

RETURN TO FOREVER What Game Should We Play Today?

Using the Planning Power of Split Dollar Life Insurance for Income and Estate Tax Planning Benefits

I have mentioned in past blogs my love for music including the fact that I was a mediocre musician myself. As a horn player (trombone and baritone) I gravitated to horn bands and what is today known as smooth jazz. In my jazz pilgrimage I was a fan of The Crusaders, Grover Washington, Jr., and Chick Corea. Sadly, Chick Corea died recently.

One of the great groups in the jazz fusion genre was called Return to Forever which featured Chick Corea on keyboards, Stanley Clarke on Bass, Airtio Moreira on drums and his wife Flora Purim provided the vocals. Airtio and Flora are Brazilians. Flora Purim had a six-octave vocal range and was Downbeat Magazine's jazz singer of the year four times and was nominated for two Grammy awards. I saw Airtio and Flora Purim perform back in the days when I was a Portuguese student at West Point. I don't think that there is a sound of an animal in the Amazon jungle that Flora couldn't imitate. One of her great recordings with Chick is a song called "What Game Shall We Play Today?"

The title of song seems to capture the essence of the back and forth between Government tax policy planners and taxpayers. The Biden Administration and several states are poised to increase taxes significantly. The estate and gift tax will be back with a "bite" that not only breaks the skin but sinks a family's efforts to accumulate and transfer wealth across multiple generations.

While my roots were cast in the retail life insurance industry while attending law school, I have been a Private Placement Life Insurance (PPLI) specialist for the last twenty years. From afar it looks like the retail life insurance industry has largely forgotten the power and glory of advanced marketing strategies such as Split Dollar life insurance focusing more on premium finance strategies. There is nothing wrong with that except life insurance producers threw out gold and silver with the bath water.

This article focuses on the use of Split Dollar life insurance and the use of the Leveraged Split Dollar Rollout™ technique combining the tax arbitrage of life insurance with the financial arbitrage of Split Dollar life insurance featuring the rollout or termination technique so that the policyholder ends up with a bunch of money with minimal tax consequences.

Overview of Loan Regime Split Dollar

a. **Loan Regime Basics.** The primary planning objective of the Loan Regime Method of Split Dollar is to provide a business owner or key executive with low-cost

death protection and equity buildup in the cash value. In the loan regime, the business owner is the applicant, and owner of the policy and collaterally assigns an interest in the policy cash value and death benefit to the employer equal to its cumulative loans plus any accumulated interest payments. The Employer provides a series of loans to the business owner to all or most of the premiums. The Employer's loans are not treated as taxable to the business owner provided the loan terms are arms-length in nature. The taxable gifts where the loans are extended to the trustee of a family trust.

b. The Impact of Below Market Rate Loans. Below-market rate or interest-free loans are sometimes used in Loan Regime Split Dollar where the Employer desires to provide premium financing to the executive through a loan with little or no interest. When no interest is charged by the Employer as a lender, the rules for below-market or interest-free loans follow under IRC Sec 7872 apply. Under Sec. 7872, if no interest or an inadequate rate of interest is charged on a loan, the IRS recharacterizes the loan into an "arm's length" transaction and imputes an interest rate equal to the applicable federal rate based upon the term of the loan that is deemed to have been received by the lender and paid by the Borrower.

c. Additional Loan Considerations. In order to avoid the application of the below-market rate loan rules in a Loan Regime Split Dollar loan, the parties should agree upon a stated interest at or above the appropriate applicable federal rate Demand loans may be used in Split Dollar plans. If the Split Dollar loan is a nonrecourse loan, meaning the policyholder is not personally liable, and is payable only from values in the policy with no further recourse to the borrower, the parties must represent in writing and attach to their tax returns in the first year of the plan that a reasonable person would expect that all payments under the loan will be made.

Treas. Reg. §1.7872-15(d)(1) provides that, except as provided in §1.7872-15(d)(2), if a payment on a Split Dollar loan is nonrecourse to the borrower, the payment is a contingent payment for purposes of §1.7872-15. A contingent payment is subject to the imposition of unfavorable assumptions when testing the loan for adequate stated interest, thus causing the OID rules to apply. Section 1.7872-15(d)(2)(ii) describes the time and manner requirements for providing the written representation required by §1.7872-15(d)(2)(i). Section 1.7872-15(d)(2)(ii) provides, in part, that the written representation be signed by both the borrower and lender not later than the last day (including extensions) for filing the federal income tax return of the borrower or lender, whichever is earlier, for the taxable year in which the lender makes the first Split-Dollar loan under the Split-Dollar Life Insurance arrangement. To avoid these rules, most Split Dollar loans are made on a recourse base so that the borrower is personally liable for repayment of the loan.

Overview of the Leveraged Split Dollar Rollout™

The Leveraged Split Dollar Rollout™ is a method to terminate an existing Loan Regime Split Dollar arrangement at a significant discount from the value of the collateral assignment interest. In the Loan Regime, the business is the lender, and receives a restricted collateral assignment interest in the life insurance policy's cash value and

death benefit equal to the value of the loan plus any accrued interest. The collateral assignment interest is restricted until the earlier of the insured's death, termination of the Split Dollar arrangement or surrender of the underlying policy.

The value of the collateral assignment note is potentially discounted due to this restriction. Since the business's collateral interest is restricted for several years until the death of insured, there is a present value calculation to determine the current value. At some point, the policyholder may decide to terminate the Split Dollar arrangement by purchasing the lender's restricted collateral assignment interest in the policy. A valuation specialist values the note receivable for valuation purchases.

The valuation specialist takes into consideration the life expectancy of the policy's insured life as well as a discount rate. Due to the restriction, the receivable is likely to be discounted. Following the purchase of the Split Dollar receivable from the lender, the Split Dollar agreement is terminated. The policyholder may use a tax-free policy loan or withdrawal to purchase the note from the lender. A decent amount has been written in the last several years about Intergenerational Split Dollar life insurance following recent Tax Court litigation in the Cahill, Morrisette, and Cahill cases which used Collateral Assignment Non-Equity Split Dollar and the Economic Benefit Method.

These arrangements were private Split Dollar arrangements typically designed to transfer large amounts of value from the taxpayer's estate at large discounts. I am personally aware of exceptionally large transactions having taken place at obscene (in a good way!) discounts. Supreme Court Justice Potter Stewart in determining a threshold test for obscenity is famously known to have said, "*I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description [\"hard-core pornography\"], and perhaps I could never succeed in intelligibly doing so. But I know it when I see it, and the motion picture involved in this case is not that.*"

In Cahill, the taxpayer claimed a 98 percent discount. Come on! How could anyone think that this level of discount wouldn't be challenged by IRS on principle alone? These cases were ultimately about valuation issues versus whether the arrangements were valid Split Dollar arrangements. The cases were largely settled based on horse trading versus legal issues. The Court in each case ruled that the arrangements were valid Split Dollar arrangements. None of these arrangements used the Loan Regime Method of Split Dollar. The use of the Loan Regime Method of Split Dollar in an employer-employee context is significantly different than the transactions in recent tax court cases involving Intergenerational Split Dollar. First, the use of restricted collateral assignment in the context of business-sponsored split dollar has existed for over fifty years. The use of private split dollar and particularly the insertion of a restriction in the collateral assignment interest is far more recent. In the early days of split dollar life insurance, planners did not realize the valuation planning opportunities created by the restriction in the collateral assignment interest. Valuation in tax planning became much more mainstream in the decade of the 1980's and 1990's in the realm of closely held business interests and family limited partnerships. Second, the tax audit exposure in Intergenerational Split Dollar using private Split Dollar in large estates was almost 100

percent. The audit rate for regular corporations and LLCs that sponsor Split Dollar arrangements is negligible at best (between 0.2-0.5 percent). Third, business Split Dollar has enjoyed significant non-business purposes ranging from employee benefit planning to business succession planning, et al, unlike the Intergenerational Split Dollar transaction which was heavily tax motivated. The IRS has seen and ruled favorably on the use of restricted collateral assignments for controlling shareholders in the employer-employee context for at least five decades for these non-tax driven purposes. Lastly, the Tax Court cases mentioned above were exclusively used the Economic Benefit Method of Split Dollar instead of the Loan Regime.

Strategy Example Using Leveraged Split Dollar Review

Richie Rich (Rich), age 51, is the majority shareholder in Acme Technology, Inc. Acme is a privately held, C corporation. Rich currently owns a life insurance policy within an irrevocable life insurance trust. He is purchasing a new equity indexed universal life insurance policy. The policy has a face amount of \$6.6 million. The projected premiums are \$485,608 per year for the next a seven-year period. Acme is making a single loan of \$3,399,256 to the Trust at the current AFR of 1.12 percent. The trustee will accrue interest on the policy.

The policy is using Option B, the increasing death benefit option. Acme adopts a corporate resolution authorizing the Company's participation in a Split Dollar arrangement and enters a Loan Method Split Dollar arrangement with the trustee of the Rich Family Trust. Acme will hold a restricted collateral assignment interest in the policy cash value and death benefit equal to the amount of the loan plus any accrued interest on the loan. Its interest is restricted until the earlier of the death of Rich, surrender of the policy or termination of the Split Dollar arrangement. The Trust will own the excess cash value and death benefit. In Year 8 the projected cash value is \$3.77 million.

The projected cash value at life expectancy is \$6.5 million. Rich's life expectancy at that point is 31 years using the mortality tables in IRC Sec 72. The accumulated loan in Year 8 is \$3.67 million. The trustee enters into an agreement to purchase the Split Dollar receivable from Acme for \$735, 530, an eighty percent discount based upon the valuation report of a specialist. The trustee takes a tax-free loan from the policy to purchase the Split Dollar receivable. At that juncture, the Split Dollar agreement has been terminated and the policy is owned within the Trust with no encumbrances. Acme treats the difference as a taxable loss that it reports on its Form 1120. The filing will begin the three-year window for the statute of limitations.

Summary

Old School strategies such as Split Dollar life insurance still work amazingly well. The combination of equity indexed universal life using the tax and financial arbitrage of life insurance and Split Dollar life insurance with the heavily discounted rollout or termination allows a taxpayer to accumulate in a manner that is very efficient for both

income and estate and gift tax purposes now that taxes are on their way back up again. What are you waiting for? Operators are standing by to take your call!