Executive Summary

Loan-Based Split Dollar

(An Alternative to Equity Split Dollar for the Corporate and Private Markets)

Abstract: There are two variations of loan-based split dollar, and both are available as illustration modules in InsMark's Loan-Based Split Dollar System. One variation, Loan-Based Split Dollar, is cast between employers and valued executives, and the other, Loan-Based Private Split Dollar, is cast between parents and irrevocable trusts formed on behalf of children. Both versions provide a new way to generate life insurance benefits and equity transfers similar to equity split dollar arrangements, and both are in compliance with the Final Split Dollar Regulations issued in September 2003.

Loan-Based Split Dollar

Loan-Based Split Dollar is an executive fringe benefit arrangement involving a series of employer-sponsored loans to a valued executive for the purpose of purchasing a cash value life insurance policy.

Loans and Loan Interest: The loans associated with the plan are evidenced by a series of promissory notes between the employer and the executive, and the life insurance policy is assigned as collateral security for the loans. The loans are term loans which are due at the end of a specific period of years; however, the promissory note calls for the acceleration of repayment should the executive die prior to the date of scheduled repayments. The interest rate paid by the executive for the life of each loan is set to the long-term Applicable Federal Rate in effect at the inception of the loan as established under IRC Sections 7872(f)(2)(A) and 1274(d). The employer typically offsets the executive's loan interest payments via a bonus.

If no interest or an inadequate rate of interest is charged on a loan, the IRS recharacterizes the loan into an "arms-length" transaction and imputes an interest rate that is deemed to have been received by the lender and paid by the borrower. The rate is published monthly and is determined by the length of the loan transaction, i.e., either the short-term rate (less than 3 years), the mid-term rate (over 3 years but not over 9 years), or the long-term rate (over 9 years).

So long as the loan interest rate is equal to or exceeds the Applicable Federal Rate, no further interest is imputed by the IRS on the transaction. In the specific illustrations associated with this plan as developed by InsMark, the interest rate may be set to equal or exceed the Applicable Federal Rate thereby adding considerably to plan flexibility.

Retirement Benefits: As owner of the policy, the executive can withdraw or borrow that portion of policy cash values in excess of the amount required to collateralize the loan. These funds are typically used to supplement retirement income. In some cases, withdrawals or loans are used as a source of funds for loan interest payments or loan repayment.

Note: Loan-Based Split Dollar should not be used for executives of public companies due to prohibitions contained in the Sarbanes-Oxley Act.

Loan-Based Private Split Dollar

Loan-Based Private Split Dollar also involves a series of loans between the parties; however, with this arrangement, the participants are parents or grandparents (referred to below as the "Lender") and an irrevocable life insurance trust ("ILIT") formed on behalf of their children or grandchildren.

Loans and Loan Interest: With Loan-Based Private Split Dollar, loans and loan interest work exactly the same as with Loan-Based Split Dollar except, with the private variation, gifts rather than bonuses are used to provide the funds for the ILIT's loan interest payments.

Since the loaned funds should not apply against the Lender's (and spouse's) annual gift exclusions or lifetime gift exemption, significantly greater amounts than usual can be allocated to the ILIT without incurring gift or estate taxes. This produces a mechanism for super-funding an ILIT.

The trustee of the trust can borrow policy cash values in excess of those that collateralize the promissory notes and any accrued interest and, if deemed appropriate by the trustee, these policy loans could be used to provide cash flow to trust beneficiaries. The trustee can also use policy loans for promissory note repayments or loan interest payments.

Assuming the ILIT is a so-called "defective" grantor trust and the Lender is the grantor of the trust, there is no income tax due by the Lender on any loan interest payment received from the ILIT; i.e., the Lender and the ILIT are considered a single income tax entity. (IRC Sections 671 and 675, IRS Reg. 1.671-2(c), and Rev. Rul. 85-13.) Consequently, when gifts for loan interest are made, they are immediately returned in the form of non-taxable interest -- a mere swapping of checks.

Private letter ruling (9809032) also provides planning guidance for Loan-Based Private Split Dollar. While applicable only to the taxpayer to whom it is directed, it specifically states that the payment of premiums with borrowed funds is irrelevant in determining whether the deceased retained any incidents of ownership in the policy under Reg. Section 20.2042-1(c)(2). The ruling confirms (and quotes 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).

The promissory note associated with Loan-Based Private Split Dollar will be included in the estate unless the holder of the note is a different party. In some cases, a charitable bequest at death of the promissory note serves the purpose of excluding the proceeds from the estate while also benefiting a favored charitable cause.

Compliance Note: In order to ensure that an illustration prepared by a licensed user utilizes the Applicable Federal Rate in effect during the month in which the illustration is prepared (or re-illustrated when the plan is implemented), the InsMark Loan-Based Split Dollar System requires monthly updates at InsMark's website (www.insmark.com) to download the Applicable Federal Rate for the current month, i.e., the licensee's system will only produce illustrations bearing a date within a month for which the Applicable Federal Rate has been downloaded.