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By **Lawrence Brody**, **David Byers** & **Alexander Jones**

Side Fund Split Dollar Under The Loan Regime

A beneficial and flexible strategy

Split-dollar life insurance transactions can be an efficient technique[1] to fund large life insurance death benefit amounts outside the insured's estate even after the Treasury Regulations Sections 1.61-22 and 1.7872-15 were enacted in 2003. If the current higher exemption isn't extended beyond its scheduled sunset at the end of 2025, or is reduced earlier, many more estates would benefit from the infusion of insurance liquidity that split dollar can efficiently facilitate.[2]

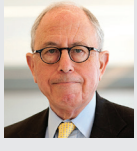
Two Regimes

The regulations provide for two regimes for split-dollar transactions: (1) economic benefit; and (2) loan.[3] Under the economic benefit regime, the measure of a grantor's annual gift is the economic benefit of the net death benefit coverage of the policy for the particular year, and at death, the greater of the policy cash value (without surrender or similar charges) or actual premium amounts paid by the grantor for the trust are included in the grantor's estate. Importantly, the trust is treated as the owner of the policy and thus qualifies for economic benefit accounting if the only benefit allocated to the trust is death benefit. Under the loan split-dollar regime, grantors may make a loan of premiums to the trust on exceptionally favorable terms, including using the applicable federal rate (AFR). At the grantor's death, the loaned amount plus accrued interest is repaid to the grantor's estate from the policy death benefit.

Our experience is that the economic benefit regime generally provides a superior result when two lives are insured on a last-to-die basis,[4] with the caveat that when the insureds reach advanced ages or one passes away, there may be a need to exit the split-dollar plan through a loan from the policy, a trust side fund cash infusion[5] or a conversion of the split-dollar plan from an economic benefit regime plan to a loan regime plan (often referred to as "switch dollar").[6]

For the purpose of this article, we'll discuss only loan split-dollar strategies and assume that only one life will be insured.[7] The loan split-dollar regime provides significant advantages for a loan made to downstream generations to invest in life insurance versus a loan to the same parties by the same lender to purchase any other asset. For example, loans made to purchase assets, such as closely held company stock or real estate, should generally pass the reality-of-sale test to distinguish the loan from an equity injection. Some planners would require a trust to be seeded with a gift valued at 10% of the overall loan to satisfy the reality-of-sale test, though others refer to the 10% touchstone as a "myth." Other inconvenient loan terms often cited as required to establish a true arm's length loan, such as a reasonable term, a prepayment penalty, a commercially reasonable interest rate, a relatively short term, required interest payments and a personal guarantee, are not only *not* required by the Internal Revenue Code split-dollar regulations but also are for the most part explicitly supplanted by other, better, terms.[8] Thus, we begin the discussion in a friendly environment created by regulations that provide a template for structuring the insurance transaction.

(From left to right) **Lawrence Brody** is senior counsel at Harrison & Held, LLP, based in St. Louis, **David Byers** is managing principal at Capital Strategies Group, Inc. in Birmingham, Ala. and **Alexander Jones** is tax counsel at Capital Strategies Group, Inc. in Birmingham, Ala.



Because of historically low Internal Revenue Service AFRs today, if transactions can be structured to permanently lock in the current AFR, it may be best to stick with the original loan transaction for the taxpayer's entire life, rather than provide for any strategy to roll out of the split-dollar arrangement. Under Treas. Regs. Section 1.7872-15, a loan for investment in life insurance under the loan regime maintains the favorable interest rate until the loan term expiration or policy surrender, whichever occurs first. If a loan of a lump sum amount of premium is made, then the entire lump sum loan would maintain an interest rate at the then-lowest AFR for that possibly extended period of time. If the lump sum loan is too large to fund the premium initially without the policy becoming a modified endowment contract (MEC) and experiencing the negative results of MEC status,[9] then the loaned premium may be feathered into the policy over time. Would the lump sum loan still qualify as a split-dollar loan? This alone shouldn't create a problem under Treas. Regs. Section 1.7872-15(a)(2)(i) if: (1) the loan was made directly by the insured/lender to the trust; (2) the loan would be considered a loan under the general principles of federal tax law or would reasonably be expected to be repaid; and (3) the loan is to be repaid from or is secured by the policy's death benefit proceeds cash value, or both. In such event, the loan would qualify under the broad definition of a split-dollar loan in the split-dollar regulations despite being made in one large advance from the insured lender.[10]

But if the loan arrangement provides for full accrual of interest until death and no recourse to the trust assets if the obligation isn't paid, could the arrangement still reasonably be said to be a "loan" under general principles of federal tax law? Not to worry—the regulations contain an interesting savings provision whereby the loan will be respected for federal tax purposes if the parties believe and file such a representation with their income tax returns that a "reasonable person" would expect the loan to be repaid in full.[11] In some situations, though, such as if the funding party—perhaps the company in a corporate split-dollar transaction or an individual donor desiring to fund a life insurance trust—wants the loaned money *returned* at a point in the future that's sooner than the insured's expected mortality date, how can the repayment before the insured's death be most efficiently effectuated?

In the private or donor/donee split-dollar scenario,[12] a repayment may be required if the grantor fears a capital need in the future or is uncomfortable parting with the money funding the premium until death. If so, the funding party, or lender, would be motivated by factors other than strictly tax planning objectives influenced by the current low AFR, and it would make sense to plan on the front end for the repayment of the split-dollar loan before the grantor/insured's death. Additionally, if the premium has been fully paid by loan proceeds and earnings, keeping the loan in place and accruing interest will add to the estate taxable loan balance without generating meaningful additional death benefit. Here as well, it may make more sense for the trust to pay off the loan with accumulated trust earnings as soon as possible.

If the trust side fund's investments return in *excess* of 5.54%, the strategy may provide an opportunity for the trust to further capitalize by allowing additional premiums to be invested into the policy, thereby increasing the death benefit amount and IRR.

Case Study

Consider clients who are a husband and wife, ages 78 and 65, respectively, whose $50 million net worth includes a $30 million investment portfolio and $20 million of personal assets. The investment portfolio contains equities, fixed income and cash.

The clients intend to leave as much of their estate as possible to their children. Because they both have already fully used their basic exclusion amounts

(BEAs), the survivor's estate will have significant exposure to the estate tax. The clients' liquidity should be more than enough to cover the projected tax at current rates; thus, an insurance transaction would be more of an investment for the purpose of specifically funding the estate tax liability with a predictable, efficient strategy, rather than a strategy focused on simply satisfying an expected liquidity need.[13]

A question may exist as to whether all loaned money plus income generated from the undeployed trust side fund invested portion of the principal must eventually be invested in insurance for the split-dollar transaction to be valid under the regulations.

The clients want to avoid *both* the gift tax (because they have no remaining BEA) *and* an insurance premium drag on investment portfolio income for the rest of their joint lives. Additionally, the clients want to be repaid their insurance investment prior to the expected death of the insured. So this is the proposition: Under a loan regime split-dollar arrangement with an accompanying side fund, often referred to as "side fund split dollar" (SFS), the clients can create a life insurance death benefit inside an irrevocable trust for their heirs (thus avoiding the estate tax on the insurance death benefit) without *any* gift tax implications, fund the insurance within a shortened term, receive a return of their principal plus interest at the end of a specified timeframe and create liquid death benefit funds with a significant internal rate of return (IRR) at the exact time such funds are needed for estate tax payment.

To lock in the current low long-term AFR of 2.25%, the clients would make a one-time loan of $8 million to the trust for 15 years.[14] Due to their 13-year age difference and the wife's preferred insurance rating, an insurance contract on her life exclusively is more efficient than a survivorship contract insuring both spouses. The premium stream during these years will consist of the investment return on the $8 million contribution less an annual amount of interest that will be accrued by the trust and ultimately repaid to the grantors. The death benefit amount of the policy will correspond to the available premium stream. And, importantly, the plan provides for the trust's repayment of the split-dollar loan to the grantors around the time of the husband's expected mortality (age 93; 15 years) so that additional cash is available for the wife at that time.[15]

To effect the split-dollar transaction, the clients would create an irrevocable trust to own the insurance policy for the benefit of their heirs. The trust is an intentionally defective grantor trust for income tax purposes so that the clients/grantors will be taxed on the trust's income, thus allowing as much income from trust assets as possible to go into the insurance strategy to create more value outside the grantors' joint estate.

Because the trust is a so-called "grantor trust," the grantor is treated as owning the trust assets for federal income tax purposes so that the trust's federal income tax incidents are included in the grantor's individual return.[16] As a result, the grantor, not the trust, will pay income tax on the trust's portfolio return, and the gross amount of the portfolio return will be available for re-investment by the trust. The grantor's payment of tax isn't a gift to the trust.[17]

A discussion of whether husband, wife or both should be grantor(s) of the trust and the income tax effect at the death of one grantor if both are grantors, or of a single grantor while the other of the couple is still alive, is beyond the scope of this article.[18] A loan regime collateral assignment split-dollar agreement will be executed between the grantor and the trust, documenting the $8 million one-time loan. Because they don't need additional income for the next 15 years, the clients will allow loan interest dollars to accrue rather than be paid to them by the trust. Accordingly, the long-term AFR interest rate

for April 2022 of 2.25% will be added to the loan balance annually, so that after 15 years, the trust will owe the clients $3,169,654 of interest in addition to the $8 million of principal, for a total of $11,169,654. Because the trust is defective under the grantor trust rules, no taxable interest income is imputed.[19]

It should be noted that the note will be an estate taxable asset. By creating the loan regime split-dollar transaction, however, the $8 million transferred by the clients to the trust was treated for tax purposes as a loan, not a gift, and thereby avoided a gift tax (or use of gift exemption) at the time of transfer. Thus, under a unified gift and estate system, the gift tax was essentially deferred until death, with the excess of the investment return over the interest accrued on the note serving as the cash flow that funded the cost to create $10 million of death benefit liquidity outside of the clients' taxable estate.

The $8 million loan will be required to accrue sufficient funds in the invested side fund to pay both the principal and interest at the end of 15 years *and* fund an insurance premium for some amount of insurance death benefit over that same 15-year period. How much death benefit can be funded will be based on the return on assets that can safely be predicted from the $8 million loan from the grantors, now invested by the trust. The investment advisor recommends that the insurance policy's premium structure depend on no more than a 6% gross rate of return in the side fund's investments.

"Side Fund in Action," p. 24, demonstrates that the annual interest at the long-term AFR will begin to accrue in the amount of $180,000 in Year 1 and grow to $245,787 in Year 15 (see Column 6). At a 6% investment return, even after annually retaining the amount of cash necessary to pay interest at the end of 15 years, there should remain more than enough available from the side fund to satisfy an annual premium of $300,000 per year for 14 years (see Column 9). The $300,000 annual premium for 14 years will fund a death benefit of $10 million that increases during the 14 premium paying years (see Column 3). The first annual premium payment would be made from the lump sum loan, and the trust's side fund would invest the remaining balance consistent with the wealth advisor's recommendation.

Assuming that over the 15-year period, the trust side fund's underlying investments earn only 5.54% (less than the projected 6%), after paying the last scheduled $300,000 premium payment in Year 14, the trust's side fund will still be able to roll out of the split-dollar plan by paying off the $11,169,654 loan balance in Year 15 (see "Side Fund Earns Less Than Projected," columns 4, 5 and 6). The death benefit of the life insurance policy would have grown to $13,423,254, and, as shown in Column 2, will remain level and in force for the rest of the wife's life. Herein lies the crux of the strategy: The life insurance policy's death benefit itself has a tax-free IRR of 5.44% at the wife's life expectancy (see Column 3), yet, the entire strategy delivers a 12.64% tax equivalent IRR for the clients at expected mortality when measured by money in and money out of the clients' account (see Column 9). The additional return is achieved by leveraging the trust side fund's investment return against the low AFR owed on the split-dollar loan to move the insurance outside the reach of the 40% estate tax.[20]

There are significant benefits available to clients by using today's low interest and annuity rates in various estate planning and estate minimization strategies.

If the trust side fund's investments return in *excess* of 5.54%, the strategy may provide an opportunity for the trust to further capitalize by allowing additional premiums to be invested into the policy, thereby increasing the death benefit amount and IRR. For example, if the side fund earned an overall 7.5% IRR, an additional $4.4 million+ would remain in the side fund after the trust repaid approximately $11 million to the clients pursuant to the loan agreement (see "Side Fund Earns More Than Projected," Column 5). With proper drafting of the split-dollar agreement at the outset, the clients should have the option to either retain the additional $4.4 million in the side fund,

Side Fund in Action

Annual interest at long-term applicable federal rate

		Policy information			Loan				Trust assets including side fund				Grantor's return on net assets at death	Grantor's tax liability
		1	2	3	4	5	6	7	8	9	10	11	12	13
Year	Age EOY	Annual policy premium	Policy cash value	Policy death benefit	Annual loan	Long-term AFR	Annual interest accrual	Loan balance EOY	Net A/T value of side fund after premium payment and investment return (EOY)	Annual side fund growth after premium payments	Net insurance death benefit after grantor recovery	Net trust assets	Equivalent B/T IRR on net trust assets	Annual tax attributable to grantor
										6.00%			(25% income, 40% estate)	(25% income)
1	66	300,000	14,752	10,179,320	8,000,000	2.25%	180,000	8,180,000	8,162,000	462,000	1,999,320	10,161,320	297.10%	(115,500)
2	67	300,000	203,084	10,361,875	0		184,050	8,364,050	8,333,720	471,720	1,997,825	10,331,545	117.49%	(117,930)
3	68	300,000	397,918	10,550,881	0		188,191	8,552,241	8,515,743	482,023	1,998,640	10,514,383	74.61%	(120,506)
4	69	300,000	601,482	10,748,548	0		192,425	8,744,667	8,708,688	492,945	2,003,881	10,712,569	55.29%	(123,236)
5	70	300,000	831,189	10,955,369	0		196,755	8,941,422	8,913,209	504,521	2,013,947	10,927,157	44.34%	(126,130)
6	71	300,000	1,072,287	11,172,030	0		201,182	9,142,604	9,130,002	516,793	2,029,426	11,159,428	37.31%	(129,198)
7	72	300,000	1,323,256	11,398,562	0		205,709	9,348,312	9,359,802	529,800	2,050,250	11,410,052	32.43%	(132,450)
8	73	300,000	1,585,294	11,636,162	0		210,337	9,558,649	9,603,390	543,588	2,077,513	11,680,903	28.85%	(135,897)
9	74	300,000	1,858,474	11,884,922	0		215,070	9,773,719	9,861,593	558,203	2,111,203	11,972,796	26.12%	(139,551)
10	75	300,000	2,142,214	12,144,242	0		219,909	9,993,627	10,135,289	573,696	2,150,615	12,285,903	23.97%	(143,424)
11	76	300,000	2,443,662	12,443,662	0		224,857	10,218,484	10,425,406	590,117	2,225,178	12,650,584	22.27%	(147,529)
12	77	300,000	2,756,734	12,756,734	0		229,916	10,448,400	10,732,930	607,524	2,308,334	13,041,265	20.87%	(151,881)
13	78	300,000	3,083,237	13,083,237	0		235,089	10,683,489	11,058,906	625,976	2,399,748	13,458,654	19.71%	(156,494)
14	79	300,000	3,423,254	13,423,254	0		240,379	10,923,867	11,404,441	645,534	2,499,387	13,903,827	18.72%	(161,384)
15	80	0	3,572,625	13,423,254	0		245,787	0	919,053	684,266	13,423,254	14,342,307	18.43%	(171,067)
16	81	0	3,747,560	13,423,254	0		0	0	974,196	55,143	13,423,254	14,397,450	17.79%	(13,786)
17	82	0	3,925,286	13,423,254	0		0	0	1,032,648	58,452	13,423,254	14,455,902	17.21%	(14,613)
18	83	0	4,106,062	13,423,254	0		0	0	1,094,606	61,959	13,423,254	14,517,860	16.68%	(15,490)
19	84	0	4,292,965	13,423,254	0		0	0	1,160,283	65,676	13,423,254	14,583,537	16.20%	(16,419)
20	85	0	4,485,816	13,423,254	0		0	0	1,229,900	69,617	13,423,254	14,653,154	15.76%	(17,404)
21	86	0	4,660,186	13,423,254	0		0	0	1,303,694	73,794	13,423,254	14,726,948	15.36%	(18,448)
22	87	0	4,834,055	13,423,254	0		0	0	1,381,915	78,222	13,423,254	14,805,169	14.99%	(19,555)
23	88	0	5,008,711	13,423,254	0		0	0	1,464,830	82,915	13,423,254	14,888,084	14.65%	(20,729)
24	89	0	5,184,618	13,423,254	0		0	0	1,552,720	87,890	13,423,254	14,975,974	14.33%	(21,972)
25	90	0	5,365,739	13,423,254	0		0	0	1,645,883	93,163	13,423,254	15,069,137	14.03%	(23,291)
26	91	0	5,558,932	13,423,254	0		0	0	1,744,636	98,753	13,423,254	15,167,890	13.76%	(24,688)
27	92	0	5,769,543	13,423,254	0		0	0	1,849,315	104,678	13,423,254	15,272,569	13.50%	(26,170)
28	93	0	6,004,232	13,423,254	0		0	0	1,960,273	110,959	13,423,254	15,383,527	13.26%	(27,740)

KEY

-Last scheduled premium paying year -Life expectancy EOY -End of year AFR -Applicable federal rate A/T -After taxes B/T -Before taxes IRR -Internal rate of return

— *Alexander Jones*

invest additional money as extra premium into the policy or a combination of both.[21]

A question may exist as to whether all loaned money plus income generated from the undeployed trust side fund invested portion of the principal must eventually be invested in insurance for the split-dollar transaction to be valid under the regulations. Because the arrangement is under the loan regime, only the principal plus stated interest is to be returned to the insured/donor, and all

Side Fund Earns Less Than Projected

Loan balance paid in Year 15

		Policy information			Loan		Trust assets including side fund			Grantor's return on net assets at death
		1	2	3	4	5	6	7	8	9
Year	Age EOY	Policy cash value	Policy death benefit	Death benefit IRR	Loan payment	Loan balance EOY	Net A/T value of side fund after premium payment and investment return (EOY)	Annual side fund growth after premium payments	Net trust assets	Equivalent B/T IRR on net trust assets
								5.54%		(25% income, 40% estate)
1	66	14,752	10,179,320	3293.11%	0	8,180,000	8,126,894	426,894	10,126,214	295.07%
2	67	203,084	10,361,875	439.83%	0	8,364,050	8,260,822	433,929	10,258,647	116.83%
3	68	397,918	10,550,881	188.34%	0	8,552,241	8,402,176	441,354	10,400,816	74.02%
4	69	601,482	10,748,548	111.09%	0	8,744,667	8,551,366	449,190	10,555,248	54.73%
5	70	831,189	10,955,369	75.67%	0	8,941,422	8,708,828	457,462	10,722,775	43.79%
6	71	1,072,287	11,172,030	55.89%	0	9,142,604	8,875,019	466,191	10,904,446	36.77%
7	72	1,323,256	11,398,562	43.47%	0	9,348,312	9,050,425	475,405	11,100,674	31.88%
8	73	1,585,294	11,636,162	35.05%	0	9,558,649	9,235,554	485,130	11,313,067	28.30%
9	74	1,858,474	11,884,922	29.03%	0	9,773,719	9,430,948	495,394	11,542,151	25.56%
10	75	2,142,214	12,144,242	24.54%	0	9,993,627	9,637,174	506,226	11,787,789	23.41%
11	76	2,443,662	12,443,662	21.13%	0	10,218,484	9,854,834	517,660	12,080,012	21.70%
12	77	2,756,734	12,756,734	18.44%	0	10,448,400	10,084,561	529,727	12,392,895	20.30%
13	78	3,083,237	13,083,237	16.28%	0	10,683,489	10,327,024	542,463	12,726,772	19.13%
14	79	3,423,254	13,423,254	14.52%	0	10,923,867	10,582,929	555,905	13,082,316	18.15%
15	80	3,572,625	13,423,254	13.05%	(11,169,654)	0	0	586,725	13,423,254	17.85%
16	81	3,747,560	13,423,254	11.83%	0	0	0	0	13,423,254	17.21%
17	82	3,925,286	13,423,254	10.81%	0	0	0	0	13,423,254	16.64%
18	83	4,106,062	13,423,254	9.94%	0	0	0	0	13,423,254	16.11%
19	84	4,292,965	13,423,254	9.20%	0	0	0	0	13,423,254	15.63%
20	85	4,485,816	13,423,254	8.55%	0	0	0	0	13,423,254	15.20%
21	86	4,660,186	13,423,254	7.99%	0	0	0	0	13,423,254	14.79%
22	87	4,834,055	13,423,254	7.49%	0	0	0	0	13,423,254	14.42%
23	88	5,008,711	13,423,254	7.05%	0	0	0	0	13,423,254	14.07%
24	89	5,184,618	13,423,254	6.66%	0	0	0	0	13,423,254	13.75%
25	90	5,365,739	13,423,254	6.31%	0	0	0	0	13,423,254	13.44%
26	91	5,558,932	13,423,254	5.99%	0	0	0	0	13,423,254	13.16%
27	92	5,769,543	13,423,254	5.70%	0	0	0	0	13,423,254	12.89%
28	93	6,004,232	13,423,254	5.44%	0	0	0	0	13,423,254	12.64%
29	94	6,271,595	13,423,254	5.20%	0	0	0	0	13,423,254	12.40%
30	95	6,586,475	13,423,254	4.98%	0	0	0	0	13,423,254	12.18%
31	96	6,800,342	13,423,254	4.78%	0	0	0	0	13,423,254	11.97%
32	97	7,041,046	13,423,254	4.59%	0	0	0	0	13,423,254	11.77%
33	98	7,322,124	13,423,254	4.42%	0	0	0	0	13,423,254	11.57%
34	99	7,646,115	13,423,254	4.26%	0	0	0	0	13,423,254	11.39%
35	100	8,044,656	13,423,254	4.11%	0	0	0	0	13,423,254	11.22%

KEY

-Last scheduled premium paying year -Life expectancy EOY -End of year AFR -Applicable federal rate A/T -After taxes B/T -Before taxes IRR -Internal rate of return

— Alexander Jones

Side Fund Earns More Than Projected

Additional premiums can be invested in policy

		Loan				Trust assets including side fund		
		1	2	3	4	5	6	7
Year	Age EOY	Loan balance EOY	Annual interest accrual	Loan payment	Loan balance EOY	Net A/T value of side fund after premium payment and investment return (EOY)	Annual side fund growth after premium payments	Equivalent B/T IRR on net trust assets
							7.50%	(25% income, 40% estate)
1	66	0	180,000	0	8,180,000	8,277,500	577,500	303.82%
2	67	8,180,000	184,050	0	8,364,050	8,575,813	598,313	119.68%
3	68	8,364,050	188,191	0	8,552,241	8,896,498	620,686	76.58%
4	69	8,552,241	192,425	0	8,744,667	9,241,236	644,737	57.17%
5	70	8,744,667	196,755	0	8,941,422	9,611,829	670,593	46.19%
6	71	8,941,422	201,182	0	9,142,604	10,010,216	698,387	39.16%
7	72	9,142,604	205,709	0	9,348,312	10,438,482	728,266	34.28%
8	73	9,348,312	210,337	0	9,558,649	10,898,868	760,386	30.71%
9	74	9,558,649	215,070	0	9,773,719	11,393,783	794,915	28.00%
10	75	9,773,719	219,909	0	9,993,627	11,925,817	832,034	25.88%
11	76	9,993,627	224,857	0	10,218,484	12,497,753	871,936	24.20%
12	77	10,218,484	229,916	0	10,448,400	13,112,585	914,831	22.83%
13	78	10,448,400	235,089	0	10,683,489	13,773,528	960,944	21.70%
14	79	10,683,489	240,379	0	10,923,867	14,484,043	1,010,515	27.27%
15	80	10,923,867	245,787	(11,169,654)	0	4,400,692	1,086,303	21.11%

KEY

-Last scheduled premium paying year EOY -End of year AFR -Applicable federal rate A/T -After taxes B/T -Before taxes IRR -Internal rate of return

— *Alexander Jones*

additional equity earned on the side fund's balance would belong to the trust. Because of the issuance of final split-dollar regulations in 2003,[22] collateral assignment transactions need to be non-equity to use the economic benefit regime, meaning that the donor is entitled to the greater of premiums advanced or cash values, so that no equity in the arrangement can accrue to the benefit of the trust.

Loan regime transactions, however, are essentially equity arrangements, because values that accrue in excess of the loan plus interest amount (or equity) are the property of the trust and, hence, may be used by the trust to satisfy its own obligations however it sees fit, including by prepaying the loan split-dollar arrangement. That decision would be made after considering the trust's liquidity needs at the time as well as the advisability of owning additional death benefit to cover their then-estimated estate tax exposure or for other purposes.

As an example of the effect of additional investment of excess investment return, an extra approximately $4.4 million deposited into the policy in Year 15 would cause the death benefit at the wife's life expectancy to increase from $13,423,254 to $21,692,614, representing an increase of $8,269,360 for the clients' heirs, free of income and estate taxes (see "Effect of Additional Investment," p. 27, Column 3). A 10.24% taxable IRR year after year on investments inside the clients' estate for next 13 years would be required to achieve an equal investment result (see Column 10). Finally, it's important to consider whether the clients are in jeopardy if the 5.54% hurdle rate isn't achieved after 15 years. If so, two options exist: (1) the clients' trustee could reduce the death benefit

Effect of Additional Investment

Death benefit increases

		Policy information				Trust assets including side fund				Grantor's return on net assets at death	
		1	2	3	4	5	6	7	8	9	10
Year	Age EOY	Annual policy premium	Policy cash value	Policy death benefit	Death benefit IRR	Net A/T value of side fund after premium payment and investment return (EOY)	Annual side fund growth after premium payments	Net insurance death benefit after grantor recovery	Net trust assets	A/T IRR on additional premium in Year 15	Equivalent B/T IRR on additional premium in Year 15
							7.50%				(25% income, 40% estate)
14	79	300,000	3,423,254	13,423,254	14.52%	14,484,043	1,010,515	2,499,387	16,983,430		
15	80	4,400,692	6,763,087	16,763,087	11.69%	0	0	16,763,087	16,763,087	-15.44%	-34.30%
16	81	0	7,144,660	17,144,660	10.52%	0	0	17,144,660	17,144,660	-8.04%	-17.87%
17	82	0	7,537,062	17,537,062	9.59%	0	0	17,537,062	17,537,062	-2.22%	-4.94%
18	83	0	7,939,106	17,939,106	8.83%	0	0	17,939,106	17,939,106	0.65%	1.44%
19	84	0	8,352,824	18,352,824	8.20%	0	0	18,352,824	18,352,824	2.30%	5.10%
20	85	0	8,775,477	18,775,477	7.68%	0	0	18,775,477	18,775,477	3.32%	7.37%
21	86	0	9,177,544	19,177,544	7.22%	0	0	19,177,544	19,177,544	3.91%	8.68%
22	87	0	9,575,412	19,575,412	6.83%	0	0	19,575,412	19,575,412	4.28%	9.50%
23	88	0	9,965,350	19,965,350	6.48%	0	0	19,965,350	19,965,350	4.50%	10.01%
24	89	0	10,343,704	20,343,704	6.17%	0	0	20,343,704	20,343,704	4.63%	10.29%
25	90	0	10,707,474	20,707,474	5.90%	0	0	20,707,474	20,707,474	4.69%	10.42%
26	91	0	11,056,055	21,056,055	5.64%	0	0	21,056,055	21,056,055	4.70%	10.44%
27	92	0	11,385,457	21,385,457	5.41%	0	0	21,385,457	21,385,457	4.67%	10.37%
28	93	0	11,692,614	21,692,614	5.20%	0	0	21,692,614	21,692,614	4.61%	10.24%
29	94	0	11,972,499	21,972,499	5.00%	0	0	21,972,499	21,972,499	4.53%	10.06%
30	95	0	12,223,276	22,223,276	4.81%	0	0	22,223,276	22,223,276	4.43%	9.84%
31	96	0	12,225,538	22,225,538	4.58%	0	0	22,225,538	22,225,538	4.16%	9.25%
32	97	0	12,141,488	22,141,488	4.36%	0	0	22,141,488	22,141,488	3.87%	8.60%
33	98	0	11,959,486	21,959,486	4.14%	0	0	21,959,486	21,959,486	3.55%	7.89%
34	99	0	11,639,655	21,639,655	3.90%	0	0	21,639,655	21,639,655	3.17%	7.05%
35	100	0	11,169,925	21,169,925	3.66%	0	0	21,169,925	21,169,925	2.73%	6.07%

KEY

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— Alexander Jones

to an amount that's supported for an appropriate duration without further premiums due; or (2) the trustee could delay the principal repayment and allow the side fund to continue to grow until accumulating the capital necessary to satisfy the note and/or the remaining premiums. If the trustee chooses the latter option, the trustee could make interest payments out of the side fund to provide income to the client while the side fund accumulates (see "Hurdle Rate Not Achieved," Columns 5, 6 and 7). The appropriate choice should be made based on the clients' situation and insurance and interest projections at that time, as well as the overall best interest of the beneficiaries.

Leverage Excess Market Return

There are significant benefits available to clients by using today's low interest and annuity rates in various estate planning and estate minimization strategies. The leverage achieved by combining these low interest rates and very favorable split-dollar regulations offers clients favorable downstream

Hurdle Rate Not Achieved

Trustee can make interest payments out of side fund

		Loan						Trust assets including side fund			
		1	2	3	4	5	6	7	8	9	10
Year	Age EOY		Annual loan	Long-term AFR	Annual interest accrual	Loan payment	Loan balance EOY	Net A/T value of side fund after premium payment and investment return (EOY)	Annual side fund growth after premium payments	Net insurance death benefit after grantor recovery	Net trust assets
									4.87%		
1	66	0	8,000,000	2.25%	180,000	0	8,180,000	8,075,305	375,305	1,999,320	10,074,625
2	67	8,180,000	0		184,050	0	8,364,050	8,154,279	378,975	1,997,825	10,152,104
3	68	8,364,050	0		188,191	0	8,552,241	8,237,104	382,824	1,998,640	10,235,744
4	69	8,552,241	0		192,425	0	8,744,667	8,323,965	386,861	2,003,881	10,327,846
5	70	8,744,667	0		196,755	0	8,941,422	8,415,060	391,095	2,013,947	10,429,007
6	71	8,941,422	0		201,182	0	9,142,604	8,510,595	395,535	2,029,426	10,540,021
7	72	9,142,604	0		205,709	0	9,348,312	8,610,786	400,191	2,050,250	10,661,036
8	73	9,348,312	0		210,337	0	9,558,649	8,715,861	405,075	2,077,513	10,793,374
9	74	9,558,649	0		215,070	0	9,773,719	8,826,057	410,196	2,111,203	10,937,260
10	75	9,773,719	0		219,909	0	9,993,627	8,941,624	415,567	2,150,615	11,092,239
11	76	9,993,627	0		224,857	0	10,218,484	9,062,824	421,200	2,225,178	11,288,002
12	77	10,218,484	0		229,916	0	10,448,400	9,189,932	427,108	2,308,334	11,498,266
13	78	10,448,400	0		235,089	0	10,683,489	9,323,235	433,303	2,399,748	11,722,983
14	79	10,683,489	0		240,379	0	10,923,867	9,463,035	439,800	2,499,387	11,962,421
15	80	10,923,867	0		245,787	(245,787)	10,923,867	9,678,484	461,236	2,499,387	12,177,871
16	81	10,923,867	0		245,787	(245,787)	10,923,867	9,904,435	471,738	2,499,387	12,403,821
17	82	10,923,867	0		245,787	(245,787)	10,923,867	10,141,398	482,751	2,499,387	12,640,785
18	83	10,923,867	0		245,787	(245,787)	10,923,867	10,389,912	494,300	2,499,387	12,889,298
19	84	10,923,867	0		245,787	(245,787)	10,923,868	10,650,538	506,413	2,499,386	13,149,924
20	85	10,923,868	0		245,787	(11,169,655)	0	0	519,116	13,423,254	13,423,254
21	86	0	0		0	0	0	0	0	13,423,254	13,423,254
22	87	0	0		0	0	0	0	0	13,423,254	13,423,254
23	88	0	0		0	0	0	0	0	13,423,254	13,423,254
24	89	0	0		0	0	0	0	0	13,423,254	13,423,254
25	90	0	0		0	0	0	0	0	13,423,254	13,423,254
26	91	0	0		0	0	0	0	0	13,423,254	13,423,254
27	92	0	0		0	0	0	0	0	13,423,254	13,423,254
28	93	0	0		0	0	0	0	0	13,423,254	13,423,254
29	94	0	0		0	0	0	0	0	13,423,254	13,423,254
30	95	0	0		0	0	0	0	0	13,423,254	13,423,254
31	96	0	0		0	0	0	0	0	13,423,254	13,423,254
32	97	0	0		0	0	0	0	0	13,423,254	13,423,254
33	98	0	0		0	0	0	0	0	13,423,254	13,423,254
34	99	0	0		0	0	0	0	0	13,423,254	13,423,254
35	100	0	0		0	0	0	0	0	13,423,254	13,423,254

KEY

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— *Alexander Jones*

tax equivalent returns without normal market risk, even if the client intends to only temporarily leverage the excess market return into an efficient death benefit-directed insurance contract. When a side fund is structured appropriately, loan regime SFS is a very beneficial and flexible strategy that should be considered for estate tax funding in many scenarios regardless of whether liquidity is otherwise available.

Endnotes

1. For these purposes, "efficient" means moving cash for premium payments from one generation to a younger generation without paying gift tax or using significant gifting capacity provided by the annual exclusion amount (AEA) or the basic exclusion amount (BEA).
2. If an estate *isn't* taxable, then some amount of the BEA or AEA can easily be allocated to a grantor's gift of insurance premium to the trust because there would be no competing use of the BEA or AEA, and no part of the policy proceeds will be included in the grantor's estate at death. Thus, there would be no need to use either split-dollar regime.
3. *See* Treasury Regulations Sections 1.61-22 and 1.7872-15.
4. Because of the dramatically lower economic benefit cost while both insureds are alive.
5. *See* the two-part article by Lawrence Brody and Michael D. Weinberg, "The Side Fund Split-Dollar Solution: A New Technique for Split Dollar," *Estate Planning* (2006).
6. *See* Lawrence Brody, David Byers and Hudson Williams, "Switch Dollar and the Power of Deferral," *Trusts & Estates* (2018).
7. The two-part article by Lawrence Brody and Michael D. Weinberg, *supra* note 5, addressed the trust exiting a nonequity economic benefit split-dollar arrangement with a second-to-die policy in which a side fund owned by the trust is funded through annual exclusion gifts and ultimately tapped to pay off the split-dollar liability to the insureds/donors. This article examines a loan regime split-dollar scenario, using an upfront loan to annually fund a single life policy *and* to create a side fund later used to exit the loan arrangement. The idea of the previous article was that by making the advantaged gifts to the trust that owned the policy, at some point the non-insurance assets in the side fund could be used to repay the premium advances, terminate the arrangement and stop the ever-increasing economic benefits. The concept of this article is that by making an upfront loan that can be feathered into the policy over time, the grantor can create a side fund to exit the arrangement at a specific date without making additional gifts.
8. Treas. Regs. Section 1.7872-15.
9. Treating lifetime distributions from the modified endowment contract (broadly defined) as distributions from an annuity—income first, basis last—and possibly subject to a 10% penalty.
10. *See supra* note 6.
11. *See* Treas. Regs. Section 1.7872-15(d)(2).
12. Private split dollar, as discussed in Private Letter Ruling 200910002 (March 6, 2009), generally involves individual insureds/donors and a trust for heirs, as opposed to a corporation and an individual related in interest to it, such as an officer or a shareholder. The final split-dollar regulations apply for federal gift tax purposes to donor/donee arrangements.
13. The insurance would likely deliver a secure, significant, non-correlated, tax-free return through its death benefit at the exact time of need. The side fund split-dollar (SFS) arrangement adds additional internal rate of return leverage by freezing the grantors' return on their investment of the cash used for premiums at the long-term applicable federal rate and shifts the balance of the return on the loaned funds to the trust.
14. The hypothetical clients qualify for the long-term rate because the wife's life expectancy is longer than nine years.
15. If the loan split-dollar arrangement is to be satisfied before the death of the insured, a date certain for the repayment should be provided to ensure that the trustee exercises its discretion in the best interest of trust beneficiaries. Failure to provide a date certain could easily create doubt.
16. *See* Internal Revenue Code Sections 671-677.
17. *See* Revenue Ruling 2004-64.
18. *See supra* note 5.
19. *See* Rev. Rul. 85-13.
20. Without the described SFS transaction, the clients would experience a mostly taxable return of approximately 5.5% on the $8 million principal; the resulting value would be subject to the estate tax at the death of the survivor. As a result of the SFS transaction, the grantors' return on the $8 million inside their estate is frozen at 2.14% and converted to a tax-equivalent return to the trust of 12.51% at the expected mortality of the surviving wife even after the trust returns the loan principal and pays the accumulated 2.14% interest in 15 years.
21. *See supra* note 11.
22. Treas. Regs. Section 1.61-22, "Taxation and Split Dollar Life Insurance Transactions."

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