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Switch Dollar and the Power of Deferral

An efficient method for funding a trust

It's no secret that deferral is the strategy underlying many a tax plan. And, for good reason. Most understand, at least on a general level, that the longer one can delay paying an obligation, the lower its effective cost. This intuitive mathematical truth is quantified in the investment world as the internal rate of return (IRR), which measures the present value of the investment (money in) against the present value of the return (money out). If the investment and return amounts remain constant, then the rate of return is higher when the time gap between those two events is shorter (for example, the investment is delayed)—a $100 investment in Year 1 for a $1,000 return in Year 10 produces a lower rate of return than a $100 investment in Year 5 for a $1,000 return in Year 10.

The same logic applies to deferring costs, and despite their perceived complexity by many practitioners, private split-dollar life insurance arrangements are, most simply, vehicles for deferral. In essence, they allow a grantor to fund a life insurance policy for the benefit of another while deferring the transfer tax cost of the premium gift until the arrangement ends, ideally when the policy funds and there's new money with which to pay the tax. To be certain, the split-dollar regulations impose an intermediate cost for achieving this deferral, but even so, the rate of return boost remains impressive and is well worth the relatively minor administrative attention needed in setting up and monitoring the plan. Let's examine how an adaptable split-dollar technique—so called "switch dollar"[1]—minimizes the intermediate cost in a way that makes it the most efficient method of funding a trust-owned life insurance (TOLI) policy with transfer taxable dollars.[2]

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Split Dollar Generally

Broadly speaking, "split-dollar life insurance" doesn't refer to a type of insurance contract, but to an ownership and funding arrangement between two or more parties. In their early years, the arrangements were primarily used in the employment context, but private split-dollar arrangements have been used in estate planning for decades and increasingly so since new regulations took effect in 2003.[3] Those regulations are lengthy and cumbersome, but the underlying concepts are relatively straightforward. In a common private split-dollar arrangement between a husband and wife (the grantors) and an irrevocable life insurance trust (ILIT), the grantors will provide the funding for a survivorship policy on their joint lives, for which actual ownership and all incidents of ownership will belong to the ILIT. Each premium payment made by the grantors under a split-dollar arrangement is then taxed according to the split-dollar regulations, which alter the default rule that the premium payments are presently taxable gifts in full.

The regulations provide two mutually exclusive tax regimes that apply to split-dollar arrangements with the right regime depending on the arrangement's structure: the economic benefit regime and the loan regime. Because the parties control how they structure the arrangement, they're effectively provided an election as to which tax regime they wish to engage. This election becomes particularly important in the context of the switch-dollar strategy, and the specifics of how the election is made are provided in the switch-dollar example below.

Under either structure, all of the premiums funded by the grantors will ultimately be repaid to them when the arrangement ends, ideally out of the death benefit on the death of the surviving spouse. At that point, the receivable (in an economic benefit arrangement) or the loan balance (in a loan arrangement) will be included in the gross estate of the decedent grantor. Herein lies the transfer tax deferral—rather than being subject to gift tax at the time the premium is initially paid, the premium (frozen in the form of a receivable or loan) is subject to estate tax at the time the policy proceeds are ultimately paid and the split-dollar arrangement comes to an end.

The benefit in real numbers looks like this: If grantors pay a premium of $100,000 for the benefit of the ILIT without a split-dollar arrangement, they'll incur a gift tax of an additional $40,000, incurred the same year the premium is paid, for a total investment in Year 1 of $140,000. If the premium is paid under a split-dollar arrangement, the additional $40,000 cost is deferred until potentially decades later when the split-dollar arrangement terminates, the policy proceeds are paid to the ILIT and the $100,000 receivable/loan is included in the grantor's estate, incurring a $40,000 tax. If the period of time between the premium payment and the grantor's death is 25 years, the IRR (on a $1 million death benefit) is improved by 129 basis points because of the deferral.

There are no gift tax consequences in a loan arrangement so long as adequate interest is required by the terms of the loan (which should be formalized with a written note).

As mentioned, to achieve the advantages of this deferral, the split-dollar regulations impose an additional, intermediate cost pursuant to one of the two split-dollar tax regimes. This additional cost is obviously a drag on the IRR boost achieved by the deferral, so the objective in structuring the arrangement is to ensure that the governing tax regime is the least burdensome of the two. That designation will largely depend on the grantors' ages and marital status and will change as those factors change.

Under the economic benefit regime, the intermediate cost comes in the form of any economic benefit provided by the grantors to the ILIT being treated as a taxable gift. There are only two economic benefits specifically named in the regulations: (1) any increase in cash value to which the ILIT has current or future access, and (2) the cost of current life insurance protection provided to the ILIT.[4] The cost of insurance (COI) economic benefit is calculated based on the insureds' ages (getting more expensive as age increases) and the number of lives insured (insuring two lives is cheaper than insuring one).[5] Thus, the COI for a young married couple can be extremely low (well below the actual premium paid), and the COI on a single elderly person can be extremely high (well above the actual premium paid).

Under the loan regime, the additional intermediate cost takes the form of real or imputed interest, as the premium payments are treated and taxed as loans from the grantors to the ILIT.[6] There are no gift tax consequences in a loan arrangement so long as adequate interest is required by the terms of the loan (which should be formalized with a written note). There are likewise no income tax consequences to the grantors resulting from the interest (real or imputed), so long as the trust maintains grantor trust status.[7]

Case Study Comparison

With this general framework in mind, consider an example using real numbers. Suppose the ILIT purchases a $20 million second-to-die universal life policy on the lives of a husband and wife, each 65 years old, and each with standard underwriting risks, for an annual premium of $200,000. An important side note regarding the policy's structure: To maximize the strategy's return, the policy should be structured toward a death benefit return rather than cash value growth. In such a structure, the purpose of the cash value is solely to ensure that the policy stays in force for the desired duration—perfect efficiency would be for the cash value to equal $1 the moment before the surviving spouse dies, but planning for the perfect is obviously ill-advised. The prudent structure is to design the cash value to last several years past the couple's joint life expectancy using conservative interest rate assumptions and monitoring

the policy at least annually to ensure it remains in line with projections and changing health circumstances. Using the cash value as a vehicle for tax-deferred growth would not only be counterproductive in this strategy (because it would drag on the death benefit return), but also would be a wasted endeavor, because the cash value is inaccessible to the grantors as an asset of the ILIT outside of their estates.

No Split-Dollar Strategy

As a starting point, imagine no split-dollar strategy is implemented, and the grantors simply gift the $200,000 to the ILIT to pay the premiums. At a 40 percent gift tax rate, the total annual out-of-pocket cost to the grantors would be $280,000. If the surviving spouse dies at the end of Year 25, at age 90, the after-tax IRR[8] on the net death benefit paid to the ILIT is 7.32 percent.[9]

As another point of reference, if the same $280,000 annual outlay were instead invested inside the grantors' estates and earned a generous after income tax return of 6.5 percent (a pre-tax return of 10 percent assuming a flat 35 percent income tax rate), the IRR on the net-to-heirs amount after a 40 percent estate tax in Year 25 would be only 5 percent. Clearly, a lion's share of improvement comes through isolating assets—in this case an insurance policy—outside of the estate. The distinction between funding premiums through a private split-dollar arrangement as opposed to outright gifting is a fine-tuning of an already hugely beneficial strategy.

Generic Economic Benefit Split Dollar

As mentioned, the split-dollar regulations alter the general rule that the $200,000 premiums will be taxable gifts in full by applying either the economic benefit regime or the loan regime, depending on how the parties structure ownership of the policy within the context of the split-dollar arrangement. To engage the economic benefit regime, the ILIT can own the policy (and all incidents of ownership), but the grantors must retain the right through the split-dollar agreement to be repaid the greater of the total premiums paid or the cash value of the policy. This "greater of" provision will ensure that the only economic benefit provided to the trust is the cost of current life insurance protection—the essential trait for engaging the economic benefit regime when the trust owns the policy.[10] In practicality, if the policy is structured toward death benefit as described above, the cash value should remain below the value of the total premiums paid for most if not the entire life of the policy, such that the latter amount represents the receivable created by the split-dollar arrangement, and the cash value is largely made irrelevant. Thus, the gift tax on the premium is converted into an estate tax on the receivable and is thereby deferred until the arrangement ends.

In the meantime, each year, the grantors will be deemed to have gifted to the trust the economic benefit of the cost of current life insurance protection. That amount is calculated based on rate Table 2001, with appropriate adjustments made to account for the second-to-die nature of the policy.[11] In our hypothetical, the economic benefit generated in Year 1 is $3,704. The gift tax on that amount ($1,482) represents, in substance, the intermediate cost imposed by the economic benefit regime for achieving one year's worth of deferral on the transfer tax due on the premium gift.

> In addition to the maximum deferral of the principal repayment, the hybrid loan structure allows for the lowest, predictable intermediate cost for the deferral given today's low interest rate environment.

This structure works wonderfully while the annual cost of insurance gift remains low; however, that luxury gradually deteriorates as the insureds get older and then ends abruptly when one spouse dies and the benefit is calculated based on a single-life rate. In our example, if we assume the husband dies at age 85 in Year 20, the economic benefit amount for the following year increases from roughly $10 per $1,000 of insurance to just over $99 per $1,000. That equates to an economic benefit value increase of over $1.4 million dollars in that year alone. The benefits of deferring the transfer tax on the premiums are soon vaporized by this heightened intermediate cost.

Generic Split-Dollar Loan

The loan regime would avoid the poor result the economic benefit regime produces in the later years. The parties engage the loan regime simply by designating the trust as the owner of the policy and establishing that the premium payments by the non-owner grantors will be repaid to them in such a way that the payments represent genuine loans secured by the policy.[12] All of the income and transfer tax laws applicable to loans generally will apply, with some favorable regulatory adjustments to accommodate the unique nature of the split-dollar arrangement. This means the parties have options in setting the terms of the loan, with the tax treatment varying widely with each distinction. The factors controlling such treatment are essentially: (1) the loan term (demand or term certain); (2) the interest obligation (whether interest is charged, and if so, how much and when); and (3) if the interest obligation results in the loan being below market such that Internal Revenue Code Section 7872 applies, the nature of the loan as a gift, compensation or dividend. It's beyond the scope of this article to discuss the complete range of outcomes possible, but it's worthwhile to lay out the workings of a few structures typical in private split-dollar arrangements, limiting the differences between them to how each addresses interest.

> In a high interest rate environment, it may be better over the long term to structure the loan as a demand loan, which uses the blended annual rate (based on the short-term AFR) to take advantage of falling interest rates over time.

Several assumptions with respect to our example should be made at the outset to allow for a manageable discussion. First, in a private split-dollar loan arrangement among family members for estate-planning purposes, assume any foregone, waived or forgiven interest will be in the nature of a gift. Further, assume a typical structure, unique to split-dollar arrangements, in which the term of the note will be for the life of the insureds—a so-called "hybrid" loan. The obvious benefit of tying the term of the loan to the death of the last insured is that the repayment obligation and the source of funds used to satisfy the obligation are synchronized. Most importantly, the transfer tax on the premium payments is thus deferred to the same extent as with the economic benefit arrangement—to the last death of the insureds.

Lastly, assume that the ILIT is a grantor trust at all times with respect to the lender and that the income tax consequences of the loan can therefore be ignored.[13] As with any loan the term of which could extend beyond the life of the grantor, maintaining wholly grantor trust status for the entire term is no guarantee; if the trust is structured as a grantor trust with respect to one spouse (such spouse being the sole lender), there's the clear chance that the grantor spouse could be the first to die, in which case the grantor status of the trust would end, and the interest would be fully taxable income for the remainder of the term. Alternatively, if the trust is structured as a joint grantor trust with both spouses (and with both acting as lenders), when the first spouse dies, the trust will become a half-grantor trust, in which case, presumably, one-half of the interest income to the surviving lender will be recognized and one-half ignored. With spouses of similar health and age (as in our example), the probability of the wife outliving her husband is high enough to justify structuring the trust to be a wholly grantor trust with respect to the wife only and to have her be the sole lender. Our example will assume such a structure. A case-by-case analysis should always be made to determine if the probabilities of one spouse outliving the other favor using a single-grantor trust or if prudence would suggest hedging the risk of the grantor dying first by using a joint grantor trust.

With all the above assumptions clarified, the question becomes what to do about interest—first, should it be charged, and second, should it be paid? As with most other loans,[14] IRC Section 7872 will apply to the extent the split-dollar loan doesn't provide for sufficient interest. The regulations provide that a hybrid loan is tested for sufficient interest under Section 7872 as if it's a term loan, with the term being the life expectancy of the insureds.[15] This means that in addition to the maximum

deferral of the principal repayment, the hybrid loan structure allows for the lowest, predictable intermediate cost for the deferral given today's low interest rate environment. In our example, the joint life expectancy of the insureds is 25 years,[16] which means the loan will be measured by a historically low, long-term applicable federal rate (AFR).

It's important to note that each premium payment made by the grantor spouse will be considered a new, separate loan measured by the AFR that applies at the time the loan is made. Rather than creating a separate loan for each premium payment, the better strategy may be for the grantor to make a lump sum loan to the ILIT in the first year in an amount expected to cover the total premiums scheduled under the policy.[17] The amount loaned should anticipate that the ILIT is able to earn a reasonable after-tax return on the principal and should therefore be less than the gross sum of the projected premium payments. The one-time loan locks in a low, long-term AFR, and by depositing the loan proceeds with the trust rather than paying them directly into the policy as a single-pay premium, the trust maintains control over the timing of the premium payments and can avoid classification of the policy as a modified endowment contract.[18]

In a high interest rate environment, it may be better over the long term to structure the loan as a demand loan, which uses the blended annual rate[19] (based on the short-term AFR) to take advantage of falling interest rates over time. A similar strategy would be to use a note with a term of just less than three years. This would lock in the lowest AFR available at the time the loan is made, thereby avoiding short-term hikes in rates during the term, but would still take advantage of an overall downward trend in interest rates as the note is reissued at a new AFR at the end of each term.

As previously mentioned, if sufficient interest is charged and paid, there are no gift tax implications, and if the interest paid by the trust to the grantor is spent, transfer taxes on the interest are avoided altogether. The drawback to this structure is that the ILIT will need its own assets with which to pay the interest—a not entirely common scenario.[20]

A better method may be to have the interest accrue, compound and ultimately be paid out of the death benefit when the arrangement ends.[21] This is a seemingly ideal option because it avoids gift tax liability on the interest and obviates the need for the trust to find funds with which to pay interest as it waits for the death benefit proceeds. Such a loan would implicate the original issue discount (OID) rules of IRC Sections 1271 through 1274, which would typically force the lender onto the accrual method of accounting for reporting the interest as income each year; however, as a loan between a grantor and a grantor trust, the loan arrangement is ignored from an income tax perspective altogether.[22]

What would be the income tax treatment of the deferred interest at the death of the grantor, which is the event that simultaneously triggers the repayment of the loan and ends the grantor status of the trust? A lack of direct authority makes it difficult to know with certainty how this repayment would be treated, but the most persuasive view is that there should be no income tax consequence to either the grantor's estate or the trust for any of the accrued interest other than what accrues in the year of the grantor's death. This result follows from the fact that income in respect of a decedent (IRD) only includes items of gross income of the decedent that weren't properly includible in the decedent's taxable income pre-death.[23] OID that's accrued in years prior to the decedent's death isn't considered IRD because it was includible in pre-death income but rightly ignored under the grantor trust rules. OID accruing in the year of the decedent's death, however, should be taxable because the decedent died before that interest ever had the opportunity to be ignored.

> The switch-dollar strategy attempts to mitigate the downside of each tax regime by using both, at different times.

If it doesn't make sense to pay the interest with other assets of the trust or to accrue and compound the interest, the loan can be structured so that interest is gifted to the trust by the lender/donor. Here again, we can draw distinctions. First, the parties can intentionally structure the loan as a below-market loan charging no interest. For gift tax purposes,[24] the regulations provide that the difference between the

present value of all payments required under the loan (discounted at the appropriate AFR) and the total amount loaned is treated as having been transferred (as a gift in our case) from the grantor/lender to the ILIT/borrower in the year the loan is made.[25] Thus, with a below-market gift term loan, the transfer tax on the principal is deferred, but the transfer tax on all of the potential interest—the intermediate cost—is accelerated into the year the loan is made. This is clearly an undesirable result not only because the acceleration causes a hit to the rate of return (the opposite effect of deferral), but also because should the insured die earlier than his life expectancy, the gifted interest amount in the first year will have been an overpayment—a

The switch doesn't happen automatically, but requires the parties to take some action.

present value calculation that assumed a term of years longer than what actually occurred.

A better gift term loan structure using a unique provision of the split-dollar regulations allows the bunching rule of Section 7872 to be sidestepped. Instead of structuring the loan as a below-market loan, assume the note provides for sufficient interest at the long-term AFR that's to be paid annually. This provision takes the loan out of Section 7872 altogether, so there's no deemed lump sum gift in the first year.[26] If the grantor/lender subsequently forgives the interest due each year, subparagraph (h) of Treasury Regulations Section 1.7872-15 controls,[27] providing a deemed transfer from the borrower to the lender for the forgiven interest (interest income but for the grantor trust status) and a retransfer of the forgiven interest back to the borrower, as a gift, at the time of the forgiveness.[28] Typically, the amount of the gift retransferred to the trust would be increased by a deferral charge,[29] but the deferral charge is avoided in the case of a nonrecourse split-dollar loan in which the parties have filed a written representation with their respective income tax returns each year a loan is made, stating "that a reasonable person would expect that all payments under the loan will be made."[30] Thus, the nuances of the split-dollar regulations offer some additional deferral over the traditional Section 7872 gift loan because the gift of the interest isn't bunched into the first year, but is spread into multiple transfers over the life of the loan on an annual basis.

To sum up the loan regime treatment, the transfer tax on the premiums is effectively deferred until the note is repaid out of the policy death benefit to the decedent's estate. The intermediate cost of this deferral is the interest, or rather, the transfer tax on the interest. This cost should never experience the sort of rapid escalation seen with the economic benefit regime that makes it untenable in the later years, but it would be more expensive than the economic benefit structure in the early years when the COI is low, even under today's extraordinarily low interest rates. Thus, in a scenario like our case study involving a married couple with a relatively long joint life expectancy, neither the economic benefit regime nor the loan regime is particularly attractive standing alone—each has its unique drawbacks.

Switch-Dollar Strategy

The switch-dollar strategy attempts to mitigate the downside of each tax regime by using both, at different times. It's distinguished from a generic private split-dollar strategy by beginning with an economic benefit structure between the wife and the trust[31] and pivoting to a loan structure at a time that ensures that the tax regime governing the arrangement is always the one with the lowest intermediate cost—economic benefit amount versus loan interest. This pivot almost invariably occurs on the death of the first spouse, when the economic benefit of the cost of current life insurance would switch from a two-life calculation to a much more expensive single-life calculation, based on the survivor's then age, but could happen earlier in a low interest rate environment with older grantors.

The switch doesn't happen automatically, but requires the parties to take some action. Assume again that the husband dies at age 85 in Year 20. At this point, the wife and the ILIT should agree to terminate the original split-dollar agreement. By doing so, the $4 million receivable generated by all premiums paid[32] by the wife in this 20-year period under the economic benefit regime will become due to her. Rather than paying the obligation outright, the ILIT should issue a note to the

wife for the full amount at the appropriate AFR based on the wife's then life expectancy.[33] A loan transaction between the wife and the grantor trust should be ignored such that interest on the note won't generate any income tax liability during the term of the note. From a gift tax perspective, assuming she forgives the interest on an annual basis as discussed above, a gift tax will be owed each year on the forgiven interest. Alternatively, gift taxes are avoided to the extent adequate interest is paid by the trust yearly or accrues and is paid out of the death benefit. The wife may then continue paying the insurance premiums, each payment representing a new loan to the ILIT at the then appropriate AFR.[34]

The switch from the economic benefit regime to the loan regime avoids the substantial increase in the economic benefit based on the single-life cost of insurance calculation after the death of the first spouse and keeps the intermediate cost manageable—and in today's interest rate environment, downright attractive—for the remainder of the surviving spouse's life. At the surviving spouse's death, the loan balance is included in her gross estate, leaving 60 percent of that amount, plus the remaining death benefit proceeds passing outside of the estate to the ILIT.

Under our facts, assuming the initial loan and all subsequent loans are gift loans at a 5 percent AFR and assuming as before that the surviving spouse dies at age 90 in Year 25, the switch-dollar strategy results in an after-tax IRR of 8.31 percent—a nearly 100 basis point improvement from the grantor's outright gifting of the premiums.[35] If the initial loans and all subsequent loans use accruing and compounding interest rather than gifted interest, the after-tax IRR is further improved to 8.38 percent.

Switch Transfer Tax Consequences

Finally, practitioners need to be aware that several provisions of the final regulations may trigger a deemed transfer of the policy for federal transfer tax purposes[36] as a result of the switch.

One set of provisions applies to conversions of non-equity economic benefit arrangements to equity arrangements and another to conversions of non-equity economic benefit arrangements to loan regime arrangements. These provisions are an attempt to treat the net value of the policies subject to these arrangements (their value—however determined—net of the obligation to the premium provider) as a transfer for federal transfer tax purposes.[37]

The first set of regulations[38] applies to the termination of the non-equity economic benefit regime arrangement and creation of an equity arrangement as a substitute arrangement. Those provisions treat a modification of an economic benefit regime arrangement that provides no benefits to the owner of the policy in addition to current life insurance protection (a non-equity arrangement) to one that does (an equity arrangement) as a deemed transfer of the policy to the owner for transfer tax purposes. Subsection (3) of that section then treats the successor split-dollar arrangement that has the effect of providing such other benefits as a "modification" of the prior split-dollar arrangement.

Very often, a TOLI policy can be most efficiently funded without the need for a split-dollar arrangement: through the use of annual exclusion gifts, income-generating assets already owned by or to be sold or gifted to a trust or other similar strategies.

It's unclear how those provisions would apply to the switch, when a non-equity economic benefit regime arrangement is terminated and replaced not by an equity economic benefit arrangement, but by a loan regime arrangement in which, arguably, any other benefits provided under the arrangement are "accounted for" by the loan interest. Again, these provisions are arguably inapplicable because they assume a conversion of one economic benefit arrangement into another, but should be noted.

Even if those provisions wouldn't apply to our switch, however, the other regulation provision[39] provides that a "deemed" transfer of the ownership of a policy occurs for federal transfer tax purposes when a party to an economic benefit split-dollar arrangement who or which is

treated under the regulations as a non-owner of a policy,[40] in our case, the trust, becomes treated as the policy owner under the regulations,[41] which is the result of the switch.[42] Note that this provision treats the policy as transferred by the donor to the trust, despite the fact that the trust has actually owned the policy from inception, so there never was an actual transfer of policy ownership from the donor to the trust for transfer tax purposes. It may not be clear that such a deemed transfer will be recognized for gift or generation-skipping transfer tax purposes; however, it's a provision that must be considered in planning for the switch.

Presumably, the value of the transfer would be determined by the policy's gift tax value, under the Section 2512 regulations; however, this may be a situation in which it would make sense to consider hiring an appraiser to value the policy for transfer tax purposes, if the interpolated terminal reserve value of the Section 2512 regulations produces an unreasonably high value. In any event, the value of the policy for federal transfer tax purposes (however determined) would be totally or partially offset by the amount due to the donor under the prior arrangement.[43] The best practice would be to determine the potential federal transfer tax result of the switch under this provision prior to the switch, and, if the federal transfer tax of the value of the policy, net of the amount due the donor, isn't reasonable, consider borrowing against the policy[44] prior to the switch to reduce its net value.[45]

Tax-Efficient Funding

Tax efficiency is, in the end, a math problem and is within the lawyer's basket of responsibilities, like it or not. Very often, a TOLI policy can be most efficiently funded without the need for a split-dollar arrangement: through the use of annual exclusion gifts, income-generating assets already owned by or to be sold or gifted to a trust or other similar strategies. But, when the only practical alternative for funding the policy is through a presently taxable gift, efficiency (and a higher rate of return) favors strategies that defer tax liability. On those occasions, appropriately structured private split-dollar arrangements prove their appeal.

Endnotes

1. *See* Lawrence Brody and Richard L. Harris, "Private Split-Dollar Arrangements," *Trusts & Estates* (May 2010), at p. 42 (referring to the switch-dollar technique as a possible exit strategy of a traditional economic benefit arrangement).
2. It nearly goes without saying that a taxpayer's circumstances could allow for premiums to be funded for the benefit of an irrevocable life insurance trust (ILIT) without any transfer tax drag, for example, through the use of annual exclusion gifts to a *Crummey* trust, if there are enough beneficiaries to allow the exclusions to cover the premium or use of his now increased gift (and generation-skipping transfer (GST) tax exemptions). Split dollar is best used by taxpayers whose annual exclusions and gift (and GST) tax exemptions are being used in other strategies, so that funding premiums without a split-dollar arrangement would require taxable gifts in full.
3. Treasury Regulations Sections 1.61-22 and 1.7872-15.
4. Treas. Regs. Section 1.61-22(d)(2). The regulations allow for a third, unnamed category of economic benefit that isn't properly described by either of the first two categories.
5. *See* Treas. Regs. Section 1.61-22(d)(3)(ii) and Notice 2002-8, which remain the authority for valuing the cost of current life insurance protection based on Table 2001, with "appropriate adjustments" to be made in the case of a survivorship policy.
6. Treas. Regs. Section 1.7872-15(a)(2)(i).
7. *See generally* Revenue Ruling 85-13.
8. All internal rate of return (IRR) figures contained in this article are net of all income and transfer taxes.
9. This calculation includes a $240,000 gross estate inclusion for gift taxes paid on the premium gifts in the three years prior to death per Internal Revenue Code Section 2035(b). The total return is therefore: $20 million - (40 percent x $240,000) = $19.904 million.
10. *See* Treas. Regs. Section 1.61-22(c)(1)(ii)(A)(2), which provides that the economic benefit regime applies to an arrangement in which a non-owner is the payor, only if the owner (that is, the ILIT) is given the cost of insurance economic benefit. If the ILIT, as the owner, receives any other economic benefit, the loan regime will apply, or the premium payments by the grantor will be outright gifts. In *Estate of Morrissette*, 146 T.C. No. 11 (April 13, 2016), the Tax Court found that "where a donor is to receive the greater of the aggregate premiums paid or the CSV of the contract, the possibility of the donee receiving an additional economic benefit is foreclosed."
11. Notice 2002-8, footnote 5. Most practitioners consider the "Greenberg to Greenberg" formula to be an appropriate adjustment to the Table 2001 rates, and it's been used for such purposes because the letter in which it was formulated was written in August 1983. The formula multiplies the two spouses' individual rates together, then multiplies that figure by 1.025, divided by 1,000.
12. Treas. Regs. Section 1.7872-15(b)(2).
13. *See generally* Rev. Rul. 85-13, footnote 7.
14. *See* IRC Section 7872(c) for a list of the types of loans to which Section 7872 applies.
15. Treas. Regs. Section 1.7872-15(e)(5)(ii). For example, if the insureds have a joint life expectancy of more than nine years under Treas. Regs. Section 1.72-9, Table IV, the appropriate rate is the long-term applicable federal rate (AFR) at the time the loan is made.
16. Treas. Regs. Section 1.72-9, Table IV, for two 65-year-old insureds.
17. The fact that the lump-sum loan to the ILIT will be larger than necessary to make an individual premium payment won't remove the loan from the purview of the split-dollar regulations. All the elements of a split-dollar loan provided in Treas. Regs. Section 1.7872-15(a)(2)(i) are present: (1) a payment between a non-owner and an owner; (2) the payment is a loan under general principals of federal tax law or a reasonable person would expect the payment to be repaid in full to the non-owner; and (3) the repayment is to be made from or is secured by, the policy's death benefit proceeds, the policy's cash surrender value or both.

18. *See* IRC Section 7702A. Not only will a single-pay premium create a modified endowment contract, but also it will produce a lower IRR than spreading the premium payments over the life of the policy.
19. Treas. Regs. Section 1.7872-15(e)(3)(ii).
20. Per Treas. Regs. Section 1.7872-15(a)(4), if the interest paid by the trust is provided by the lender, the interest provisions will be ignored and the loan will be treated as a below-market loan under Section 7872.
21. Of course, if the grantor/lender specifically devises the note (which at death will be due and payable) to the ILIT, then the obligation disappears altogether, leaving the ILIT with the loan proceeds net of the estate tax liability they generate. Any discharge of indebtedness income to the ILIT is exempt under IRC Section 102. *See* Private Letter Ruling 9240003 (June 17, 1992).
22. *See generally* Rev. Rul. 85-13, footnote 7.
23. Treas. Regs. Section 1.691(a)-1(b).
24. Treas. Regs. Section 1.7872-15(e)(5)(iv)(D). For income tax purposes, the interest is deemed transferred and retransferred on a yearly basis as if the loan were a demand loan, but at the AFR appropriate for the term of the loan rather than the blended annual rate. Treas. Regs. Section 1.7872-15(e)(5)(iv)(B). Because the case study example assumes grantor trust status, the income tax treatment of the loan is ignored.
25. Treas. Regs. Section 1.7872-15(e)(4)(iv).
26. Treas. Regs. Section 1.7872-15(e)(5)(i)(B).
27. Treas. Regs. Section 1.7872-15(f)(1), last sentence.
28. Treas. Regs. Section 1.7872-15(h)(3).
29. Treas. Regs. Section 1.7872-15(h)(1)(i). *See* (h)(4) for calculation of the deferral charge.
30. Treas. Regs. Section 1.7872-15(h)(1)(iv). *See* (d)(2) for the requirements of the written representation.
31. Again, our example assumes the parties have structured the trust to be a wholly grantor trust with respect to the wife only. Therefore, no contribution to the trust should be made by the husband, a non-grantor.
32. Assuming the premiums advanced exceed the policy's then cash value.
33. If the parties had chosen to structure the trust as a joint grantor trust, then the economic benefit arrangement would have been between the trust and both spouses, and the husband would have generated a receivable of $2 million, representing the premiums paid by him prior to his death (one-half of the total premiums paid). That receivable would be included in his gross estate and should be specifically devised in his will. *See Morrissette, supra* note 10, discussing the disposition of an economic benefit regime receivable. It's important for purposes of the switch-dollar strategy that the receivable pass to his wife, taking advantage of the marital deduction and therefore generating no estate tax. The wife would then become the holder of the entire receivable for all premiums paid by both her and her husband under the economic benefit regime ($4 million in total) and can proceed with the loan transaction with the now one-half grantor trust, reporting one-half of the interest income generated thereby.
34. Alternatively, if the AFR at that time is particularly attractive and expected to rise, she could make an additional lump sum loan for an amount necessary to cover the remaining premium payments.
35. This calculation includes a $288,000 gross estate inclusion for gift taxes paid on the interest gifts in the three years prior to death per IRC Section 2035(b).
36. This applies for both gift, and in appropriate cases, GST tax purposes.
37. This isn't unlike the treatment of pre-regulation equity economic benefit arrangements when they're terminated—the equity is considered transferred for tax purposes; of course, there was no equity in this arrangement to begin with so what the regulations deem transferred is the net value of the policy, not the equity.
38. Treas. Regs. Sections 1.61-22(c)(ii)(B)(1) and (2).
39. Treas. Regs. Section 1.61-22(c)(3).
40. Because the premium provider is treated as the policy owner under the exception for non-equity economic benefit collateral assignment arrangements in a donor/donee context.
41. Because the exception that treats the premium provider as the policy owner in a non-equity collateral assignment arrangement would no longer apply after the switch (under the loan regime, the actual policy owner is treated as the owner).
42. Note that this is a deemed, not an actual, transfer of the policy; accordingly, there will be no potential transfer for value issue under IRC Section 101(a)(2) as a result of such a deemed transfer.
43. Although note that if the switch occurred at an older age for the surviving insured, depending on the type of policy, the unborrowed value of the policy for transfer tax purposes could be well in excess of the amount due the donor.
44. Note that, as discussed in the text and in endnote 40, this is a deemed, not an actual, transfer of the policy so that the loan could exceed the owner's basis in the policy, without triggering gain under the theory of Rev. Rul. 69-187.
45. Any such policy loan will be deducted from the policy's interpolated terminal reserve value on the Form 712 issued by the carrier; although the IRC Section 2512 regulations don't provide for such a deduction, the Form 712 itself and the instructions to it do so.

    Also, note that the example discussed in this article assumes that to the extent the switch creates a deemed transfer of ownership of the policy, the transfer is fully offset by the note from the ILIT; therefore, the IRR calculations don't assume any additional transfer taxes resulting from the switch. Alternatively, in many cases, the increased gift and GST tax exemptions would exceed the net value of the policy.