



LAW OFFICE OF GERALD R. NOWOTNY, PLLC

THE WONDER YEARS

Rediscovering the Magic of Split Dollar Life Insurance

The TV series *The Wonder Years* is one of my favorite TV series. The series depicts the social and family life of a boy, Kevin Arnold, in a typical American suburban middle-class family from 1968 to 1973, covering the ages of 12 through 17. This time period parallels my own childhood and adolescence. The difference in my case is the fact that I grew up in the Panama Canal Zone. As my wife (aka Mrs. Nowotny or Long Suffering) would say, I was almost American. But as she would quickly state Point #1, she would make her Point #2, that I was not Panamanian either. My Dad (of blessed memory) always said that when President Carter signed the Panama Canal Treaty in 1977, Canal Zone kids lost the only country they ever knew.

I watched those “wonder years” from the outside looking in. While the Vietnam War was raging in 1968, Panama had a mostly non-violent revolution and change of government. As the revolution was occurring, my older brother, age 11 and I, age 8, rode the public bus (Chiva) to the bus terminal in Panama to see the revolution firsthand. The bus terminal also happened to be in a dangerous neighborhood where no American kid would ever go. Yes, this was with our mother’s permission. I still wonder today what she was thinking.

The show provided with me with a sense of what it must have been like growing up in America. I enjoyed a version of that but not an entirely “Red, White and Blue,” version except the Panamanian flag has the same colors. As the Country endures a pandemic, economic turbulence, and social unrest, many of us are just trying to imagine better days or at least different days.

Split dollar version was a beautiful tax shelter in the best sense of the word. The wonder years of split dollar life insurance are largely thought to be behind us. Other than the application of intergenerational split dollar in the last decade for ultra-high net worth taxpayers in very specialized planning situations, split dollar life insurance is largely forgotten and rarely spoken of by financial advisors and life insurance agents. What a mistake!

This article is the first segment of articles intended to highlight some of the magic that still exists in split dollar life insurance planning and why tax planners and their clients need to dust off and reconsider split dollar life insurance.

Overview of Split Dollar Life Insurance

Split dollar life insurance is not a type of life insurance product but rather a contractual agreement between two or more parties to share the rights and benefits of a life insurance policy. The genesis of split dollar life insurance dates back to the mid-1950s and evolved through the decades to support the purchase of permanent life insurance in the realm of employer-sponsored purchases of life insurance as an executive benefit for executives and business owners. Split dollar also developed in the family estate planning context known as Private Split Dollar. Split dollar life insurance was highly effective from the standpoint of a benefits program which provided substantial financial benefit to the executive with minimal taxation to the executive relative to the amount of premiums paid by an employer.

“Old School” or traditional split dollar life insurance was divided between the endorsement method and collateral assignment methods. In the endorsement method the employer is the owner of the policy. The policyholder owns an interest in the policy equal to the entire cash value and a death benefit equal to the cash value. The employer “endorses” the excess death benefit to the executive who nominates a beneficiary for the “endorsed” portion of the death benefit.

The executive is taxable each year on value of the “economic benefit” which is measure by the term insurance cost associated with the endorsed death benefit amount. The measure for the economic benefit is the lower of the one-year term cost or Table 2001 cost based on the age of the insured and net amount of risk payable to the executive.

In the collateral assignment method, the executive is the policyholder. The policyholder (executive) collaterally assigns an interest in the policy cash value and death benefit equal to the employer’s premiums. Under prior law, the executive enjoyed the excess cash value without current taxation and death benefit subject to the annual economic benefit valuation. It was a beautiful tax shelter in the best sense of the word. That was then and this is now!

“New School” split dollar life insurance is quite different from traditional life insurance but still offers tremendous, but unappreciated benefits. Final Split Dollar Regulations became effective for plans established or materially modified after September 17, 2003. Interest in split dollar life insurance largely disappeared at this point. Endorsement Split Dollar life insurance follows the Economic Benefit Regime set forth in Reg. 1.61-22(b)-(h). The two methods – endorsement and collateral assignment - continue to exist but limit the executive’s share to the policy cash value without current taxation.

The split dollar regulations introduced Loan Method Split Dollar which in the current low interest rate environment provides powerful planning opportunities. In the Loan Method, the executive owns the policy and the employer enters into an arms-length loan arrangement with the employer for a series of loans in order to make premium payments. The policyholder collaterally assigns an interest in the policy cash value and death benefit to the employer equal to the amount of the accrued loan using a market rate of interest. The market rate of interest for Loan Method Split Dollar plans must be equal to or greater than the Applicable Federal Rate. The current long term-AFR is 1.17 percent for July 2020.

A below-market rate or interest-free loans can also be used in loan regime split dollar. However, when no interest is charged by the lender (employer), the below-market or interest-free loans follows special tax rules governed by Internal Revenue Code Section 7872. The amount of inadequate interest (difference between the long-term AFR and the loan charged) is imputed to the executive as taxable income. The

lending arrangement may also be structured as a demand loan. The current rate for demand loans is .89 percent annually and adjusts annually.

The upside for the policyholder in a Loan Method Split dollar arrangement is the opportunity for the policyholder to enjoy the benefit of the excess cash value and death benefit from the policy on a tax-free basis. As long as the investment return within the policy exceeds the split dollar loan rate, the split dollar will provide significant financial and tax leverage for the policyholder.

For example, the policyholder of a PPLI policy can enjoy the tax-free inside buildup of all of the cash value in excess the amount collaterally assigned to the employer. The policyholder has the ability to access these amounts on a tax-free basis. The death benefit in excess of the collateral assignment interest will be paid tax-free to the policy beneficiary. The policyholder is not taxed on the loans and may either pay or accrue the interest (currently 1.17%) each year.

Case Study

The Facts

Joe Smith, age 50, is the principal of an investment management firm in Greenwich that manages several hedge fund strategies. He is married and has two children. Smith has a personal net worth of \$40 million. Joe is married with two children.

The investment management firm has a management agreement with each domestic and offshore fund that it manages that provided for a management fee of two percent and an incentive fee of twenty percent after providing investors a return of their investment with a five percent return.

The firm is no longer able to defer incentive fees from the management activities of their offshore fund and would like to implement a strategy that can provide a vehicle can provide a significant but tax efficient benefit to Joe.

The investors agree to arrangement whereby the offshore fund agrees to provide a one-time loan to Joe in lieu of 50 percent of the incentive fee in 2020. The agreement provides that the loan amount will be at least \$10 million.

The Strategy

The offshore fund is structured as a Cayman corporation (“Corporation”) and is not subject to corporate taxation. The investment management company (“Management Company”) and the offshore fund (investors) agree to an arrangement whereby the Management Company agrees to forego fifty percent of any incentive fee earned in 2020 in exchange for an arms-length loan between the Corporation and Joe. The projected loan amount is \$10 million. The loan will be an arms-length loan at the current long term AFR of 1.17 percent. The loan is a recourse loan between the Corporation and the Joe’s Trust.

The trustee of an irrevocable trust created by Joe’s wife is the applicant, owner, and beneficiary of a PPLI policy insuring Joe’s life. The policy has a \$30 million death benefit and projected premiums of \$2.5 million per year for four years. The Corporation will have a collateral assignment interest in the cash value and death benefit equal to the amount of the loan plus any accrued interest. The Trust will own the excess cash value and death benefit. The policy is a non-modified endowment contract.

Acme Life, a specialty life insurer in Bermuda, issues a PPLI contract featured a separately managed account. Hector Heathcoat, an established money manager and friend of Joe, is appointed by Acme to

manage the investment account within the policy. The trustee transfers the entire amount of the loan to Acme who maintains the premiums for future years in a premium deposit account.

The Trustee can request policy loans and withdrawals and distribute the proceeds to Joe on a tax-free basis. The policy within the Trust is beyond the reach of Joe's personal and business creditors. The policy death benefit will be income and estate tax-free. The proceeds will also be multi-generational. The trustee pays the annual interest on the \$10 million loan. The annual interest payment is \$117,000. The loan term is 45 years. The projected growth rate within the policy is 8 percent.

The chart below projects the benefits to Joe under the arrangement.

Year	Accumulated Loan	PPLI CV	PPLI DB
10	\$10 million	\$26.25 million	\$30 million
20	\$10 million	\$56.67 million	\$65.17 million
30	\$10 million	\$122.35 million	\$128.47 million
40	\$10 million	\$264 million	\$277.2 million

Summary

The planning opportunities under prior split dollar regulation may have represented the "Wonder Years" in life insurance and tax planning for financial advisors. Equity split dollar represented the best of life insurance planning. Under the tax doctrine that all good tax benefits must come to an end or at least be significantly changed, the final split dollar regulations changed the rules of the game. Life insurance agents moved on without strong consideration of the benefits of split dollar under the final regulations. The current low interest environment creates a unique planning opportunity for loan method split dollar. One of the lessons in life and tax planning is that we are blessed with wonder and opportunity in every circumstance.

Future articles on split dollar life insurance will highlight the benefits of split dollar in the current "Wonder Years."