Advanced Sales

Private Loan Regime Split Dollar

An Alternative to Paying Gift Tax

The traditional Irrevocable Life Insurance Trust (ILIT) has long been a universally accepted strategy for the preservation of family wealth. Funding an ILIT is straightforward – right? Simply gift the premiums to the ILIT and use the Grantor(s)' annual gift tax exclusions together with the trust beneficiaries' Crummey withdrawal rights to avoid gift tax consequences.

The Problem

But what about when the premiums are too large, the number of annual exclusion beneficiaries are too few, or the clients' annual gift tax exclusions are already being used in an alternative manner? One solution is to use the clients' lifetime exemptions. However that may not be feasible if the clients have already made significant lifetime gifts, or if their existing estate plan requires that their unified credit be allocated elsewhere.

A Solution: Private Loan Regime Split Dollar

When gift taxes are an issue, the client may want to consider Private Loan Regime Split Dollar as an alternative.[1] **In a Private Loan Regime Split Dollar arrangement, the grantor and ILIT enter into an arms-length agreement in which the grantor agrees to loan money to the trust to enable the trustee to apply for, purchase and own a life insurance policy on the grantor's life.** The ILIT agrees to repay the loan(s) and to pay loan interest to the grantor. The loan interest rate should at least equal the Applicable Federal Rate (AFR) based on the term of the loan.[2]

The annual loan interest will be considered a gift from the grantor to the ILIT, unless the ILIT actually pays the interest to the grantor each year. The ILIT may repay the loan out of the policy's death proceeds or with a withdrawal from the policy's cash value, or from other trust assets.

What are the advantages?

- The gift tax costs may be avoided or significantly reduced, since the gift is only the loan interest and not the full premium.
- There is no risk of the loan being called by a third party lender.
- The loan can be made in an up-front lump sum, which can be used to lock-in the interest rate.
- A Return of Premium rider can be included so that the ILIT receives the full specified face amount net-of-loan.

What are the disadvantages?

- The loan repayment may be subject to estate taxes.
- Loan interest payments may be subject to income taxation if the lender and the trust are considered separate taxpayers.
- Loan interest must be paid from assets in the trust.

An Example: Sheila Grant

Sheila Grant is 62 years old and has an estate of $20,000,000. She already has $5,000,000 of life insurance in an ILIT and needs an additional $4,000,000. Sheila has plenty of liquidity and could afford to pay the premium outright if she chose. However, she is strongly opposed to paying gift taxes.

Sheila's planner has advised her to consider a private loan arrangement. Sheila can also make a lump-sum loan to her ILIT and avoid paying gift taxes as long as the trust pays or accrues interest at the appropriate applicable federal rate (AFR). She ultimately decides to make a lump-sum loan to the ILIT of $3,000,000 for a period of nine years, accompanied by a one-time seed gift of $300,000. By doing so, the trustee could use the earnings off of the loan proceeds to pay the loan interest and the annual life insurance premium. Sheila is satisfied with the plan because she knows she will get the $3,000,000 back in year nine and she will avoid gift taxes.

Let's assume that the $3,000,000 is able to earn a total return of 5%[3] and that the current mid-term AFR is 0.45%. Between the gift and the income off of the loan proceeds, the trust will have enough money to pay interest annually and pay an annual premium of $126,912. This premium will purchase a $4,000,000 nine-pay UL based on Sheila's age of 62, and her preferred non-smoker status.[4] At the end of the ninth year, the ILIT will pay the loan back to Sheila.[5]

The Bottom Line

Through a private financing arrangement, Sheila is able to secure an additional $4,000,000 of death benefit in trust for her heirs, without having to pay any gift taxes.

Do you have clients who could benefit from this concept? **We're here to help!** Contact your Tellus Account Manager or Advanced Sales Director to discuss how you can succeed with Private Loan Regime Split Dollar.

[1] The design and implementation of a Private Loan Regime Split Dollar agreement should be made with the advice and guidance of the client's qualified tax and legal advisors.

[2] Under the Final Split Dollar regulations, a demand loan provides for sufficient interest if, in each calendar year, the interest rate, compounded annually, is no lower than the blended annual rate for the year. A term loan (including loans payable upon the insured's death) provides for sufficient interest if the interest rate charged is equal to or greater than the Applicable Federal Rate (AFR) that corresponds to the term of the loan. Each premium payment is viewed as a separate loan based off the the AFR at the time the loan is made.

[3] No representation can be made that these hypothetical rates of return can be achieved for any one year or sustained over any period of time.

[4] Based on a John Hancock Protection UL illustration with nine payments of $126,912 on a female preferred nonsmoker, age 62, in the state of Pennsylvania, run on July 7, 2020.

[5] If Sheila dies during the term while the note is outstanding it is included in her estate. However, note that this strategy did not increase her gross estate because these assets would be in her estate anyway.

Case studies are offered to show how Tellus can provide insurance solutions in the advanced sales marketplace. Results may vary, and this example does not guarantee a similar result.

For Insurance Professional Use Only. Not intended for use in solicitation of sales to the public. Not intended to recommend the use of any product or strategy for any particular client or class of clients. For use with non registered products only. Tellus operates under the license of Tellus Brokerage Connections, AR license #100103477. Products and programs offered through Tellus are not approved for use in all states. Products are subject to the terms and conditions of the annuity and/or insurance contract issued by the carrier. Tellus makes no representation regarding the suitability of this concept or the product(s) for an individual nor is Tellus providing tax or legal advice. Clients should always consult their own tax, legal, or other professional advisor. 07.20 ADVM20-9670-A, 0122.