Split dollar loans to purchase life insurance

In brief

ANOTHER OPTION FOR PAYING PREMIUMS

Often, one party wants to pay premiums for a life insurance policy owned by another party but would rather lend those premium dollars than transfer them outright.

- In an employment context
  - From the perspective of employers:
    - The employer might prefer to "get something back" if the employee quits in a few years. If so, lending the premium might fit better than bonusing the premium.
    - The employer might also provide the employee an independent nonqualified deferred compensation plan that could provide the employee sufficient income – albeit taxable – to repay the loan.
    - The employer enforces the loan and gets its money back.
  - From the perspective of employees:
    - Borrowing the premiums generally means that they pay just the *interest amount* out-of-pocket, rather than income tax on the full premium.
    - Even if there is no nonqualified deferred compensation plan, over many years the policy might grow well enough such that its accumulated value provides the employee enough cash to repay the loan and keep ownership of a permanent policy that will provide a (perhaps reduced) death benefit that protects the employee's family.
- In a gift context
  - From the perspective of donors:
    - A donor might want to pay the premium for a policy owned in an irrevocable trust but avoid using any of their gift tax exemption for that purpose. A loan might fit better than a gift of the premium.
    - The donor simply might not be ready to let go of such large amounts of wealth. If years go by and the donor eventually feels that they have enough to live on, they could make a large gift to the trust by forgiving the loan principal.
  - From the perspective of donees:
    - Even if the trust repays the loan, there often is ample death benefit payable to the trust that is income tax free and estate tax free.

Of course, lending premiums has tax effects. This is particularly true if the borrower pays no interest or pays interest at a rate that is lower than the market rate. These effects are discussed on the following pages.

I.R.C. § 7872 IMPUTES INTEREST ON "BELOW-MARKET" LOANS

The lender's act of making money available for use by the borrower has a value, and this value is measured by an interest rate.

Because lending money provides value to the borrower, Internal Revenue Code (I.R.C.) § 7872 was created in 1984 to apply to most loans whenever the borrower does not pay at least a market rate of interest to the lender. When such "below-market" loans are made, I.R.C. § 7872 imposes tax as if two transfers are occurring:

- payment of an interest amount from the lender to the borrower, and
- payment of an interest amount from the borrower "back" to the lender.

The relationship between the lender and borrower dictates the nature and taxation of these imputed transfers of interest (compensation, dividend, gift, or otherwise). See Treas. Reg. § 1.7872-15(a) and (e).

SPLIT DOLLAR LOAN REGULATIONS

Although I.R.C. § 7872 has existed since 1984 and applies to below-market loans generally, very few *final* treasury regulations have been issued under this Code section. Most are in the form of final "split dollar loan" regulations that were created in 2003 and apply when the borrowed funds are used to purchase life insurance.

More specifically, under Treas. Reg. § 1.7872-15(a)(2), an arrangement is treated as a "split dollar loan" if all the following are true:

- the lender (non-policyowner) makes a premium payment directly or indirectly to the insurer for a life insurance policy owned by the borrower;
- the payment is a loan under general principles of federal tax law or, if it is not (for example, because of the nonrecourse nature of the obligation or otherwise), a reasonable person nevertheless would expect the payment to be repaid in full to the lender; and
- repayment is to be made from, or is secured by, the policy's death benefit proceeds, the policy's cash surrender value, or both.

CHARGING AT LEAST A MARKET RATE OF INTEREST AVOIDS I.R.C. § 7872

To avoid the two constructive transfers of interest under I.R.C. § 7872, the lender must charge at least a market rate of interest on the loan. This minimum interest rate is determined monthly by the Internal Revenue Service (IRS) and is known as the applicable federal rate (AFR). The relevant initial AFR is determined the month that the loan is made and largely depends on whether it is a term loan or demand loan.

Demand loans

- A demand loan is payable in full whenever the lender demands repayment.
- The relevant AFR for demand loans generally is the "blended rate." Treas. Reg. §1.7872-15(e)(3)(ii). This is published by the IRS in July each year and is equal to the product of one-half of the January semi-annual short-term AFR multiplied by one-half of the July semi-annual short-term AFR. See below for definition of short-term loan.
- With demand loans, the relevant AFR changes annually and *applies to the entire outstanding loan balance* (cumulative loaned premiums plus any accrued interest).
- As such, with demand loans it is not possible to know at each loan's inception what minimum interest rate must be charged for the loan's duration to avoid imputed interest.

Term loans

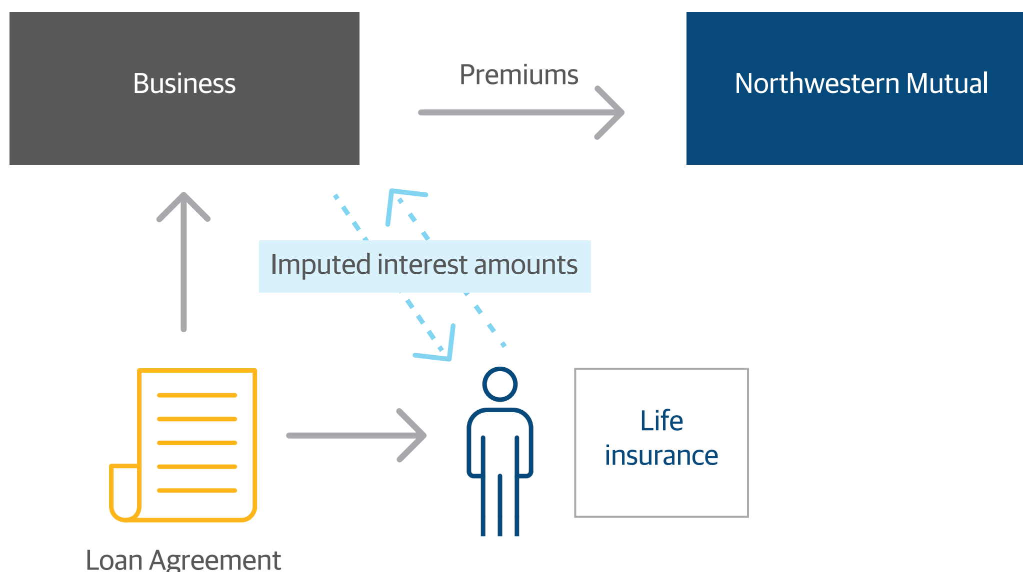
- Term loans are any loans that are not demand loans, but generally are to be repaid after a stated time period. The relevant AFR differs depending on whether the loan is short-term, mid-term, or long-term, defined as:
  - Short-term loans (not over three years).
  - Mid-term loans (more than three years but not over nine years).
  - Long-term loans (more than nine years).
- When multiple annual premiums are loaned for a term, each premium is a new loan, subject to a new AFR. Given that the ultimate repayment date (term of the loan) gets closer each year, the first loans might be long-term, while subsequent parallel loans might be mid-term and then short-term.
- In contrast to demand loans, with term loans the minimum interest rate that must be charged to avoid imputed interest is determined at each loan's inception and remains the relevant rate for that loan's entire duration.

Common split dollar loan situations generally result in term loans

- If a split dollar loan is to repaid upon someone's death (usually death of the insured), or at the *earlier* of a term of years or someone's death, the relevant AFR is based on a term that is measured by the *shorter* of the stated term or the individual's life expectancy as measured under Treas. Reg. § 1.79. See Treas. Reg. § 1.7872-15(e)(5)(ii)(C).
- If a split dollar loan is to be repaid upon the *later* of a term of years or someone's death, or the *later* of a term of years or termination of employment, the relevant AFR is based on the stated term. See Treas. Reg. § 1.7872-15(e)(5)(v)(A) and (B).
- If a split dollar loan is to be repaid whenever someone's employment terminates, then the term is assumed to be 7 years. See Treas. Reg. § 1.7872-15(e)(5)(iii)(C).

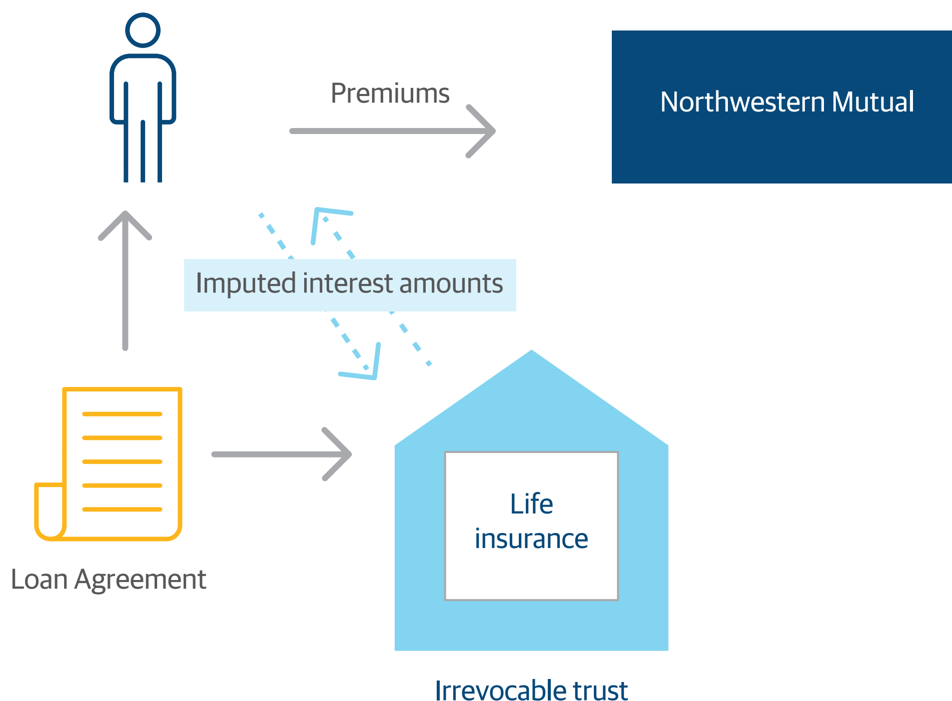
BELOW-MARKET LOANS IN BUSINESS CONTEXT

- If an employer makes a below-market loan to an employee, then:
  - the first imputed transfer of interest is treated as compensation, generally deductible for the employer and income taxed to the employee, and
  - the second imputed transfer of interest is income taxable to the employer, generally offsetting the employer's deduction, ultimately meaning there is no net tax effect to the employer. The borrowing employee cannot deduct this constructive payment of interest. Treas. Reg. § 1.7872-15(c).
- Interest is generally imputed differently for below-market term loans that are repayable at a term certain (for example, 15 years) than it is for those that are repayable upon termination of employment or death (including those repayable at the earlier of a death or a term certain).
  - With *term certain* loans (rare with split dollar loans), the first imputed transfer from the lender to the borrower does not take the form of foregone interest amounts imposed annually, but instead takes the form of a large, one-time upfront amount that is equal to the excess of the loan amount over the present value of the cumulative amount to be repaid upon expiration of the term (calculated by using the relevant AFR as a discount rate). See Treas. Reg. § 1.7872-15(e)(4). For example, if a $100,000 pure term loan charges no interest and is owed back many years later, such that the present value of what is owed back is only $60,000, there is a $40,000 imputed transfer from the lender to the borrower in the first year (and only that year) with respect to this one term loan.
  - With a loan that is repayable upon *termination of employment or death* (true of most split dollar loans), the imputed transfers of interest are calculated in a manner similar to what occurs for demand loans. That is, there is no present value calculation, but interest is imputed annually.
  - Importantly, if the first imputed transfer of interest for a below-market term loan from the lender would be a *gift* (such as an individual lending to a trust), the present value calculation methodology that's normally applicable only to term certain loans applies to that transfer, even if the loan is repayable upon termination of employment or death. See Treas. Reg. § 1.7872-15(e)(5)(iv)(D), and "Below-Market Loans in Gift Context," next page.
- If the relationship between the lender and borrower is not employer and employee, but is a business and one of its owners, then the imputed transfers would generally be treated as (i) distributions/dividends and (ii) transfers back to the corporation. See, for example, Treas. Reg. § 1.7872-15(e)(4)(vi).
- Of course, if the loan charges sufficient interest, these imputed interest rules do not apply.



BELOW-MARKET LOANS IN GIFT CONTEXT

- If a donor makes a below-market loan to a donee (for example, where an individual lends to an irrevocable trust), then many but not all the imputed interest rules are similar to those in the business context.
  - The first imputed transfer of interest is treated as a gift and is subject to gift tax (but normal rules about annual exclusions and the gift tax exemption apply).
  - The second imputed transfer of interest is potentially income taxable to the lending donor. The borrowing donee cannot deduct this constructive payment of interest. Treas. Reg. § 1.7872-15(c).
- If the borrowing donee is an irrevocable trust that is also a "grantor trust" under I.R.C. §§ 671–678 with respect to the lending donor, then the second imputed transfer of interest would not be income taxed to the donor. See Rev. Rul. 85-13, 1985-1 CB 184. Many irrevocable life insurance trusts are grantor trusts.
- Importantly, for gift tax purposes, split dollar term loans that are *gift loans* and charge below-market interest do *not* enjoy the *annual* imputation of interest treatment that is provided under Treas. Reg. § 1.7872-15 to other below-market split dollar term loans. See Treas. Reg. § 1.7872-15(e)(5)(iv)(D).
  - As such, if a *split dollar gift loan is a term loan* that charges below-market interest, then the first imputed transfer – the gift to the trust – takes the form of a large, one-time up-front amount that is equal to the excess of the loan amount over the present value of the cumulative amount to be repaid upon expiration of the term (calculated by using the relevant term AFR as a discount rate).
  - This present value calculation underlying the determination of the imputed interest applies only for purposes of the first transfer, the gift. It does not apply when calculating the second imputed transfer(s) back to the donor, such that the gift is not offset or undone by the second imputed transfer(s).
  - The split dollar below-market gift term loans subject to this present value calculation include those repayable upon death (including the earlier of death or a term certain) or upon termination of employment.



OTHER DETAILS OF SPLIT DOLLAR LOANS

- **Accruing interest.** Parties avoid below-market loan rules by charging interest, but this can done by interest being accrued and added to the loan balance, rather than having the borrower actually paying interest. Nonetheless, parties should be cautious about accruing interest, as doing so can make the ultimate loan amount to be repaid extremely large (over many years, the loan balance might even exceed the policy's death benefit).
- **Accrued interest that is subsequently waived, cancelled, or forgiven.** If accrued but unpaid interest is subsequently waived, cancelled, or forgiven by the lender, the split dollar loan regulations treat the interest as if it is being transferred twice, but *switches the ordering* from other portions of the regulations, namely (i) from the borrower to the lender, and (ii) then retransferred from the lender to the borrower.
  - With regard to the retransfer to the borrower, the split dollar regulations add a "deferral charge," which calls for multiplying interest amounts by the borrower's highest *income* tax rate. Apparently, this is meant to impose additional cost to the borrower based upon a hypothetical understatement of federal income taxes. See Treas. Reg. § 1.7872-15(h).
  - This makes enough sense if the lender and borrower are employer and employee or corporation and shareholder, but it is not clear how this rule is to be applied if they are donor and irrevocable trust, where any lender-to-borrower transfer would be *gift* taxed rather than *income* taxed.
- **Interest disregarded when lender pays interest, directly or indirectly.** Under the split dollar regulations, if the loan agreement requires the payment of interest, *and* all or a portion of the interest is to be paid directly or indirectly by the lender, then the requirement to pay the interest is disregarded. Treas. Reg. § 1.7872-15(a)(4).
  - Unfortunately, the regulations are not entirely clear on when interest is deemed paid by a lender "indirectly."
    - The only example in the split dollar loan regulations of an "indirect" payment of interest involves an employer and employee entering into a term loan agreement that accrues interest, and then *on the same day* also entering into a nonqualified deferred compensation agreement in which the employee is *immediately vested* and that promises to pay the employee the *accrued interest amount* when the loan matures.
    - A different example in the regulations contains similar facts, but there the vested nonqualified deferred compensation plan was created five years before the loan agreement was created. Under those facts the lender was not deemed to be indirectly paying interest, and interest was not disregarded.
  - Even when the lender is found to pay interest indirectly, the split dollar regulations are not entirely clear on what the effect of "disregarded" interest is, but it might mean double taxation. That is, that interest presumably would be *imputed, and income taxed* as going from the employer to the employee even though the employer had *actually* paid the same or similar amount to the employee and it had *actually been income taxed already.* This would be somewhat contrary to existing law that honors the separateness of split dollar plans and nonqualified deferred compensation plans (see *Miller v. Heller,* 915 F. Supp. 651 (S.D.N.Y. 1996)), but it is likely best to avoid triggering this provision if possible.
  - This provision addresses the lender paying *interest* directly or indirectly. Presumably it is not meant to negate the general tax principle that forgiveness of a loan's *principal* is tantamount to just one transfer of that principal amount at the time of forgiveness from the lender to the borrower (income taxed or gift taxed, as the case may be), but this is not entirely clear.

SPECIAL CONCERNS WITH IRREVOCABLE TRUSTS

- **Indirect payments of interest by donor.** Trusts often get all their assets from one donor, so when this donor lends premiums to an irrevocable trust, the parties will have to be careful to avoid the characterization that the donor is indirectly providing interest amounts to the trust (so that the trust's payments of interest to the donor are not disregarded under Treas. Reg. § 1.7872-15(a)(4)). The donor might want to make gifts to the trust at times and in amounts that do not "match" the interest payments paid by the trust to the donor, and perhaps also give income-producing property early on to decrease the need to make any gifts in subsequent years.
- **Indirect participants.** When the relationship between the lender and borrower indicate that some third party is the nexus between the lender and borrower, a below-market loan is recharacterized as if it were two loans: (i) from lender to the indirect participant/nexus, and (ii) from indirect participant/nexus to the borrower.
  - The most common example of this is a loan from an employer to an employee's irrevocable trust that owns a policy on the employee. The below-market loan is treated as two loans: (i) first from the employer to the employee, and (ii) second from the employee to the irrevocable trust.
  - Correspondingly, the first below-market loan could trigger income tax to the employee, and the second below-market loan could trigger gift tax to the donor/employee (and maybe income tax too, if the trust is not a grantor trust).
- **Beware of below-market *term* loans in *gift* contexts.** As stated above, term loans include those repayable at death, which is when many loans to trusts are due. And although the split dollar regulations call for the imputation of interest on below-market term loans in a *non-gift* situation in a "normal way" – specifically, tax on foregone interest annually – the treatment for below-market *gift* term loans is different, imputing a large up-front one-time gift based on a present value calculation.
  - Parties should keep this in mind particularly when a business considers lending premiums at a below-market rate to the irrevocable trust created by an employee or owner of that business. The imputed *income tax* on small annual amounts of interest might be manageable, but the corresponding *gift tax* on the large imputed interest in one year might be burdensome.
  - This large upfront imputed gift for foregone interest can be avoided if (i) it is a demand loan rather than a term loan, or (ii) the parties charge a market rate of interest for the term loan.
- **Limited collateral assignment helps avoid incidents of ownership.** When an irrevocable trust borrows funds to pay premiums from the insured grantor or from a business that the insured grantor controls, it is often unwise for the lender to secure the right to repayment by holding a *traditional* collateral assignment on the policy.
  - A traditional collateral assignment normally provides the collateral assignee (lender) much power over a policy, including unilateral power to withdraw cash or take policy loans. When such power is held by an assignee who is the insured or by a business that the insured controls (over 50% owner if a corporation; any percent general partner if a partnership), this generally constitutes "incidents of ownership" under I.R.C. § 2042 and causes estate inclusion for the death benefit paid to the irrevocable trust. See Treas. Reg. § 20.2042-1(c)(6) and Rev. Rul. 83-147, 1983-2 C.B. 158.
  - Instead, the parties generally should have no collateral assignment (unsecured loan) or use a "limited" collateral assignment that limits the assignee by denying the assignee any access to cash from the policy until it is surrendered or the insured dies. Limited collateral assignments generally do not constitute "incidents of ownership." See Priv. Ltr. Ruls. 200825011 (June 20, 2008) and 200910002 (March 6, 2009).

HOW TO GET OUT OF THE LOAN

Everyone should know how they can exit a loan before they enter into it. Possible ways to terminate the loan include:

- The borrower could repay by using the policy's accumulated value / cash value, or the policy's death benefit. Again, however, if the policy itself is the main source of repayment, the parties should be cautious about accruing interest, as this can make the loan extremely large after multiple years.
- The borrower could repay by using other assets it owns. In particular, if the borrower is an irrevocable trust:
  - The fact that the premium itself had not been given to the trust means that the grantor likely had more gift-giving room to contribute other assets to the trust while the loan was outstanding.
  - The trust that holds the life insurance might also be the remainder beneficiary of a split interest trust created by the grantor elsewhere, such as a Grantor Retained Annuity Trust or Charitable Lead Trust.
- The lender might forgive what is owed. The parties and their attorneys will need to carefully arrange this to not trigger the split dollar loan rule described above that disregards interest when the lender pays the interest "indirectly."

IS IT POSSIBLE FOR THE SPLIT DOLLAR LOAN REGULATIONS TO NOT APPLY?

There are times when premiums are borrowed but it is not certain that the split dollar loan regulations apply.

- For example, when an irrevocable trust owns a policy, the parties might hope to better ensure that the lender/insured does not have incidents of ownership by not securing the loan with even a limited collateral assignment on the policy, instead making the loan wholly unsecured.
  - When this occurs, it is unclear whether the arrangement still satisfies the split dollar loan definition requirement that the lender's recovery "*is to be made from, or is secured by,* the policy's death benefit proceeds, the policy's cash surrender value, or both."
  - This is especially true if the loan agreement states explicitly that repayment to the lender/insured is also *not to be made from the policy,* which parties might do given that incidents of ownership can attach whenever the insured has any economic benefits in the policy. See Treas. Reg. § 20.2042-1(c)(2).
- If the split dollar loan regulations do not apply, presumably the *general* rules of I.R.C. § 7872 would still apply, as they cover virtually all loans. Even if true, the effect on loans used to buy life insurance would be unclear.
  - Potential upsides of falling outside the split dollar loan regulations include that, outside those rules, there is no provision that calls for disregarding interest when the lender "directly or indirectly" pays the interest, and there is no "deferral charge" when interest is waived or forgiven. Also, non-split dollar loans repayable at death are still term loans where the term is measured by life expectancy. See Prop. Reg. § 1.7872-10(a)(2).
  - Potential downsides of falling outside the split dollar loan regulations include that, even *outside the gift context,* the imputed interest for below-market *term* loans is a large one-time upfront amount based on the excess of the loan over the present value of the ultimate repayment amount. Borrowing employees would probably dislike that result. Also, loans that are due whenever employment ends are generally treated as demand loans, rather than 7-year term loans. See Prop. Reg. § 1.7872-10(a)(5).
- Parties should seek sophisticated legal counsel before treating the split dollar loan regulations as inapplicable.

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