it is not, then the parties may be able to convert by mutual agreement. That is, the PSD agreement could be terminated and the premium payor could receive a promissory note for his/her interest from the policy owner. The note should have a principal amount equal to what the premium payor would have received if the insured had died on the date of the termination. The note should bear a fair market interest rate and can be structured as either a demand loan or a term loan.

The main advantage to ending the PSD arrangement and switching to a private loan is that the economic benefit is no longer the measure of the gift tax consequences. While the PSD arrangement was in place, the premium payor made an annual taxable gift to the policy owner equal to the economic benefit, regardless of whether any premiums were paid.

The decision whether to switch to a loan arrangement will include the fact that under the PSD arrangement, the policy owner is usually not required to make any payments to the premium payor. In a private loan arrangement, however, interest on the note must be paid annually (unless the loan is structured as an interest-free loan).

It can also make sense to convert to a private loan arrangement if the policy cash values begin to exceed the premiums advanced under the PSD agreement. This is the point in time when the policy is developing "equity." If the PSD arrangement remains in place, this equity will belong to the premium payor (who is entitled to recover the greater of cash values or premiums paid). This results in a larger taxable estate for the premium payor and a reduction in the death benefits that will ultimately be delivered to the policy beneficiary. Converting to a private loan prior to the build up of equity means that the equity will belong to the policy owner and be paid out as generally income tax-free death benefits at the second surviving insured's death.

Who Should Consider a PSD Arrangement?

Private split dollar can be useful to individuals who have several different kinds of objectives:

- Parents/grandparents who want to transfer money to their children/grandchildren at death by leveraging their gift tax exemptions.
- Parents/grandparents who want to transfer money to their children /grandchildren at death but who want the ability to recover some or all of their money if their personal financial circumstances, objectives or the tax laws change.
- Unmarried domestic partners in committed relationships who want to create death benefits for their partner outside their probate estate or taxable estate but who want the ability to recover their money if the partner dies first or if the relationship ends.

Conclusion

Private split dollar can be a useful wealth transfer tool. It can help a variety of clients use funds not needed for retirement income to increase the financial legacy they pass on to their family and others they care about. It can also help them retain the ability to recover funds they commit to the PSD arrangement if circumstances change. If you have questions about illustrating a private split dollar arrangement or just want more information about how they work, please call ING Life Sales Support at 866-ING-SELL (866-464-7355).

Appendix I

Q&A: Use of ING Life Companies' One-Year Term Product Rates in Split Dollar Arrangements

Question: May the rates of the new One-Year Term (OYT) products issued by certain ING Life Companies* be used to calculate the value of the life insurance protection a taxpayer receives when participating in a split dollar arrangement taxed under the economic benefit regime?

Answer: In 2001, the IRS withdrew the PS 58 rates and replaced them with the IRS Table 2001 rates as one standard for measuring the value of life insurance protection under a split dollar life insurance arrangement. In 2002, the IRS issued Notice 2002-8 to provide guidance for split dollar arrangements entered into after January 28, 2002 and pending publication of further guidance. Notice 2002-8 allowed taxpayers to use an insurance company's published one-year term insurance rates available to all standard risks to value the life insurance protection as an alternative to the Table 2001 rates. Those rates must also satisfy two conditions. First, the insurer must make the availability of these one year term rates known to persons who apply for term insurance coverage (the "availability" requirement). Second, it must regularly sell term insurance at those rates to people who apply for life insurance coverage through its normal distribution channels (the "sales" requirement).

When the final split dollar regulations were published to govern arrangements entered into after September 17, 2003, they referred to a "life insurance premium rate factor" for valuing the life insurance protection that was to be designated or permitted in guidance published in the Internal Revenue Bulletin. However, no such guidance has yet been published. Thus, it can be argued that the IRS has not provided final guidance for determining the value of life insurance protection provided under split dollar arrangements taxed under the economic benefit regime. As a result, until further and/or final guidance is issued, taxpayers may be able to use an insurance company's published one-year term rates from term insurance products that satisfy the availability and sales requirements of Notice 2002-8. Taxpayers who decide to use an insurance company's published one-year term rates have no assurance that the values produced from the use of those rates will be accepted or grandfathered in future/final guidance.

Regarding the availability requirement, the OYT products referenced in this bulletin are products that are offered on a male/female/unisex underwriting basis. They are short term products designed for short term insurance needs. The availability of these products has been actively announced through communications with licensed producers and pertinent product information has been added to the store of product information that is readily available to the general public through the companies' representatives and internet websites. Forms for applying for and administering these products are also generally available.

Regarding the sales requirement, the OYT products described in this bulletin can only be sold by agents licensed with the issuing ING member company. These products were first offered for sale in February, 2009 and sales results since the policies were first introduced are lower than the sales of other ING Life Company term life insurance products. The ING Life Companies offering these products will continue to publish information about them and promote their use. The ING Life Companies that have issued these products should be able to show a track record of sales of these policies over time but cannot with certainty say how the IRS will interpret the "sales" condition or that it will conclude that the number of policies sold is sufficient to meet this requirement.

Therefore, it is unclear whether an insurer's published one year term product rates should be used to value the life insurance protection in split dollar arrangements entered into after September 17, 2003, or if the OYT products referred to in this bulletin would be considered sufficient by the IRS. The ING Life Companies cannot guarantee that these products satisfy the conditions of Notice 2002-8, the final regulations or any future guidance offered by the IRS as a substitute for the IRS Table 2001 rates. Taxpayers wishing to use the OYT product rates to determine the economic benefit value of the life insurance protection in split dollar arrangements established after January 28, 2002 should do so only after consultation with their tax advisor and they must be aware that that these rates may be found inapplicable at any time by the IRS.

*ING One-Year Term, policy form #1311-01/09, and ING Survivorship One-Year Term, policy form #1312-01/09, may vary by state and may not be available in all states, are issued by Security Life of Denver Insurance Company. ING One-Year Term NY, policy form #3311-01/09, and ING Survivorship One-Year Term NY, policy form # 3312-01/09, are issued by ReliaStar Life Insurance Company of New York. Within the state of New York, only ReliaStar Life Insurance Company of New York is admitted and its products issued. Both companies are members of the ING family of companies.

Appendix II

ING One-Year Term Rates vs. Table 2001 Rates

ING One-Year Single Life Term Rates
Annual Rates per $1,000 at Specified Ages

Insured's Age	Table 2001	One-Year Term Rate
30	.87	.39
35	.99	.37
40	1.10	.42
45	1.53	.58
50	2.30	.85
55	4.15	1.17
60	6.51	1.84
65	11.90	2.86
70	20.62	4.64
75	33.05	7.85
80	54.56	12.24
85	88.76	19.07
90	144.30	38.87
95	228.35	59.15
99	281.05	114.95

We cannot guarantee that our One-Year Term product rates will satisfy any applicable IRS requirements as a substitute for the IRS Table 2001 rates. Each client should rely on their tax advisor to determine which rate to use in calculating the economic benefit.

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