

# Managing gift and estate tax over the life of insureds

Individuals subject to the federal estate tax often buy life insurance in an Irrevocable Life Insurance Trust (ILIT). Traditionally, they simply give premium dollars to the trust and apply either their annual exclusion or gift tax exemption to the gift. But for those hoping to preserve their gift tax exemption, a split dollar arrangement can be a flexible tool for paying premiums for a policy in the ILIT while keeping the gift tax effects small. What’s more, the ability to “switch” the design of the split dollar arrangement from an economic benefit regime (non-equity)<sup>(1)</sup> to a loan regime as insureds age can further manage gift tax impacts. This approach is often referred to as Private Switch Dollar.

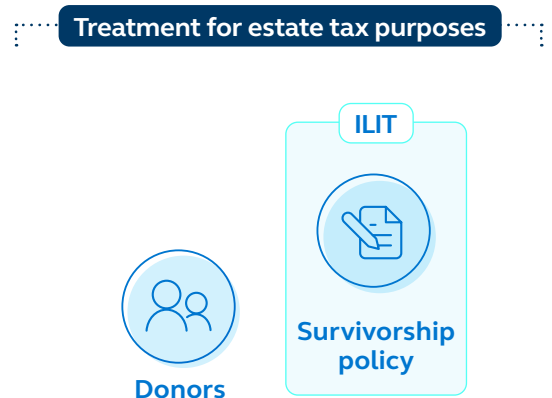
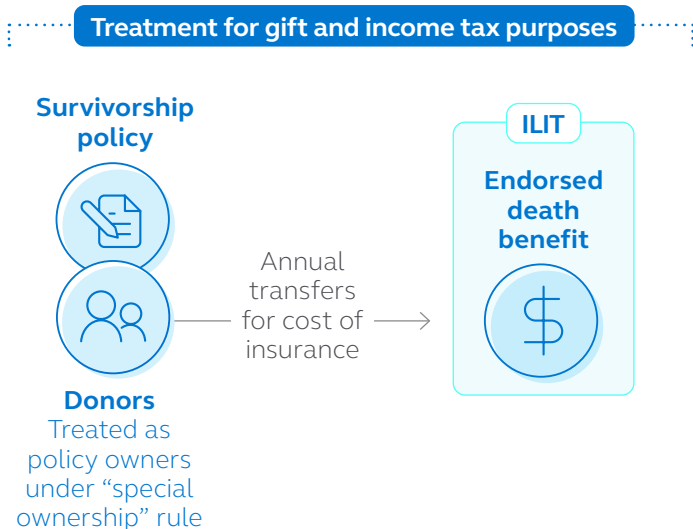
## Here’s how it works.

### Split dollar – economic benefit regime

The donors and the ILIT enter into a non-equity split dollar agreement, which limits the ILIT to controlling only a policy’s death benefit. Under this plan, the donors make the premium payments for a survivorship life insurance policy (insuring the married donors) owned by the ILIT. The ILIT is named beneficiary but a limited collateral assignment is put on the policy in favor of the donors, which ensures the donors receive an amount equal to cash value upon the policy’s surrender or the death of the insureds.

Given that the ILIT controls only death benefit (and no cash value) under the split dollar plan, the IRS imposes a “special ownership” rule that—for income tax and gift tax purposes—treats the donors as if they are the policy owner, and as if they are endorsing death benefit to the ILIT (making annual transfers to the ILIT equal to the cost of insurance, rather than premium amount).<sup>(2)</sup>

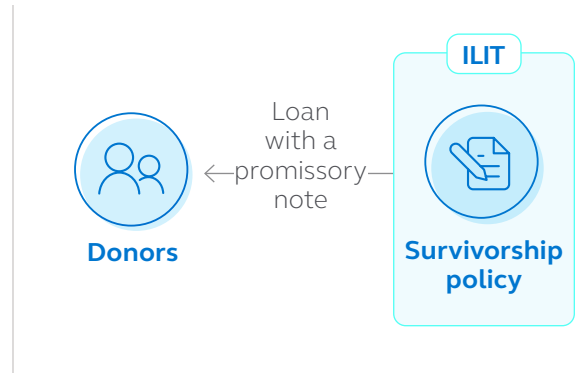
However, for estate tax purposes, the ILIT is recognized as owning the policy (and the death benefit paid to the ILIT would not be included in the estate of either donor).



## Split dollar – loan regime

As the donors age and gifts become larger (due to the annual cost of insurance increasing) the donors terminate the non-equity split dollar plan and switch to a loan split dollar plan. The ILIT “buys” the policy from the donors using a loan with a promissory note. This would not be taxable if the ILIT is a “grantor trust,” as many are.<sup>(3)</sup>

The initial loan amount is equal to the value of the policy<sup>(4)</sup> the day the economic benefit split dollar plan was terminated. After the “switch,” the ILIT owns the policy for all tax purposes, not just estate tax.



Thereafter, interest on the loan is either paid by the trust to the donors or is recognized as a gift by the donors to the ILIT. The ILIT can repay the loan from other assets, or the donors(s) can forgive some—or all—of the loan, thereby making a gift to the ILIT of the forgiven amount. The ILIT can also repay the loan from the policy’s death benefit, but that’s usually a last resort.

## Hypothetical example

Consider a married couple (donors), both age 45. They pay for a \$10 million survivorship life insurance policy in an ILIT with 20 annual premiums of \$105,000.

The following table shows how low the gift tax value is for the \$10 million of death benefit controlled by the ILIT—especially at younger ages and when both insureds are living.

### Economic benefit split dollar plan

Insured(s) age	Amount of insurance exceeding cash value	Annual gift to ILIT – both insureds alive*	Annual gift to ILIT – one insured alive**
45	\$10,000,000	\$23	\$6,600
55	\$10,000,000	\$168	\$12,300
65	\$10,000,000	\$1,382	\$30,900
75	\$10,000,000	\$10,657	\$87,100
85	\$10,000,000	\$76,862	\$238,200
95	\$10,000,000	\$508,719	\$901,700

This is a hypothetical example for illustrative purposes only.

\* Joint-life rates calculated using Table 2001:  $[(\text{Life 1 Rate} \times \text{Life 2 Rate}) / 1.025] / 1,000$ .

\*\* Calculated using one-year term insurance rates.

Switching to loan split dollar offers an alternative to rising economic benefit rates.

Insured(s) age	Projected policy cash value	Annual gift to ILIT: Loan regime	Annual gift to ILIT: Economic benefit regime (single insured)
45	\$63,727	\$2,549	\$6,600
55	\$915,499	\$36,620	\$12,300
65	\$2,152,746	\$86,110	\$30,900
75	\$3,141,660	\$125,666	\$87,100
<b>81</b>	<b>\$3,951,662</b>	<b>\$158,066</b>	<b>\$161,400</b>
85	\$4,409,735	\$176,389	\$238,200
95	\$4,439,949	\$177,598	\$901,700

In our example, if the first spouse died at age 81 and the surviving spouse converted to a loan split dollar plan at that time, the purchase price of the policy (the loan) would equal the cash value of \$3,951,662. The gift from that point on would be \$158,066 per year and would not grow as the insured ages. That's lower than the gift of \$161,400 derived from the One-Year Term rate at that age, which would continue to grow each year as the surviving insured ages.

This is a hypothetical example for illustrative purposes only.

*Assumptions:* Survivorship universal life insurance policy, male and female age 45, Preferred Non-Tobacco risk class, \$10 million level death benefit, 20 annual premiums of \$105,000. Loan interest - unchanging 4% annual blended rate.

## Conclusion

Buying life insurance in an ILIT is a time-honored way to help replace wealth that may be reduced by an estate tax. There are multiple ways to pay for the policy. Split dollar arrangements can help lessen the gift tax effects and provide flexibility. Using a “switch dollar” concept, the parties can change their plans over time to help provide better tax results while being prepared to meet their estate planning goals.





**Get started today!** Let's begin discussing your current situation and customize a strategy that meets your objectives.

- <sup>(1)</sup> A non-equity plan is where the only benefit provided by the premium-paying party to the benefitted party is current life insurance protection.
- <sup>(2)</sup> The amount of the gift is calculated using Table 2001 rates or the carrier's one-year term rate table.
- <sup>(3)</sup> A "grantor trust" is generally a trust that has one or more of the attributes described in IRC §§ 671-678 (e.g., donor ability to reacquire assets out of trust) that cause some person—usually the grantor/donor—to be treated as one and the same with the trust for income tax purposes. See Rev. Rul. 85-13.
- <sup>(4)</sup> More precisely, it's the value of the policy under gift tax regulations. One of the safe harbor formulas for determining such value is "interpolated terminal reserve, plus unused premiums, minus loans," but this is usually pretty close to a policy's net cash value. See Treas. Reg. § 1.61-22(c)(1)(ii)IB(2) and (g)(2); and § 25.2512-6.



[principal.com](https://www.principal.com)

Principal National Life Insurance Company and Principal Life Insurance Company, Des Moines, Iowa 50392-0002, [www.principal.com](https://www.principal.com)

Insurance products issued by Principal National Life Insurance Company (except in NY), Principal Life Insurance Company®, and the companies available through the Preferred Product Network, Inc. Plan administrative services provided by Principal Life. Securities offered through Principal Securities, Inc., member SIPC, and/or independent broker/dealers. Referenced companies are members of the Principal Financial Group®, Des Moines, IA 50392.

The subject matter in this communication is educational only and provided with the understanding that Principal® is not rendering legal, accounting, investment, or tax advice. You should consult with appropriate counsel. financial professionals, and other advisors on all matters pertaining to legal, tax, investment, or accounting obligations and requirements.

**Not FDIC or NCUA insured**

**May lose value • Not a deposit • No bank or credit union guarantee  
Not insured by any Federal government agency**

Principal®, Principal Financial Group®, and Principal and the logomark design are registered trademarks of Principal Financial Services, Inc., a Principal Financial Group company, in the United States and are trademarks and service marks of Principal Financial Services, Inc., in various countries around the world.