

**Two Interesting Alternatives for the Funding of Life Insurance Premiums:
Split Dollar Arrangements and Third Party Financing**

By Joshua E. Husbands*

Life insurance is often an integral part of sophisticated estate planning, as its benefits can be significant when used properly. These benefits include the fact that the proceeds are received free from income tax, the internal cash value growth occurs income tax free and, if owned properly, the proceeds are not included in the decedent's taxable estate. This versatile and useful asset does not come for free however, and the expense of paying premiums for the insurance coverage can be steep, particularly when the amount of coverage grows into the many millions of dollars. This article explores two options for funding large policies and compares their strengths and weaknesses. Portions of this article relating to split dollar financing were published in the May/June 2008 issue of *Probate & Property* and that article may be reviewed for further in-depth analysis regarding the law governing split dollar arrangements.

Most life insurance policies used as part of an estate plan for a substantial estate will be owned by an irrevocable life insurance trust ("ILIT") to ensure the proceeds are excluded from the value of the taxable estate of the decedent. In some instances, the trust that owns the policy has sufficient other assets to fund the

* **Joshua E. Husbands**, a partner in the Private Wealth Services Section of Holland & Knight LLP, represents clients in an array of business, tax, business succession and estate planning matters, including mergers and acquisitions and business divestitures. He often writes and speaks on a number of business, tax, life insurance and asset protection matters facing businesses and high net worth individuals.

payment of the annual premiums. That is the rare exception, however, and usually a planner will need to consider the source of funds for premium payment and the method that will be employed to transfer the funds to the trust when needed.

The simplest way to fund premium payments is for the grantor to transfer funds directly to the trustee to use to pay the premiums when due. If the annual premiums are small enough to avoid eroding the estate tax credit of the grantor through just the use of Crummey rights, this is probably the appropriate manner in which to pay premiums rather than adding any unnecessary additional complexity to the arrangement. This type of funding arrangement will be of particular use if the insured is young and the policy in question is a term policy. But if the premiums are considerably greater than the annual gift tax exclusion amounts available, other options must be explored to determine what funding method is best suited to the scenario at hand.

Two popular techniques for providing the needed funds to a trust for the payment of premiums are split dollar financing and third party financed premiums. Both techniques can be very effective applied correctly in the right circumstances, but neither one is a silver bullet that cures all potential issues. Split dollar life insurance funding is a technique in which a funding party, typically the grantor of an ILIT or an entity in which the grantor has an ownership interest, advances money to pay premiums in return for a promise by the trust to repay the advanced premiums upon the occurrence of certain triggering events, such as the death of the insured. Premium financing, on the other hand, typically involves borrowing from a

third party lender who will charge interest for the use of the funds. The taxation of these two different financing strategies is discussed in detail below.

The distinct differences in the taxation and economics of split dollar and third party financing results in each being more useful in different instances. A split dollar arrangement typically will be more appealing if the insured person is younger or a survivorship life policy is used. This is because the cost of life insurance protection that is used to determine the transfer tax implications of an economic benefit arrangement, or just the total annual premium due in the case of a below market loan, is minimized when the insured is younger or there are two measuring lives involved. The contrary is true for third party financing. Because interest is accruing on the amount borrowed to pay the premiums, often at a higher rate to reflect the lender's risk, the window for repayment is necessarily shorter and a more aged insured is preferable. These concepts will be discussed in more depth below.

SPLIT DOLLAR DEFINED

The Regulations under IRC §61 define split dollar insurance arrangements. Once defined as a split dollar arrangement, its taxation is defined under IRC §61 or §7872. The definition is quite broad:

A split dollar life insurance arrangement is *any arrangement* between an owner and a non-owner of a life insurance contract that satisfies the following criteria:

- (i) Either party to the arrangement pays directly or indirectly all or a portion of the premiums on the life insurance contract including a payment by means of a loan to the other party that is secured by the insurance contracts;
- (ii) At least one of the parties to the arrangement paying premium under the paragraph above is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract; and
- (iii) The arrangement is not part of a group term insurance plan described in Section 79 unless the group-term life insurance plan provides permanent benefits to employees (as defined in §1.79-0). Reg. §1.61-22(b)(1).

The definition goes on to include compensatory arrangements where the employer or service recipient pays directly or indirectly all the portion of the premiums and the beneficiary is designated by the employee or service provider, or is a person that would be reasonably expected to be designated as the beneficiary. Also, if the employee or service provider has an interest in the cash value of the policy, it is a split dollar arrangement that is covered by the Regulations.

OWNERSHIP AND METHOD

Under the split dollar Regulations, if the owner is the employee or donee, §7872 dealing with below market loans will control the relationship. The employee or donee will receive a benefit measured by the current cost of the foregone interest.

If, on the other hand, the employer or donor owns the policy, the old economic benefit regime will apply and the term cost will be the measure of the benefit. The person named as the policy owner is generally considered as the owner of the contract. Having such a simple standard is deceptive, however, for its application can be extraordinarily complex.

One such complexity is illustrated by the Regulations, which now provide an exception for the simple ownership test of identifying the owner in the contract. Even if the employee or donee is listed as the owner on the policy, if the employee's benefit is limited to only annual death benefit coverage (the entire cash value is pledged to the employer), the employer or donor is *deemed* the owner.

This deemed ownership rule effectively provides an election for the parties. They can treat the arrangement as debt controlled by §7872, or they can elect to treat the arrangement under the economic benefit regime. They should consider which method provides better results and for how long. If the insured is young or the policy is a second-to-die policy with low term costs, they would typically chose economic benefit treatment and structure the agreement to provide the greater of premiums paid or cash value would be paid to the employer or donor at termination of the agreement. If the parties elected economic benefit treatment and

subsequently terminated the split dollar arrangement, there should be no taxable transfer of property, and with all the cash value paid to the employer, no economic gain should be reportable by the owner/employee.

The regime under the final Regulations applies for arrangements entered into on or after September 18, 2003. It also applies to older arrangements preceding the effective date if there has been a material modification of the arrangement after September 17, 2003. The definition of material modification discussed below will be critical to parties under an older split dollar agreement (pre final Regulations) contemplating any change at all in the relationship. A foot fault in restructuring the arrangement that constitutes a material modification will subject the arrangement to the new regime under the final Regulations, with potentially adverse consequences.

PRIVATE EQUITY SPLIT DOLLAR

The use of private split dollar arrangements has existed for some time, and has been acknowledged, but perhaps not legitimized, by the IRS since 1996. In 1996 and 1997 private letter rulings, the parties entered into a non-equity split dollar arrangement whereby the donor in the family situation was to get back the greater of cash or gross premiums paid. The language in the rulings, however, did not require the arrangement to be non-equity, and many such arrangements have been structured as equity private split dollar, returning to the owner the excess of the cash value over premiums paid.

Equity arrangements are no longer allowed under the Final Regulations. Nonetheless, there are many grandfathered arrangements in existence that were structured as equity arrangements and must be reviewed currently to determine the best course of action to be taken going forward. If the parties to a grandfathered split dollar arrangement attempt to amend the agreement to convert from equity to non-equity, they have unquestionably materially modified the arrangement and are thus governed by the Regulations. Logically, it would appear that they would be thrown into the below-market interest regime of Section 7872. As indicated above, however, the Regulations specifically provide that if the arrangement provides the employee/donee only with insurance coverage, the employer/donor will be deemed to be the owner of the policy and thus the parties would continue under the economic benefit regime. This redefinition of ownership would allow a conversion of equity private split dollar to non-equity and the continued use of economic benefit reporting to determine the taxation of the arrangement.

If the arrangement is converted from equity to non-equity it will avoid additional gift tax on any cash build up in the policy at the termination of the arrangement because the entire cash value is pledged back to the employer/donor. As a result, there is no value the IRS can attempt to deem as transferred when the arrangement is terminated. The parties, however, should modify the agreement before there is equity attributable to the employee/donee. The concern is that the IRS will attempt to characterize the equity in the cash value as an additional gift to

the employee/donee under a §83 transfer type of theory. But the Service's argument may not be successful. Because the employee/donee has owned the entire policy since the inception of the arrangement there is no transfer of any property, but a client may not want to run the risk of such a challenge in any event.

The results of the retention of the economic benefit treatment can be highly significant. The term cost, particularly in second-to-die policies, may be much less than the amounts that will be paid under the below-market interest regime. The reverse is also true: it may be beneficial to convert from an economic benefit arrangement to a below market loan if the arrangement was originally structured around a survivorship policy and one of the two insureds dies. The term cost associated with insuring only the one remaining life will be considerably more expensive than when both insured individuals were alive. Because the economic benefit method treats the cost of insurance as the measure of the annual gift to the ILIT, that annual gift tax cost may become prohibitive.

To avoid the potentially enormous rise in the gift tax cost of the arrangement, it may be preferable to convert the arrangement to a below market or interest free loan. The initial principal balance of the loan will be the amount that was owed back to the donor under the economic benefit agreement (the greater of aggregate premiums advanced or the policy cash surrender value). The annual gift tax cost under the loan method will, in many instances, be lower than the economic benefit cost when the insured is an older person. The taxation of the loan regime is explored below.

SPLIT DOLLAR LOANS

In contrast to the economic benefit rules, the loan regime for the taxation of split dollar agreements treats the arrangement as a loan between the parties that is governed by the general tax rules for debt instruments, including the original issue discount rules of IRC §§1271-1275, if the note carries sufficient interest. If the split dollar loan is a below-market loan, as will typically be the case, then its treatment will be governed by IRC §7872 and Reg. §1.7872-15. As noted previously, treatment of a split dollar arrangement under the loan regime is mutually exclusive with taxation under the economic benefit regime.

The Regulations are concerned predominantly with measuring adequate interest, the waiver of interest, indirect payments of interest, and the like. Whereas it is necessary to define these cases, the vast majority of split dollar loans are—and will be—either completely interest free or, much less often, provide for adequate interest. If no interest is charged, the majority of the Reg. §1.7872-15 rules are inapplicable, beyond determining the amount and timing of the forgone interest charge. If adequate interest is charged, the rules do not apply at all.

It is very rare to come across a pure term split dollar loan in practice. In the context of employment, the employer almost always will require that the continuance of the agreement is dependent on the employee's continued employment or be terminated upon the employee's death, both of which are subject to the hybrid term loan rules. In the private split dollar loan context, the loan will,

in almost all instances, be a gift loan and terminate upon the death of the insured, which also will fall under the hybrid term loan rules.

THREE TYPES OF SPLIT DOLLAR LOANS

Under the Regulations, there are three types of split dollar loans, each with distinct tax treatment. Reg. §1.7872-15(b) defines the two basic types of split dollar loans as a demand loan or a term loan. Certain term loans receive special treatment and are often referred to as “hybrid” loans. The three types of loans are discussed below.

Split Dollar Demand Loans. A split dollar demand loan is one that is repayable in full at any time on the demand of the lender, or within a reasonable time after the lender’s demand for repayment. Reg. §1.7872-15(b)(2). Under a split dollar demand loan, the employer is deemed to pay as compensation to the employee the amount of foregone interest, and the employee is deemed to simultaneously repay that amount to the employer as interest paid on the loan. These transfers are deemed to occur on the last day of the calendar year to which they are attributable. Reg. §1.7872-15(e)(3)(iii)(B). The interest rate deemed to be paid on any split dollar demand loan outstanding for at least one year will be the blended annual rate published annually by the Service, which is the average of the applicable federal rates (“AFR”) for demand loans outstanding for the entire year. Reg. §1.7872-15(e)(3)(iii)(B)(1).

In practice, the split dollar demand loan is the most common type of loan utilized in the employment context, because it is typical for either party to the split

dollar agreement to have the right to cancel the agreement at any time after 30 days (or some other relatively short time period) notice. Upon termination of the agreement, the amount owed to the lender is typically due immediately.

In the context of a private split dollar loan, it may be best to exclude a unilateral termination provision for the lender if it is contemplated that the note held by the lender may be gifted by the lender at a later date. A discount from the face value of the note should be available if the ultimate timing of its repayment is uncertain. The inclusion of a unilateral termination provision for the lender in the agreement will vitiate the discount applicable to the note, because the transferee would be able to effectively call the debt at any time, which would fix the value of the obligation.

Split Dollar Term Loans. Reg. §1.7872-15(b)(2) defines a split dollar term loan as any split dollar loan other than a demand loan, unless payable on the death of an individual, or conditioned on the future performance of substantial services by an individual. The term of a split dollar term loan generally will be the period from the date the loan is made until the loan's stated maturity date. As discussed earlier, true term loans are uncommon in the context of split dollar loans.

The interest rate deemed to be charged on a split dollar term loan will be the appropriate short, mid or long-term AFR in effect on the date the loan is made. On that date, the employee will be considered to have received an amount of compensation equal to the amount of the loan minus the present value of all future payments required to be made under the terms of the loan. Reg. §1.7872-

15(e)(4)(iv). The amount of imputed income recognized by an employee upon the issuance of an interest-free term loan could be quite large if repayment is not required for a number of years.

Split Dollar Hybrid Loans. A split dollar hybrid loan is a split dollar term loan that is either: 1) payable not later than the death of the borrower; or 2) nontransferable and conditioned on the future performance of substantial services by the employee, as such terms are treated within the meaning of §83. Reg. §1.7872-15(b)(3), and (e)(5)(ii) and (iii). Split dollar term loans that are in the nature of a gift are also governed by similar rules.

In the case of a split dollar term loan that is payable upon the death of the borrower (or the insured if someone other than borrower), the loan will be treated as a split dollar demand loan, as far as the timing of the interest payments is concerned, with the annual transfer and retransfer of interest. Unlike the demand loan, however, the appropriate AFR in effect on the date the loan is made will determine the amount of the foregone interest, rather than using the blended annual rate as with a typical demand loan. Reg. §1.7872-15(e)(5)(ii)(B).

Reg. §1.7872-15(e)(5)(ii)(C) states that the term of a split dollar loan payable on the earlier of the term certain or the death of the individual will be whichever is shorter. The term based on the death of an individual will be equal to the life expectancy of that person determined under the appropriate table in §1.72-9 on the day the loan is made.

A split dollar loan that is not transferable and is conditioned on the future performance of substantial services by an individual is considered to have a term equal to the period from the date the loan is made until its stated maturity date, or seven years if no maturity date is given. For each year that the loan is outstanding, the AFR used in the determination of forgone interest is not the blended annual rate, but is instead the AFR appropriate for the loan's term for the month in which the loan is made. Reg. §1.7872-15(e)(5)(iii).

Gift Split Dollar Term Loans. Whether a gift split dollar term loan bears sufficient interest will be determined in the same fashion as a regular split dollar term loan. If the gift loan does not bear sufficient interest it will be treated as a split dollar hybrid loan, where the transfer and retransfer of interest occurs annually, as with a demand loan. As is the case with the other two types of split dollar hybrid loans, rather than using the blended annual rate, the amount of foregone interest is determined by reference to the appropriate AFR in effect at the time the loan was made. The term of a gift split dollar term loan will be the period from the time it is made until its stated maturity date: if no maturity date is stated, it will be assumed to be seven years. Reg. §1.7872-15(e)(5)(iv)(C).

The hybrid treatment described in the preceding paragraph only applies to gift split dollar term loans for Federal income tax purposes. For gift tax purposes under Chapter 12, the amount of the gift in the form of foregone interest will be determined under the typical term loan principals. The amount of the gift in such a situation will be equal to the amount of the loan, less the present value of all future

payments, using a discount rate equal to the appropriate short, mid or long term AFR in effect at the time of the loan. Reg. §1.7872-15(e)(5)(iv)(D).

FINANCED PREMIUM ARRANGEMENTS

As mentioned above, a split dollar arrangement may not be advisable if the insured individual is older and the term cost consequently results in a prohibitive gift tax cost. An older individual may also prefer the option of looking to an outside lender to provide the funds to pay insurance premiums, thereby keeping his or her personal funds free for other uses. In these cases a third party premium financing arrangement may provide a desirable option. In select instances, both premium financing and a split dollar agreement may be overlaid to provide the best result.

The confluence of low interest rates and the confusion surrounding split dollar financing since 2001 has caused the insurance industry to advance financed life insurance as an alternative to split dollar arrangements. The concept is quite simple, as well as appealing: borrow from a third party lender (other than the insurer) all of the premiums and, if possible, defer both the principal and interest until the death of the insured and the payment of the policy proceeds. The policy, if it performs properly, will add paid up additions of coverage that will pay the debt created by premium borrowing and allow the net proceeds to be used for their intended purpose.

Structure. To work effectively, the policy must generate an internal return exceeding the interest rate that the owner is paying on the borrowed premium

amounts. The economic efficacy is completely dependent on an arbitrage between the investment component return on the policy and the interest paid to a lender.

The policy, in order to provide a level death benefit, must generate paid-up additions of coverage that match the amount of principal and accrued interest that will be repaid upon the death of the insured. The mathematics of financed life dictate that the age of the insured is critical. In fact, age 70 seems to be the youngest age of an insured that will sustain premium financing. If the insured is younger, the life expectancy is concomitantly longer, and more borrowed funds are necessary to finance the policy until death. Because a lender almost certainly will charge a variable interest rate, the longer that the loan is outstanding, the greater the risk for increased interest costs, as well as the risk of a decreasing return on the policy.

The insured will finance the policy directly with a third party lender (typically a bank) who is familiar with life insurance and willing to loan on an “evergreen” or interest-only basis. If the loan is amortized over a stated period, cash demands for repayment can be prohibitive. A lender may be willing to accrue the interest and have the principal of the debt and the interest paid out of the proceeds of the policy upon the death of the insured. Generally, application of the original issue discount (“OID”) rules of Internal Revenue Code sections 1272-1275 will dissuade lenders from accruing interest over the life of the loan. The OID rules would cause the lender to recognize the interest income on an annual basis, despite the fact that it receives no cash until the loan is fully repaid at the death of the

insured. The lender would not recognize additional income at the time that the accrued interest is finally paid.

The insured may, and one would expect that he or she would, transfer the insurance contract to another owner, typically a life insurance trust. The loan, in that instance, might run directly to the trust, with a guaranty by the insured. The loan also could be directed to the insured, who would transfer the borrowed proceeds to the trust for the payment of premium. Relative advantages from a tax perspective will be discussed below.

Most lenders will require a guaranty if a life insurance trust owns the policy. Regardless of the borrower, the policy typically will be required as security for the loan. Additionally, if a trust owns the policy, the insured grantor will be asked to guaranty the loan or fund the trust with sufficient assets as security for the loan. In some instances, financed life insurance may be used to supplant an existing split dollar arrangement on an older policy. The loan would pay off the employer and future premiums could be borrowed to continue the policy.

The taxation of financed life insurance. If the loan runs to the insured grantor who, in turn, transfers the proceeds to the trust on an annual basis, the grantor will be deemed to have given that amount and will be subject to a gift tax. When the borrowing is done by the insured the debt will be a claim against the estate and, thus, deductible against the gross estate. But how could the loan be made to the insured and yet avoid the gift tax when the insured transfers the borrowed funds to the trust?

To avoid the gift tax, the grantor may consider imposing an overlay of a private split dollar arrangement on the borrowed funds from the bank, which are then advanced to the trust. In this combined arrangement, the grantor would transfer funds to the trust under a private split dollar agreement. This would avoid the gift tax, but it would create an asset ostensibly of equivalent value to the bank loan, thus nullifying the impact on the estate of the deduction of the bank loan. Although the obligation from the trust under the private split dollar agreement to the insured is of purported equal value, the fair market value of that obligation should be substantially less than its stated dollar amount. No such discount would apply to the bank loan. In the case of a second-to-die policy that is structured in the manner suggested above, the surviving grantor after the death of the first spouse should consider transferring the obligation to another trust, thus establishing the discounted value of the split dollar obligation.

If the trustee of the life insurance trust borrows directly, the grantor would not make a gift by transferring the borrowed funds to the trust. Correspondingly, the bank debt, which is an obligation of the trust, would not be a claim against the estate and deductible against the estate tax. If the bank requires the grantor to guaranty the payment, will the guaranty be an annual gift measured by the amount of the loan advanced for that year? If the IRS adopts the rationale it articulated in PLR 9113009, the guaranty should not constitute a gift in that year. Harris v US, 902 F. 2d 439 (5th Cir. 1990) (holding that a shareholder guaranty did not create basis to the shareholder in an S-corporation).

The interest, regardless of who owns the policy, will not be deductible against the income tax. First, the borrowing would constitute personal interest and thus not be deductible under Section 163(h). In any event, Section 264(a)(2) would disallow the interest deduction for amounts paid on a loan used for acquiring the insurance policy. Properly structured, however, the interest might be deductible against the estate tax. If the loan allows the accrual of the interest with the entire amount of the principal and interest payable at the death of the insured, the entire amount, including the interest, should be deductible as a claim against the estate. IRC § 2053. If the trust borrows the funds and the insured grantor guaranties the loan with the bank, does the guaranty constitute an incident of ownership resulting in the inclusion of the policy in the insured's estate? Properly structured, the answer should be "no," for the guaranty, by itself, should not result in the inclusion of the proceeds. On the other hand, if the guaranty allows access to the policy during the life of the grantor, the insured risks inclusion.

Comparison with split dollar. As indicated above, private split dollar may be used in connection with premium financing. There are distinct differences between split dollar and premium financing viewed as separate financing vehicles. The chart below illustrates these differences.

SPLIT DOLLAR

FINANCED LIFE

1. Premium

Employer pays all or employer/employee split the cost of the premium with economic benefit or imputed interest attributed to the employee.

Third party lender furnishes all of the premium and interest.

2. Gift & income tax

Foregone interest at AFR or economic benefit is treated as income or a gift.

Gift of the amount paid by insured/grantor, which can be interest, if interest is required on an annual basis and the trust is not separately funded, which itself would constitute a gift in most cases, unless the assets were transferred by sale. The guarantee by itself is not a gift.

3. Estate tax

The insured/grantor should not have proceeds included in estate, if a life insurance trust is holding the policy.

Same.

4. Incidents of ownership and majority owner of a closely held corporation

No inclusion if debt only and

Same.

policy is merely security for the payment of debt. No expanded powers over the policy or its cash value.

5. Interest deduction

None. IRC § 264.

No income tax deduction because interest constitutes personal interest. IRC § 163.

CONCLUSION

Both premium funding techniques discussed in this article are complex and are not the right fit for all situations, so each proposal and arrangement must be closely analyzed in the context of the specific fact pattern presented by the client in question. The economics of each arrangement need to be scrutinized to ensure that the plan achieves the desired goal at an acceptable cost. Not all plans are appropriate in all cases and in some instances should be avoided in almost any context. With that said, both split dollar and third party financing can, in the right circumstances, be powerful tools used to minimize gift taxes and leverage the value of premium payments for large life insurance policies.

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