



# Loan-Based Split Dollar

## (Loan and Loan Interest Logic)

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One of the decisions to make when funding any form of a loan-based split dollar is what type of loan to use. There are four from which to choose:

1. Demand Loans
2. Short-Term Loans (3 years or less)
3. Mid-Term Loans (over 3 years but not over 9 years)
4. Long-Term Loans (over 9 years)

Each of these loans has its own loan interest structure established under IRC Section 7872. This is usually referred to as the “Applicable Federal Rate” (also known as “AFR”).

The apparent advantage of a *demand loan* is its low interest rate. Producers and their customers may be attracted to it for this reason; however, *the interest rate changes every month* on an in-force loan -- unless the so-called *blended rate* is used (announced by the IRS in July of each year), in which case, the rate changes every year. Either are dangerous rates on which to base a pro-forma illustration that covers many years due to the unknown nature of the future course of interest rates. A client using a demand loan is subject to the *uncontrollable fury of future spikes in the AFR*.

Because of this, we strongly recommend that demand loans not be used. If they are, due to the extremely high likelihood that they are currently at a generational low, we believe that their use for multi-year illustrations (typically 20 years or more) will result in *very misleading projections that may well cause yet another consumer backlash regarding unsupportable illustrations involving life insurance policies*.

A demand loan is also risky because the lender can demand payment at any time. For a sole or majority shareholder, this may not cause concern; however, a minority or non-shareholder executive may have unease about it. Table 1 shows a recent high/low history of the AFR.

**Table 1**  
**High/Low Applicable Federal Rates (1994-2003)**

Type of Loan	High AFR	Low AFR
Annual Blended Rate (for demand loans):	1995: 6.58%	2003: 1.52%
Short-Term Rate (3 years or less):	12/94: 6.66%	8/03: 1.21%
Mid-Term Rate (over 3 years but not over 9 years):	12/94: 7.74%	7/03: 2.55%
Long-Term Rate (over 9 years):	12/94: 8.23%	7/03: 4.17%

Although the borrower always has the option to repay a *term loan* before it is due, the lender cannot require repayment prior to the due date. These loans have the further advantage of locking down the loan interest rate for the term of the loan. This makes the short-term loan very appealing due to its low interest rate. For example, a short-term loan for three years issued in August 2003 would have an associated AFR of 1.21%; however, if that loan is renewed and continued after three years, *the borrower has no idea now what that rate might be then.*

A mid-term loan for nine years issued in July 2003, for example, would have an associated AFR of 2.55%; however, if that loan is renewed and continued after nine years, *the borrower has no idea now what that rate might be then.*

With loan-based split dollar, the loans are typically expected to remain in effect for long periods of time -- well over nine years. A long-term loan issued in July 2003, for example, would have an associated AFR of 4.17%, and the borrower knows *now* what that rate will be for all years of the loan -- 4.17%.

Although it might be tempting from a sales perspective, it could be seriously misleading to illustrate either the demand or short-term rate over a long period of time. Illustrating the mid-term rate when the loan will be in effect for longer than nine years is also difficult to justify.

### Renegotiating the Long-Term Loan Interest Rate

AFR rates go up, and AFR rates come down, and it is anyone's guess what rates might prevail over the term of the loan(s). An analysis of the historic long-term AFR is instructive.

**Table 2**  
**Long-Term Applicable Federal Rate (10-Year History)**

	'93	'94	'95	'96	'97	'98	'99	'00	'01	'02	10 Yr. Avg.
High month	7.30%	8.23%	8.17%	7.21%	7.18%	6.13%	6.47%	6.77%	5.82%	5.85%	6.91%
Low month	5.84%	6.30%	6.36%	6.07%	6.31%	5.10%	5.21%	5.96%	5.05%	4.60%	5.68%

For example, if a policy with five scheduled premiums had been purchased in 1993 and, through several strokes of bad timing, the loan for each of the five premiums had been made at the highest rate that occurred during each of the first five years of Table 2, the average loan interest rate on the composite of all loans would end up at 7.62%, as shown in Table 3 below.

**Table 3**

	'93	'94	'95	'96	'97	'98	'99	'00	'01	'02
1st loan:	7.30%	7.30%	7.30%	7.30%	7.30%	7.30%	7.30%	7.30%	7.30%	7.30%
2nd loan:		8.23%	8.23%	8.23%	8.23%	8.23%	8.23%	8.23%	8.23%	8.23%
3rd loan:			8.17%	8.17%	8.17%	8.17%	8.17%	8.17%	8.17%	8.17%
4th loan:				7.21%	7.21%	7.21%	7.21%	7.21%	7.21%	7.21%
5th loan:					7.18%	7.18%	7.18%	7.18%	7.18%	7.18%
Composite:	7.30%	7.77%	7.90%	7.73%	7.62%	7.62%	7.62%	7.62%	7.62%	7.62%

However, if *each* loan had been subsequently renegotiated at the lowest rate available over the following years, a far different result would have been produced, as shown in Table 4 below.

**Table 4**

	'93	'94	'95	'96	'97	'98	'99	'00	'01	'02
1st loan:	7.30%	6.30%	6.30%	6.07%	6.07%	5.10%	5.10%	5.10%	5.05%	4.60%
2nd loan:		8.23%	6.36%	6.07%	6.07%	5.10%	5.10%	5.10%	5.05%	4.60%
3rd loan:			8.17%	6.07%	6.07%	5.10%	5.10%	5.10%	5.05%	4.60%
4th loan:				7.21%	6.31%	5.10%	5.10%	5.10%	5.05%	4.60%
5th loan:					7.18%	5.10%	5.10%	5.10%	5.05%	4.60%
Composite:	7.30%	7.27%	6.94%	6.36%	6.34%	5.10%	5.10%	5.10%	5.05%	4.60%

This example (which may not be representative of interest rates over all durations) reduces the long-range loan interest rate on a regular basis. By the tenth year (2002), it would have been permanently reduced from 7.62% to 4.60%, a 40% reduction -- significant indeed for a series of loans scheduled to stay in force over many years. Any future dips in the AFR below 4.60% could lower it further, and future spikes would not affect it.

With InsMark's Loan-Based Split Dollar System, we allow users to input loan interest rates *equal to or greater than* the current long-term AFR in order to provide a comfort zone in the initial illustration for those clients concerned that the AFR might spike over the premium paying years. The strategy illustrated in Table 4 should be kept in mind when deciding on an illustrative loan interest rate for any loan-based split dollar arrangement.

A final thought on loan interest renegotiations: Many readers of this report have refinanced their home mortgage interest rates downward over the last several years -- in some cases, more than once. There have been dozens of opportunities to do so as rates fell; however, the decision to act was controlled to a great extent by 1) the hassle and 2) the costs associated with refinancing, e.g., appraisal fees, points, etc. Imagine if there had been no hassle and no costs -- just a simple form to sign. Under these circumstances, imagine how many times the refinancing would have taken place. Renegotiating the loan interest rates on the loans that support loan-based split dollar should be just that simple.

### **Multiple Loans**

There is a way to lock down a known loan interest rate for the life of all funds needed for premium payments -- but only if long-term loans are used. The employer could make a single long-term loan to the executive of all the funds needed for the multiple premiums (probably discounted by a reasonable interest assumption the executive could be expected to earn on the funds reserved for future premiums). The executive would use the single loan as a sinking fund and pay each annual premium from the fund as it becomes due. Since it is a one-time, long-term loan, the loan interest rate is both *known and locked down*.

With this approach, the renegotiating strategy discussed above could also be used effectively.

### **Loan Interest Deemed or Paid**

There is another critical decision to make -- should the loan be interest-free?

Interest-Free Demand Loans: An interest-free demand loan creates "deemed" loan interest paid by the borrower and received by the lender. If the loan is from an employer, the employer is deemed to have paid the executive a *taxable* sum equal to the Applicable Federal Rate for that loan and is further deemed to have received a like amount from the executive as loan interest. At first glance, this appears to be a wash, and it is for the employer -- unless the executive is a shareholder in the company (as is often the case) in which case the IRS characterizes the deemed loan interest paid as a dividend which is *non-deductible*. There appears to be no way to recharacterize it as compensation so long as the executive is both an employee *and a shareholder*.

The executive is deemed to have received *taxable income* (either compensation related or a dividend in the case of a shareholder) and is further deemed to have paid *non-deductible* loan interest to the employer.

Interest-Free Term Loans: An interest-free term loan produces even worse results due to the Original Issue Discount (OID) rules established in IRC Sec. 7872(b). Although the tax treatment of each interest component is the same as above, the executive's taxable income is bunched into the first year as follows: The difference between the loan amount and the present value of the loan amount at the loan's Applicable Federal Rate is deemed taxable income to the executive

when the loan is first executed. If the executive is a shareholder, there is no offsetting compensation deduction available to the employer.

Example: \$100,000 interest-free long-term loan for 20 years. Assume the Applicable Federal Rate for the loan on the date of the loan is 5.00%. The present value of \$100,000 at 5.00% over 20 years is \$37,689. The difference between \$100,000 and \$37,689 is \$62,311 which is the amount of taxable income to the executive in year 1 of the loan. And, if the executive is also a shareholder, the employer is not entitled to an offsetting deduction.

Below is a paperwork-avoidance reason to avoid interest-free loans:

*In any taxable year in which a lender or a borrower either has imputed income or claims a deduction for an amount imputed under IRC Section 7872, the following actions must be taken: 1) A statement must be attached to the income tax return explaining that it relates to the amount includable in income or deductible by reason of the below-market loan rules; 2) provide the name, address and taxpayer identification number of the other party; and 3) specify the amount includable or deductible and the mathematical assumptions and method used in computing the amounts imputed. Prop. Reg. Sec. 1.7872-11(g).*

On balance, do interest-free loans have any saving grace? No, as you will see below, the best choice is an interest-bearing loan.

Interest-Bearing Term Loans: If the loan is interest-bearing at a rate equal to or greater than its Applicable Federal Rate, no further loan interest is deemed between the parties. In addition, the executive does not suffer the bunched income that results from the nasty OID rules mentioned above because the OID rules have no bearing on any loan that is at or above the AFR established for that loan.

### **Loan-Based Split Dollar Systems Available From InsMark**

There are two loan-based split dollar illustration systems available the InsMark Loan-Based Split Dollar System and the InsMark Loan-Based Deferred Compensation System.

#### **InsMark Loan-Based Split Dollar System**

This System has two components: Loan-Based Split Dollar and Loan-Based Private Split Dollar.

Loan-Based Split Dollar: This involves employer-sponsored loans to valuable executives for the purpose of purchasing cash value life insurance policies. The loans are designed to bear interest at the Applicable Federal Rate and the System allows the option for the employer to adjust compensation for a covered executive for all/part of the loan interest due. This approach provides far more flexibility than interest-free loans which deem loan interest paid and loan interest received between the parties. (It also avoids the nasty Original Issue Discount rules of IRC Sections 1271-1275.) Loan-Based Split Dollar is a powerful replacement for employer-sponsored equity split dollar plans. In addition, since steeply accelerating term-based economic benefit costs are not present, Loan-Based Split Dollar is significantly more viable as a long term benefit plan -- particularly for shareholder-executives.

Loan-Based Private Split Dollar: This is a variation of Loan-Based Split Dollar in which the lender (typically a parent) is the grantor of an "intentionally defective" irrevocable life insurance trust that owns the life insurance policy.

With Loan-Based Private Split Dollar, parents gift funds to the trust to provide it with the cash flow needed to pay the loan interest. Loan interest is generally treated as taxable income, but not if paid to the grantor from an intentionally defective grantor trust. 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.)

Among its other uses, Loan-Based Private Split Dollar provides a new way to superfund irrevocable trusts because using loans for funding should not require use of the parents' lifetime gift exemption. (Private Letter Ruling 9809032.). To give an extreme example of the impact of the new funding possibilities, InsMark's Chairman, Bob Ritter, and his wife, Laurel, have 8 children (all married) and 18 grandchildren. Together, this produces 34 possible annual gift exclusions for each of them (8 times 2 plus 18 = 34) or \$374,000 (34 x \$11,000, the current annual gift exclusion for each) for a combined total of \$748,000 (2 times \$374,000).

Assuming an AFR on a long-term loan of 5%, for example, the \$748,000 could be gifted to an irrevocable trust to provide the trust with the cash flow for the loan interest on \$14,960,000 in long-term loans (\$748,000 divided by .05) -- all without using a dime of Bob and Laurel's subsequent annual gift exclusion or any of their lifetime exemption. The annual gift of \$748,000 would be immediately returned to Bob and Laurel by the trust as non-taxable loan interest. In other words, it would be a *cash flow neutral* transaction insofar as gifts and loan interest are concerned.

### **InsMark Loan-Based Deferred Compensation System**

A separate illustration system, InsMark's Loan-Based Deferred Compensation System illustrates an employer-sponsored executive benefit in which compensation adjustments made by the executive are used to fund an EXOLI (Executive Owned Life Insurance) plan which, by the nature of its policy ownership, can produce tax free income at retirement through policy loans (unlike COLI plans).

### **Updating Loan-Interest Rates**

Both the InsMark Loan-Based Split Dollar System and the InsMark Loan-Based Deferred Compensation System require a monthly update from InsMark's website at [www.insmark.com](http://www.insmark.com) in order to download the appropriate Applicable Federal Rate for the various types of loans. A user who skips this download cannot date an illustration during any month the download has not been completed. Both Systems also allow a user to illustrate a loan interest rate higher than the current rate for the type of loan selected in order to provide a cushion in the event of unexpected spikes in the Applicable Federal Rate for loans scheduled to be made in future years.

### **Customization**

The standard System releases of the InsMark Loan-Based Split Dollar System and the InsMark Loan-Based Deferred Compensation System reflect long-term loans only. If an insurance company licensee wants its version of either System to illustrate loan types in addition to long-term, InsMark will accommodate the request provided the insurance company gives InsMark its written approval for such customization.

### **Conclusion and Recommendation**

For the reasons discussed, interest-bearing long-term loans with loan interest at or above the Applicable Federal Rate are the strongly recommended approach for the loan-based split dollar arrangements discussed above.

This is the recommended approach for *illustrations*. It is inevitable that certain clients and their advisors may wish to implement plans using demand or short-term or medium-term loans. To accommodate this, the specimen documentation that is provided to licensees as part of the InsMark Loan-Based Split Dollar System and the InsMark Loan-Based Deferred Compensation System includes specimen language for all four types of loans. Because of the possibility of uncontrolled spiking of the interest rate associated with shorter term loan durations when such

loans mature and are renewed (and the associated likelihood of future litigation from distressed and disappointed clients), InsMark strongly recommends that only long-term loans be illustrated -- and let the decision to use other types of loans rest solely with the client and his/her advisers as they implement and administer the plan.

### **Important Note**

Illustrations and specimen documentation from the InsMark Loan-Based Split Dollar System and the InsMark Loan-Based Deferred Compensation System must be reviewed and approved by a client's legal and tax counsel before they are utilized for any purpose.