

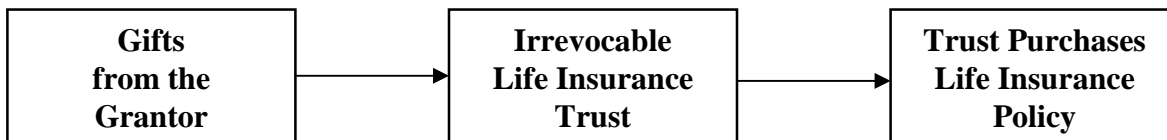


Loan-Based Private Split Dollar

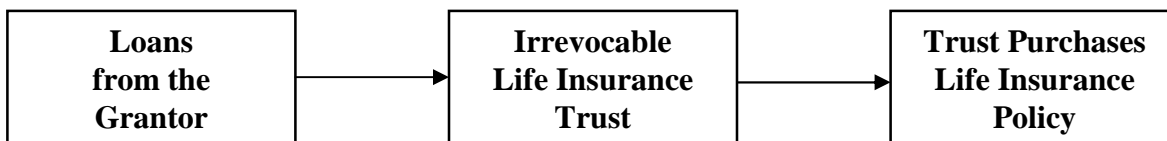
by

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This article discusses a powerful wealth preservation concept called Loan-Based Private Split Dollar (“LB-PSD”) -- a strategy used in conjunction with an irrevocable life insurance grantor trust. Typically, these trusts are funded with gifts that are used to purchase a life insurance policy, as follows:



With LB-PSD, the trust also purchases a life insurance policy, but does so with funds acquired via loans, as follows:



Below are the steps in the LB-PSD transaction we will analyze:

- ◆ The trust borrows money from the grantor at the Applicable Federal Rate (“AFR”). The long-term AFR in July 2008 (when this article was prepared) is 4.60%.
- ◆ The trust uses the loan proceeds to purchase a life insurance policy.
- ◆ Policy cash values and death benefits secure the loan.
- ◆ The grantor gifts the trust in an amount equal to the loan interest due by the trust, and the trust uses the gift proceeds to pay the loan interest due.

There are two major reasons to use loans to fund the policy instead of gifts: 1) gifts are limited by the amount of available annual exclusion and 2) gifts are limited by the amount of available unified credit. Loans are not bound by such rules.

The gifts made to the trust to cover loan interest might, at first glance, look counterproductive since they appear to be returned to the grantor as *taxable* interest; however, the trust is a grantor trust and, under grantor trust rules, the trust and the grantor are a single income tax entity, and income tax consequences on transactions *between* them are ignored. (IRC Secs. 671 and 675, IRS Reg. 1.671-2(c), and Rev. Rul. 85-13.) Consequently, with LB-PSD, gifts to the trust for loan interest payments are returned to the grantor without taxation.

Case Study: Tom and Whitney Hutchinson are age 60 and 55 respectively. If they were both to die, their estate would total almost \$11.5 million. They are considering loaning a grantor trust \$175,000 a year for 10 years to fund a \$10 million survivor universal life policy (5.5% assumed interest rate) using LB-PSD. [Click here](#) to review the LB-PSD illustration.

Let's analyze keeping the money in the estate versus loaning the money to the trust.

**Table 1
(Keep the Money in the Estate)**

Year of Death	M/F Age	(1) Value of Funds in Lender's Estate*	(2) Portion of Column (1) Lost to Estate Tax**	(3) Net Wealth to Heirs (1) - (2)
5	65/60	1,081,931	595,062	486,869
10	70/65	2,561,200	1,408,660	1,152,540
20	80/75	4,720,755	2,596,415	2,124,340
30	90/85	8,657,987	4,761,893	3,896,094
35	95/90	11,724,916	6,448,704	5,276,212

*Source of Data: Equity Calculator in the InsMark Illustration System. Assumptions for Col. (1): 10% yield; 1.00% management fee; 35% portfolio turnover; 35% short-term gains; 65% long-term gains; 40% income tax bracket; 20% capital gains tax.

**Assumption for Column 3: 55% estate tax bracket.

**Table 2
(Loan the Money to the Trust at an AFR of 4.46%)**

Year of Death	M/F Age	(1) Death Benefit of Trust's Policy	(2) Trust's Note Repayment to Estate of Lender	(3) Portion of Column (2) Left After Estate Tax*	(4) Net Wealth to Heirs (1) - (2) + (3)
5	65/60	10,000,000	875,000	393,750	9,518,750
10	70/65	10,000,000	1,750,000	787,500	9,037,500
20	80/75	10,000,000	1,750,000	787,500	9,037,500
30	90/85	10,000,000	1,750,000	787,500	9,037,500
35	95/90	10,000,000	1,750,000	787,500	9,037,500

**Assumption for Column 3: 55% estate tax bracket

As you can see, by comparing Column (3) in Table 1 with Column (4) in Table 2, loaning the money to the trust to acquire LB-PSD is considerably more advantageous -- *even though we are comparing survivor universal life at 5.5% to an equity account at 10%*.

Another key issue is this: Does the loan to the trust contaminate the estate tax free nature of the life insurance proceeds? Fortunately, IRS has issued a Private Letter Ruling ("PLR") on this subject that says it does not (PLR 9809032). While applicable only to the taxpayer to whom it is directed, this PLR specifically states that the payment of premiums with borrowed funds is irrelevant in determining whether the deceased retained any incidents of ownership under Reg. Section 20.2042-1(c)(2). The PLR also quoted as precedent two well-established court cases dealing with the same subject: Estate of Leder v. Comm., 893 F.2d 237 (10th Cir. 1989) and Estate of Headrick v. Comm., 918 F.2d 1263 (6th Cir. 1990).

Plan Design Comments: The LB-PSD illustration uses a constant long-term AFR of 4.60%, the rate in effect in July 2008. On plans with a series of annual loans such as the one reflected herein, the interest rate on new loans must bear the appropriate AFR in effect during the year each new loan is executed. This introduces an “unknown” into the concept

There are three ways to deal with unknown future AFRs:

1. Accept the risk. Gifts to the trust for loan interest are returned in the form of non-taxable interest, so it makes little difference in most cases if the loan interest varies.
2. If the AFR increases, accrue the additional interest. (LB-PSD can illustrate this.)
3. Change the plan design so that all loans are consolidated at the inception of the plan. The loaned funds in excess of the dollars needed to pay the policy’s initial premium are then reserved by the trustee in a Premium Reserve Account (“PRA”) and used to pay the remaining stream of premiums. (LB-PSD can illustrate this as well.)

Note: You can review a comprehensive history of Applicable Federal Rates at the following website: <http://evans-legal.com/dan/afr.html>.

Illustration Resources: Licensees for the Loan-Based Split Dollar System can review all related menu inputs for the accompanying LB-PSD illustration by going to <http://insmark.com/WorkbookDownload/ConceptLibrary.html>, locating the Loan-Based Private Split Dollar section, and selecting the Loan-Based Split Dollar Workbook. Licensees for the InsMark Illustration System can review all related menu inputs for the equity calculations reflected in Table 1 by selecting the InsMark Illustration System Workbook from the same location.

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