Split Dollar Insurance And Premium Financing Planning (Part 2)

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C. Loans To Finance Premiums

1. *Concept*

a. *Why Use Loans To Finance Premiums?*

i. *Reduces Gifts To Trust*. If the premium exceeds available gift tax annual exclusions and unified credit, a loan of the premiums to the trust would reduce the annual gifts to equal the interest on the loan rather than the full premium.

ii. *Cash Flow*. If the insured does not have the resources to pay the premiums, the trust can borrow the funds from a third party.

b. *Analogous To The Old Collateral Assignment Equity Split Dollar Contracts*

i. *Pre-Split Dollar Regulation Equity Split Dollar Arrangements*

(1) The employer or insured paid the premiums.

(2) The employer and the insured had a collateral assignment up to the amount of premiums paid.

(3) The employee or the employee's life insurance trust owned the equity cash value.

(4) The employee or the trustee paid an annual term premium.

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(5) No authorities determine whether the equity constitutes additional income to the employee and a gift to the trust for grandfathered arrangements. *See* Notice 2002-8, 2002-1 C.B. 398. *But see* Preamble to proposed section 409A regulations.

ii. *Loan Regime Under 2003 Regulations*

(1) The employer or the insured loans the money to the employee or the employee's life insurance trust.

(2) The employer or the insured has a collateral assignment up to the amount of the loan.

(3) The employee or the trust owns all of the cash value, including the equity.

(4) The employee or the trustee pays the AFR to the employer or the insured.

(5) The advantage of the loan regime is that the cash value equity is not subject to income and gift taxes.

(6) The disadvantage of the loan regime is that the employee or the trustee must pay the higher AFR rather than the lower term rate.

2. *Secured Loans And Variable Life Insurance*

a. *Bottom Line*

i. If the premium loan involves a variable life insurance policy, using the policy as security for the loan could subject the lender (employer, donor, or third party) to the margin loan limits and registration requirement of the Federal Reserve Board as discussed below.

ii. The margin rules would not apply if the policy is not a variable policy. They would also be avoided if the policy is not used as security despite the gift and estate tax reasons for doing so for loans by the insured, related parties, or related entities. Even without a collateral assignment, the loan might be "indirectly secured" if the trustee's right to sell, pledge, or otherwise dispose of the variable policy is any way restricted by the trust or loan agreements. 12 C.F.R. §221.2. It is the author's understanding that the application of the margin rules is one of the reasons that third party financial institutions will not lend money for premiums for variable life policies.

iii. *See* Brody, *Evaluating Insurance Products*, 40th U. Miami Heckerling Inst. on Est. Plan., Special Session III-F, at p. III-F-4, 5, 6 (2006).

b. *Variable Policies Subject To Margin Rules*. For the purpose of Regulation U with regard to loans from lenders other than the issuing insurance company that are secured by variable life insurance policies, the underlying mutual fund shares are indirectly securing the loan and those shares are margin stock. FRRS 5-878.1 (1987); FRRS 5-917.191 (1988); FRRS 5-919.111 (1987).

c. *The Margin Rules Of Regulation U*. For lenders other than brokers and dealers, the maximum loan value for the purpose of purchasing or carrying margin stock is limited to 50 percent of the current market value of the margin stock used as security for the loan. 12 C.F.R. §§221.3 and 221.7.

d. *Reporting Requirement Of Regulation U*

i. Lenders other than banks, brokers, and dealers must register with the Federal Reserve within 30 days after the end of any calendar quarter during which the amount of credit extended in the ordinary course of business secured by margin stock equals $200,000 or more *or* the amount of each credit outstanding equals $500,000 or more. 12 C.F.R. §221.3(b)(1).

ii. Every registered non-bank lender must file an annual report with the Federal Reserve within 30 days after June 30 each year. 12 C.F.R. §221.3(b)(3).

iii. Every non-bank lender is required to obtain a signed "purpose statement" on Form FR G-3 from the customer. 12 C.F.R. §221.3(c)(1)(ii).

3. *Must Be A "Real" Loan*

a. *What Is a Loan*? Loan treatment is provided if (Treas. Reg. §1.7872-15(a)(2)):

i. Premium payment is made directly or indirectly by the non-owner (for example, the employer or donor) to the policy owner or insurance company.

ii. The payment is a loan under general principles of federal tax law or, if it is not a loan under general principles of federal tax law (for example, a non-recourse loan), a reasonable person would expect the payment to be repaid in full to the non-owner (whether with or without interest).

iii. The repayment is to be made from, or is secured by, either the policy's death benefit or its cash surrender value, or both.

b. *Sham Interest Payments*

i. The final regulations provide that certain "sham" interest provisions will be disregarded. The requirement to pay interest by the owner of the policy will be disregarded if the split dollar loan provides that all or a portion of the interest is to be paid directly or indirectly by the lender (or a person related to the lender). The regulation states that all of the facts and circumstances determine whether a payment to be made by the lender is sufficiently independent from the split dollar loan for the payment not to be an indirect payment of interest by the lender. Treas. Reg. §1.7872-15(a)(4)(i). If the interest is disregarded, the loan would be an interest-free loan subject to the full income and gift tax impact of section 7872.

ii. The regulation contains an example in which a split dollar term loan provided for five percent interest, payable in a balloon at maturity, accompanied at the same time by a vested nonqualified deferred compensation arrangement between the employer and the employee by which the employer would pay to the employee the amount equal to the accrued but unpaid interest due at the maturity of the loan. The example concludes that the employer was indirectly paying the interest and the interest would be disregarded in determining the tax treatment of the loan. Treas. Reg. §1.7872-15(a)(4)(ii), Ex.1. Another example demonstrates that the interest payment requirement is not disregarded if the nonqualified deferred compensation arrangement was executed at a different time and amounts paid did not have any relationship to the interest paid on the loan. Treas. Reg. §1.7872-15(a)(4)(ii), Ex.2.

iii. What if there is an agreement (or understanding) that the employer will bonus the funds to the employee to pay the interest? If the bonus is closely tied to a balloon interest payment, there

will probably be an interest-free loan subject to section 7872. If the interest payment is annual with a closely tied annual bonus in the amount of the interest, it is not clear whether this would be an interest-free loan under the regulation. If this is an interest-free loan, there might be an incongruous result of double taxation—forgone interest under section 7872 and a taxable bonus under section 61.

iv. What if the donor/lender annually gives an amount to the trust that owns the policy to provide funds to pay the interest to the donor/lender? Again, if the gift is so tied to the interest payment that the "facts and circumstances" indicate that the donor is "required" to pay the interest, section 7872 could apply with imputed income to the donor and imputed gift to the trust of the forgone interest. Is this a double gift—once an imputed gift under section 7872 and again a direct gift of the cash to the trust?

v. What if the lender (employer or donor) waives the accrued interest? Treasury Regulation §1.7872-15(h) will treat any forgiven interest up to the AFR as if it were paid to the lender and then retransferred by the lender to the policy owner. In an employer-employee loan, there will be interest income to the employer and compensation to the employee. In a donor/life insurance trust loan, there will be interest income to the donor and gift to the trust. If a grantor trust is involved, there will be no interest income to the grantor. In addition, the amount of the income or gift will be increased by a deferral charge tied to the underpayment rate under section 6621(a)(2). Treas. Reg. §1.7872-15(h)(4).

c. *Sham Principal Payments*

i. The preamble to the regulations states that loan treatment will not apply if, because of an agreement between the policy owner and the lender, the arrangement does not provide for repayment. "For example, if a non-owner makes a payment purported to be a split-dollar loan to an owner, and the non-owner and owner enter into a separate agreement providing that the non-owner will make a transfer to the owner in an amount sufficient to repay the purported split-dollar loan, Reg. Section 1.7872-15(a)(2) will not cause the payment to be treated as a loan."

ii. If there is a separate agreement between the employer and the employee that the employer will transfer funds to the employee or the employee's life insurance trust to cover the loan, presumably the entire "loan" would be taxable income to the employee under section 61 and an equal gift by the employee to the life insurance trust. Although the preamble does not give an example of a separate agreement, presumably a deferred compensation contract between the employer and employee to pay to the employee an amount tied to the balance due on a loan at maturity or at the employee's retirement would be such a separate agreement just like under the sham interest regulation. Hopefully, the income and gift tax consequences would not occur while the deferred compensation arrangement is subject to a substantial risk of forfeiture.

iii. Likewise, if there is a provable agreement or understanding that the donor will not require the trust to repay the loan, the entire "loan" will be a gift and section 7872 will not apply. The Tax Court in *Miller v. Commissioner*, 71 T.C.M. (CCH) 1674 (1996), *aff'd without opinion*, 113 F.3d 1241 (9th Cir. 1997), cited nine factors in determining whether a family loan was a gift or a debt.

d. *Uncertainty*. Needless to say, there is much uncertainty with outside agreements to pay deferred compensation or to bonus funds tied to either the interest payable on the loan or the principal of the loan itself. Until this uncertainty is cleared up, parties should avoid having any contractual tie between the interest and principal loan payments and the amount of deferred compensation, bonus, or other source of funds provided by the employer or donor.

4. *Estate Tax Considerations For Loans From Family Corporation Or Partnership To Life Insurance Trust*

a. *Generally, Not A Problem*. With a properly drafted irrevocable life insurance trust, the insured/employee should have no direct incidents of ownership in the insurance policy under section 2042 and no prohibited powers under sections 2036, 2038, and 2041.

b. *Potential Controlled Corporation Problems*

i. *Controlled Corporation Incidents Of Ownership Rule*. If the insured owns the majority of the voting stock of a corporation, the incidents of ownership possessed by the controlled corporation over any policy on the insured shareholder's life will be attributable to the shareholder except for proceeds of the policy payable to the corporation (or payable to a third party for a valid corporate business purpose). Treas. Reg. §20.2042-1(c)(6).

ii. *Premium Loan Should Not Cause Incidents of Ownership*. The loan regime is treated as a loan rather than an ownership interest by the controlled corporation in the insurance policy. Treas. Reg. §1.7872-15(a). Consequently, the loan itself should not result in incidents of ownership under section 2042. In PLR 9809032, the IRS ruled that the lending of premium payments by the insured to a trust the insured created does not create incidents of ownership. Likewise, the lending of premium payments by the controlled corporation to the trust should not create incidents of ownership.

iii. *Careful Of Collateral Assignment*. However, care should be taken if the controlled corporation receives a collateral assignment against the cash value and death proceeds of the policy to secure the loan. For the loan to look like an arm's-length transaction for gift tax purposes, the collateral assignment back to the corporation is very helpful but might not be appropriate if a variable life insurance policy is involved. The typical collateral assignment would give broad powers to the controlled corporation—in case of default, the ability to withdraw from, surrender, or borrow against the policy. These powers might constitute incidents of ownership. It could be argued that the incidents of ownership are confined to the cash value of the policy and do not taint the death proceeds under Treasury Regulation §20.2042-1(c)(6). However, to play it safe, the collateral assignment should be drafted as a bare bones collateral assignment discussed below.

c. *Partnership Incidents Of Ownership Problems*

i. *Aggregate Theory Versus Entity Theory*

(1) Under the aggregate theory, a partnership is an aggregate of its individual partners and any incidents of ownership in a life insurance policy held by a partnership are effectively held by the partners as individuals.