Split Dollar Comments re Blog #75
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The Appropriate Applicable Federal Rate

Regarding which Applicable Federal Rate (AFR) to use for loan-based split dollar, no one should illustrate the Demand AFR although such illustrations are common today and can look tempting to the unwary. For a loan payable on Demand, the Short-Term AFR applies a month at a time, and because the rate changes monthly, the calculation of interest has to be month-by-month with monthly compounding of accrued interest. Who advises the client of these changing rates on an in-force plan? One mistake with an under-market loan, and the nasty Original Issue Discount (OID) rules kick in.

Although the recent history of Short-Term AFRs has been low, notice the last 10 years as shown below (using October as an example):

October 2005: 3.89%

October 2006: 5.00%

October 2007: 4.19%

October 2008: 2.19%

October 2009: 0.75% (Recession begins)

October 2010: 0.41%

October 2011: 0.16%

October 2012: 0.23%

October 2013: 0.32%

October 2014: 0.38%

The current recession, coupled with quantitative easing (QE) has resulted in a huge reduction in all AFRs, but clearly, we are at an economic point where, over the next few years, we can expect a significant reduction in QE causing the Demand rate to return to more normal levels. This is not the time to use the Demand rate for illustrations that can run, in many cases, for 20 or more years.

Blended (one year), Short-Term (3 years), or Mid-Term (9 years) AFR rates are also weak choices for similar reasons for any plan illustrated as split dollar for longer than the years for which a specific AFR is applicable.

The agent, the life company, and InsMark are all better advised to be conservative when illustrating Long-Term rates with split dollar plans. The client, with the help of his tax advisers, may elect to use Demand, Blended, Short-Term, or Mid-Term AFRs in the actual documentation and management of the plan, but the written record for the agent, the life company, and InsMark should be conservative in relation to potential, unhappy, split dollar policyholders who will undoubtedly become disenchanted (and possibly litigious) in a world of sure-to-be spiking AFRs.

Sam's Repayment of the Split Dollar Loans

As you can see in the illustrations for Sam Hunt in Blog #75, Sam is shown repaying BFI's loans of $700,000 at the beginning of year 15 by way of an increase in compensation (bonus) granted by BFI[1]. (See illustration pages 12 and 13 for details.)

This results in an income tax liability for Sam of $280,000 in his 40% tax bracket. Similar in ways to paying the income tax associated with stock options, there are four ways for Sam to fund the tax:

- Use $280,000 in personal funds. (We used this source when we integrated the loan-based split dollar data with Wealthy and Wise.)
- With the employer's permission[2], negotiate a secured bank loan for $280,000 using the policy as collateral.
- With the employer's permission[2], use a withdrawal or loan on the policy of $280,000 at the beginning of year 15. (Sam's policy cash value is illustrated to be $1,153,477 at the beginning of year 15, and his cost basis is $700,000 at this point.)
- Have the employer increase compensation to offset the cost of the income tax.

[1] If a bonus is used to assist with repayment of the employer's loans (or loan interest payments), care must be taken so as not to have the employer directly or indirectly make loan repayments (or loan interest payments) on behalf of the executive. The purpose of this is to comply with the prohibition against the employer making such payments as provided in the split dollar final regulations issued in 2003 (TD 9092, 9/11/03 & Rev. Rul. 2003-105).

[2] Some split dollar plans have an endorsement of ownership rights that will prohibit Sam from withdrawing or borrowing funds or surrendering the policy prior to retirement without the permission of the employer. Such endorsements are binding even if Sam were to terminate employment. Most employers would likely be accommodating in granting a request for a withdrawal or loan in order to provide funds for the income tax due on the rollout of the loans (beginning of year 15 in Sam's case). Permission to surrender might be more difficult to obtain since plans like Sam's are designed to provide family protections and retirement cash flow for key executives, not provide funds to enter, perhaps, into a competitive business.

Important Note: This report is for educational purposes only. In all cases, the approval of a client's legal and tax advisers must be secured regarding the implementation or modification of any planning technique as well as the applicability and consequences of new cases, rulings, or legislation upon existing or impending plans.

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