Designing a Dual Security Buy-Sell Plan Funded with Loan-Regime Split Dollar

The avoidance of income tax is the secret sauce to the Dual Security Buy-Sell Plan's long-term effectiveness – based on the following steps:

- The LLC is the purchaser of each life insurance policy. It owns all policy cash values subject to the provisions of the split-dollar arrangement with the underlying operating company, a C or S corporation. Each policy acts as collateral for the split-dollar loans. The insured Members also guarantee the loans.
- The LLC is the beneficiary of each policy's death benefits before retirement. The death proceeds finance a buy-sell agreement funded by their distribution to the surviving LLC Member(s) via a K-1. This distribution is income tax-free to the receiving Member(s) under IRC Sec. 731(a).

  With some plans, the death benefit also includes an amount to reimburse the LLC for the insured Member's lost expertise. The InsMark Illustration System contains a Key Executive Calculator on the Executive Benefits tab to establish the rationale for this amount.
- The life insurance policies are generally maximum-funded to the extent provided by law.
- The split-dollar loans from the underlying operating company are typically repaid at retirement using guaranteed, secured policy loans.
- Ownership of the policy on the surviving Member then transfers to that Member via a tax-free K-1 distribution at retirement.
- Premiums are typically not scheduled after retirement.
- Each LLC Member uses guaranteed, non-callable, policy loans in post-retirement years to produce tax-free retirement cash flow.
- Each Member keeps the policy in force until death with family members or a family trust as beneficiary.[1]

[1] *There is a potential tax bomb in life insurance that can accidentally be triggered by a careless policyowner. This unfortunate development occurs when policy loans are present, and net cash values are so low that the income tax on the gain on surrender can be significantly more than the net cash surrender value.*

This lurking tax bomb can be present in all forms of cash value life insurance contain policy loans of any type. Be sure your clients are aware of how to sidestep it.

The tax bomb can be avoided if the policy is neither surrendered nor allowed to lapse since the policy death benefit wipes away the income tax liability. The foundation of this particular tax treatment involves IRC Section 101. This statute provides that the proceeds of life insurance maturing as a death claim are exempt from federal income tax. This exemption applies to the full death benefit, including any cash value component, whether or not loans exist.

Note: It is best to design the policy with no premiums scheduled after retirement if loans may occur in retirement years. This design may require higher premiums during pre-retirement years, but a policy with no premiums scheduled is much more tolerable at advanced ages than one with continuous premiums.

Can your clients remember these facts years into the future? If they are incapacitated, will family members understand the issues? It is probably best to file a short note with the policy – something like this (although your compliance officer will likely have preferred language):

If/when you take policy loans on this policy, be sure to talk to your financial adviser before surrendering or lapsing the policy to anticipate unexpected tax consequences that may otherwise be avoided.

Does this note make it harder or easier to deliver the policy? It's harder if you haven't discussed it with your client, and that's the point – you should discuss it.

Some life insurance companies have concierge units that monitor loan status at the point of lapse or surrender. You would be well-advised to select an insurance company with this capacity as carriers need to be proactive in their client relationships, not merely reactive to client inquiries. I hope that the policyholder service division of all life insurance companies will ultimately bring this potential liability to those surrendering or lapsing policies, particularly those with 50% or more of the gross cash value subject to outstanding loans.