

**INTEREST-FREE TERM NOTE  
BETWEEN PARENT AND CHILD  
WITH COLLATERAL ASSIGNMENT OF POLICY**

**HIGHLIGHTS OF THE PLAN**

**OVERVIEW**

Below-market rate loans are often used where a Parent desires to provide money to a Child or trust by way of a loan with little or no interest. When no interest is charged by the Lender, these interest free loans follow special tax rules governed by Internal Revenue Code Section 7872. Under Sec. 7872, 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 (known as the "Applicable Federal Rate" or "AFR") that is deemed to have been received by the Lender and paid by the Borrower.

An interest-free loan can be used as a substitute for a private split dollar life insurance plan. This below-market rate or interest-free loan treatment is approved under the interim guidelines issued in IRS Notice 2002-8. As such, the interest-free loan would permit a Child or Trust to use the loan principal to purchase life insurance, usually on the life of the Lender/Parent, but sometimes on the Child or Trust Beneficiary. The Borrower/Child would give a note to the Lender/Parent and assign to the Lender/Parent a security interest in the policy equal to the outstanding loan principal.

The note may be either a demand note with interest imputed for tax purposes at the applicable federal short-term loan rate (less than 3 years) or a term note with interest imputed for tax purposes at the applicable federal short-term rate (less than 3 years), mid-term rate (over 3 years but not over 9 years), or long-term rate (over 9 years).

Note: Although the language is ambiguous, in transactions involving life insurance funded with interest-free loans in an employer/employee context, the wording of Notice 2002-8 seems to require term loans rather than demand loans in order, for a plan to qualify as a Sec. 7872 variation.

An interest-free loan can also be used to freeze the value of part of the Lender/Parent's estate for estate tax purposes. In other words, a Parent may loan \$500,000 to a Child at no interest. Although the Borrower/Child has an obligation to pay back the loan upon demand from the Lender/Parent or his/her executor or at the expiration of the term of the note, the Borrower/Child may invest the money in any way he/she desires and the growth on that investment will escape estate taxation in the Lender/Parent's estate.

InsMark has produced an illustration system called the InsMark Section 7872 Illustration System

that contains an illustration module called the Private Leveraged Benefit Plan ("PLBP"). that illustrates the #2 example. PLBP is a wealth preservation technique involving a term loan of at least 10 years' duration (evidenced by a promissory note) between a Lender -- usually a parent or grandparent -- and a so-called defective, irrevocable Grantor trust formed on behalf of children or grandchildren. In this context "defective" refers to income tax and provides that the Grantor and the trust are a single income tax entity.

With PLBP, the loan (plus, perhaps, additional funds in the form of a gift using all or part of the lifetime gift exemption) is used by the trust to pay the premium on the trust-owned life insurance policy. The policy is collaterally assigned to the Lender/Grantor as security for the loan. The interest rate for the life of the loan is based on the long-term (more than 9 years) IRC Section 7872 rate in effect during the month when the loan is first extended.

Note: The InsMark Section 7872 Illustration System also includes an illustration module called the Leveraged Benefit Plan ("LBP") that illustrates a Section 7872 plan cast between an employer and an employee.

### **ADVANTAGES OF INTEREST-FREE LOANS**

An interest-free loan can be used to:

1. Purchase life insurance on the life of the Lender/Parent or Borrower/Child;
2. Freeze the value of part of the Lender/Parent's estate;
3. Provide money to the Borrower/Child for education, business, or personal needs.

### **DISADVANTAGES OF INTEREST-FREE LOANS**

An interest-free loan:

1. Results in income or gift imputation on the amount of the foregone interest "transferred" from the Lender/Parent to the Borrower/Child (although the Private Leveraged Benefit Plan technique noted above can eliminate this issue);
2. Results in income tax on the deemed "payment" from the Borrower/Child to the Lender/Parent;
3. Generally, does not permit an income tax deduction for the "payment" of foregone interest.

### **IMPORTANT NOTICE**

In all cases, the approval of a client's legal and tax advisers must be secured regarding the implementation or modification of any form of interest-free or below-market loan as well as the applicability and consequences of new cases, rulings, or legislation upon existing or impending plans.