

## Preface

Borrower and Policy Owner: Anthony Family Trust  
Insured: Tom Anthony/Donna Anthony

Loan-based private split dollar involves a series of promissory notes between a Lender -- usually a parent or grandparent -- and an irrevocable trust formed on behalf of children or grandchildren.

**Promissory Notes:** The loans associated with the arrangement are evidenced by a series of promissory notes between the Lender and the trust, and the life insurance policy is assigned as collateral security for the loans. The loans are term loans, i.e., they are due at the end of a specific period of years; however, the promissory note calls for the acceleration of repayment should the insured die prior to the date of scheduled loan repayments.

**Loan Interest:** The interest rate for each loan must bear interest equal to or greater than the Applicable Federal Rate ("AFR") established under IRC Sections 7872(f)(2)(A) and 1274(d) at the inception of the loan.

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 borrower.

The AFR 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).

So long as the loan interest rate is equal to or exceeds the Applicable Federal Rate, no interest is imputed by the IRS on the transaction.

The loan interest rate for each new loan will likely be different, and each future loan must bear interest equal to or greater than the AFR in effect during the month the new loan is executed. Each new loan should be evidenced by its own promissory note.

**There are four ways to deal with unknown future loan interest rates:**

1. Accept the risk: If the loan interest is paid in cash, gifts to the trust for its loan interest are immediately returned in the form of non-taxable interest, so it makes little difference in most cases if the loan interest varies.

2. Accrue additional loan interest: If the loan interest rate increases, the trust could be allowed to accrue the additional loan interest. Alternatively, the trustee may be able to withdraw funds from the policy to make up the difference in the loan interest due.
3. Renegotiate the loans: Wait until a time when the AFR dips and recast the series of notes into a new note at the reduced rate.
4. Consolidate all loans at the inception of the plan: In this case, the loaned funds in excess of those needed to pay the policy's initial premium should be reserved by the trustee to pay the remaining stream of premiums as they fall due.

### **AFRs in effect for April 2017**

Long-term loans (over 9 years): 2.82%

Mid-term loans (over 3 years; not over 9): 2.12%

Short-term loans (3 years or less): 1.11%

The accompanying calculations assume the trust is a so-called "intentionally 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 Section 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 as non-taxable loan interest.

### **Annual Gift Exclusions and Lifetime Gift**

**Exemptions:** The loaned funds should not apply against the Lender's (or spouse's) lifetime gift exemption or annual gift exclusions; therefore, significantly greater amounts than usual can be allocated to the trust without incurring gift or death taxes.