Superfunding™

Overview of Loan-Based Private Split Dollar

Important Note: *This report is not a substitute for advice from legal and tax advisers of all participants, and the arrangement described, or any variation thereof, should not be utilized without their specific review and approval.*

Loan-Based Private Split Dollar involves a promissory note between a Lender -- usually a parent or grandparent -- and an irrevocable trust formed on behalf of children or grandchildren. The arrangement is designed to be in compliance with the Final Split Dollar Regulations issued in September 2003.

Loans To The Trust: The promissory note associated with Loan-Based Private Split Dollar is a term loan in which the Lender lends funds to the trust which uses the borrowed funds to purchase a life insurance policy usually on the life of the Lender and/or spouse. The policy is assigned to the Lender as security for the loan, and the loan is due within a specific term of years but no less than ten years. If the Lender dies before the loan is repaid, the promissory note calls for the immediate repayment of the loan. The loan should not require use of the Lender's annual gift exclusion and/or lifetime gift exemption, thus this portion of the transaction should have no restrictive funding limitations.

Superfunding: A loan to a trust is not limited by annual gift exclusions or lifetime gift exemptions; therefore, trusts can be superfunded using loans rather than gifts. The use of a Premium Reserve Account (see below) eliminates problems associated with modified endowment contracts (MECs) as well as fluctuating loan interest rates.

Loan Interest: Interest on the loan can be paid in cash or accrued, i.e., added to the loan. The interest rate for the life of the loan is set to the long-term rate in effect at the beginning of the loan under IRC Section 7872 -- referred to as the long-term Applicable Federal Rate. Under this code section, 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 trust. The rate is published monthly and is determined by the length of the loan transaction, i.e., either the short-term rate (3 years or less), the mid-term rate (over 3 years but not over 9 years), or the long-term rate (over 9 years).

The plan assumes the trust is a so-called "defective" grantor trust, and additional gifts to the trust are usually scheduled to offset any loan interest due by the trust. The Lender is assumed to be the grantor of the trust and, due to grantor trust rules, there is no income tax due by the Lender on such loan interest received, i.e., the Lender and the trust are a single income tax entity. (IRC Sections 671 and 675, IRS Reg. 1.671-2(c), and Rev. Rul. 85-13.) Thus, if gifts for loan interest are made, they are returned at once as non-taxable loan interest.

The Plan's Leverage: There are two possible sources of leverage: 1) The potential spread in value between the policy's values and the loans and 2) Since the loaned funds should not apply against the Lender's (and his/her spouse's) lifetime gift exemption or annual gift exclusions,

significantly greater amounts than usual can be allocated to the trust without incurring gift or estate taxes.

Taxation At Death: The life insurance payable to the trust should be free of all estate transfer taxes as the presence of the loan to the trust should not contaminate the estate tax free nature of the life insurance death benefit (PLR 9809032). The promissory note is repayable by the trust at the end of the term of years specified in the promissory note or at the death of the Lender, whichever occurs first, and repayment proceeds triggered by the death of the Lender will be subject to estate settlement costs in the estate of the Lender. If there is any accrued loan interest included in the repayment proceeds, there should be no income tax consequences to the Lender's estate on the loan interest component since, as indicated above, the Lender and the trust are a single income tax entity.

Premium Reserve Account: Although the loan to the trust involves a one-time transfer of funds from Lender to the trust, the life insurance policy should bear multiple premiums due to the more favorable taxation of policies not funded with a single premium. The loaned funds in excess of the dollars needed to pay the policy's initial premium are reserved by the trustee in a Premium Reserve Account ("PRA") and used to pay the stream of multiple premiums required for the most favorable taxation of policy values. Any taxable interest earned by the trust on its PRA from an outside source is taxable to the Lender (grantor trust "single entity" rules do not apply to interest from outside sources). Due to this, a tax exempt account is often the preferred vehicle for the PRA.

Another advantage of the PRA is it locks down the long-term Applicable Federal Rate for the entire lifetime of the plan.

Policy Loans: 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.

Note: Policy loans reduce cash values and death benefits, and the lapse of a loaned policy could result in severe tax ramifications to the policy owner. Be sure to consult your professional tax adviser if you have any questions about this issue.