

Wealth Strategies

Loan Split Dollar (S/D) – A Valid Planning Tool Now & If Tax Laws Change

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Split Dollar plans are used to allow one party to assist another in paying for life insurance coverage. Some Split Dollar arrangements can be difficult to understand, especially, if you are not familiar with them in the first place.

Not **Loan – Based Split Dollar (S/D)** though! Everyone understands borrowing money to pay for something you need. Everyone understands that some interest must be applied against the loan. Everyone understands that a loan must be paid back¹.

Everyone also understands that there are changes to the tax law proposed in Congress. So how does Loan – Based Split Dollar under the current law and under some of the proposed changes?

Possible Tax Law Change ²	Life Insurance Solution	No Tax Law Change
Increased income & Social Security Taxes for highly compensated professionals and management level employees with income over \$400,000.	Equity (loan) split-dollar minimizes income while providing affordable protection, tax deferred cash accumulation, tax free access, and in many states, asset protection (See: https://www.insuranceandstates.com/life-insurance-creditor-protection-by-state/ for an interactive breakout on each state's level of protection.)	Taxes are set to increase in 2026 under the TCJA ³ . All the favorable reasons apply today, if the law is changed, and when the TCJA expires.
Increased C corporate tax rate to 28% from 21% today.	Equity (loan-based) split-dollar minimizes owner's double taxation	Double taxation is a problem in any C corp – regardless of any tax rate changes. Owners are looking for a way to avoid it.
Estate and gift tax exemption decrease	Loan S/D is available to employers and within families. Private (family) split-dollar minimizes any gift amount and lifetime exemption usage freeing it for use elsewhere.	The TCJA includes a reversion to the 2017 levels (approx. \$6M) in 2026. Planning now is suggested.

¹If either the interest or principal amounts are forgiven, that forgiveness is either treated as income (if an employee) or a gift (if a family member).

²See: KPMG report: Initial impressions of tax proposals in Biden Administration's budget for FY 2022 (May 2021)

³TCJA - Tax Cuts and Jobs Act of 2017

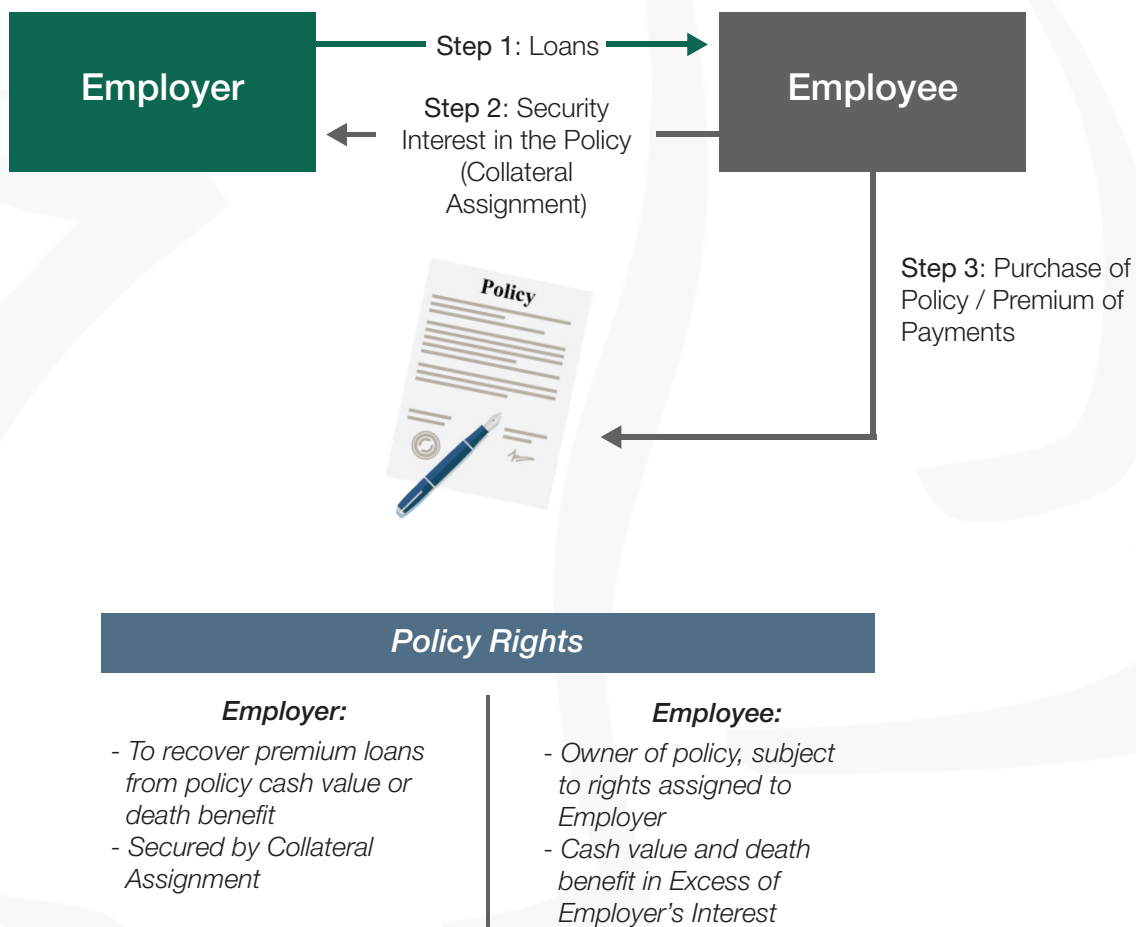
So How Does Loan Split Dollar work?

One party is acting as a bank – loaning premium dollars – to the party they wish to benefit. The lender can be an employer or a family member (known as private split dollar). If it is a private split dollar, the lender is usually dealing with an Irrevocable Life Insurance Trust (ILIT). Making a loan means the lender isn't using any of his gifting allowance, allowing it to be used for other purposes. Any forgiveness of interest or principal will be treated as gift.

As with any bank loan, a collateral assignment on the policy is used to protect the lender's interest. There should also be loan agreement drafted by the client's attorney.

CHART ONE

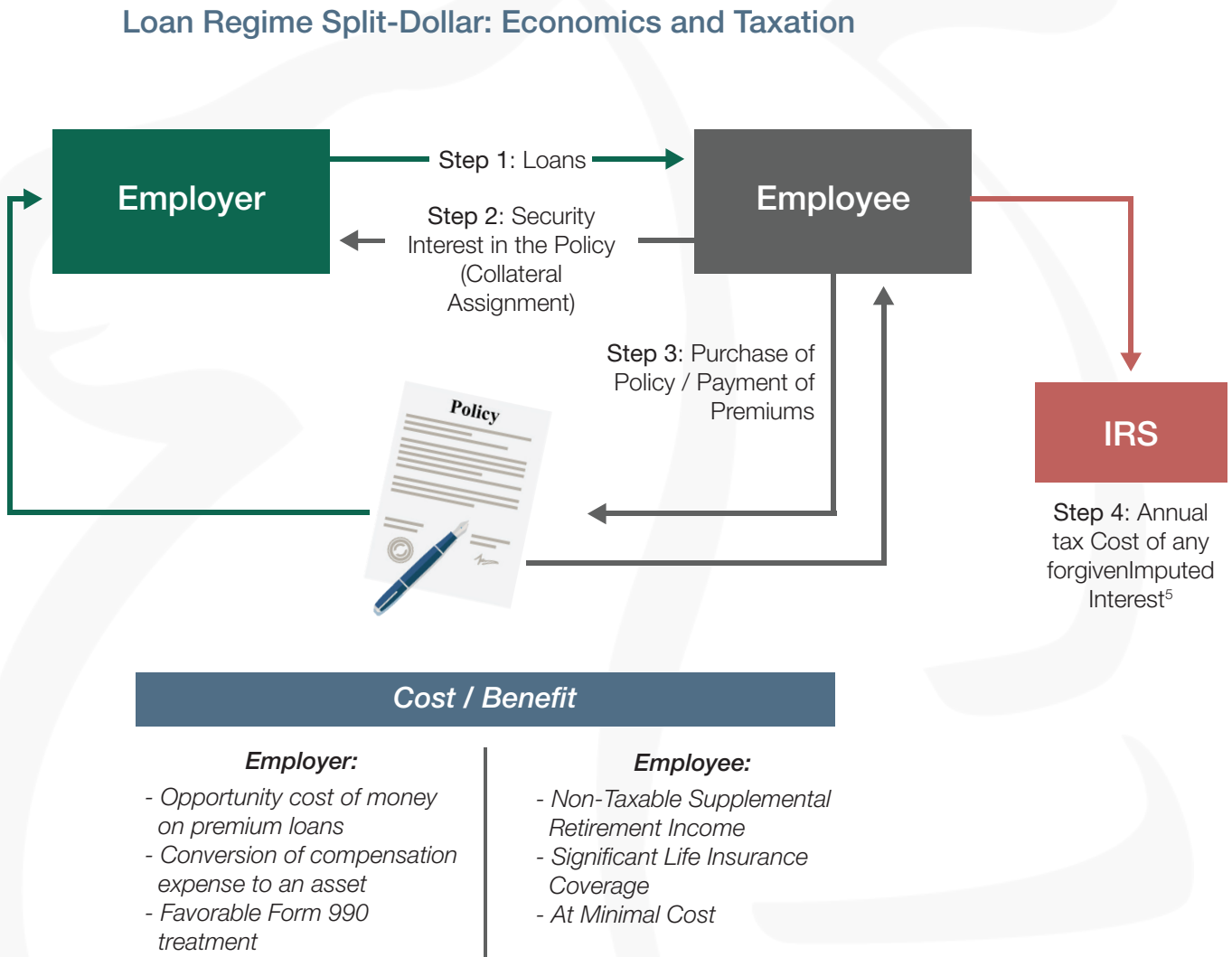
Loan Regime Split-Dollar: Mechanics and Contract Rights



Interest Rate

To be treated as arm's length, the rate must be at least a rate determined by using the AFR⁴ tables or the Demand Note rate (which is 0.13% *from now until the end of the year*). Other AFR Rates for *Short Term* (0-3 yrs.), *Mid-Term* (3-9 yrs.), & *Long Term* (9yrs +) loans are available. The rate selected depends on the client's planning needs.

CHART TWO



⁴AFR - Applicable Federal Rate: See <https://apps.irs.gov/app/picklist/list/federalRates.html>

⁵Alternatively, the plan could be structured to require the Employee to pay interest on the Employer Loans and the Employer could Bonus a "grossed-up" payment to the Employee to reduce his/her cost to zero.

Loan Taxation

Here, the difference between an employment based Loan S/D plan and a Private S/D is more apparent. Although forgiveness of a loan (principal or interest) results in *cancellation of debt (COD) income* to the borrower, the tax code recognizes *an exception for debts canceled as a “gift, bequest, devise or inheritance.”* As a result, Private (intra-family) loans are often forgiven and treated as gifts rather than income.

Forgiveness of a debt between an employer and employee is treated as COD income. The loan must be paid back or forgiven. If forgiven, that’s taxable income to the employee and a deduction for the employer. The same is true of loan interest that is forgiven. (Employers can choose to bonus the tax amount when forgiveness occurs. Please note that the interest paid on a loan is taxable income to the recipient. The historically low AFR rates available today make the tax on interest received or forgiven a relatively insignificant amount.

