



LAW OFFICE OF GERALD R. NOWOTNY, PLLC

## FATHER KNOWS BEST

### **Rediscovering the Lost Glory of Split Dollar Using Loan Regime Split Dollar**

My father (of blessed memory), Willy Wolfgang Nowotny, died last November at the age of 85. He was born and raised in the Saxon region of East Germany on the Czech and Polish borders. I always figured his town was the German equivalent of Hooterville. It is so small that it is not even on many maps. He came to the United States in 1953 as a refugee through Canada with nineteen dollars in his pocket. He had enough of the Russians as they probably had their fill with him. He made his exit from East Germany in 1952 by swimming across a river on the border studying the guards for a week before escaping. He was sponsored by the Chaplain of the U.S. Army as a refugee. He was a very gifted soccer player with an opportunity to play professionally in the early version of the Bundesliga, but instead left for a new life in America.

The day that he arrived at Penn Station from Canada, there was a transportation strike that prevented his great Aunt from meeting him. No one spoke German and he spent his first night in America sleeping on a bench at Penn Station. He later worked for a family that owned and operated a bakery in Falls Church, Virginia. His cardboard suitcase remains a prized possession in the family.

This family became his second family and my father remained in contact with them until their death but continued to have a relationship with their only son who suffered with mental challenges. He visited my Dad for a week every year.

My Dad was drafted into the U.S. Army in 1954 before he could speak English. I never appreciated how difficult it must have been being a private in Uncle Sam's Army with a heavy German accent right after World War II. It was hard enough for me even without a German accent. He was stationed in Panama which ultimately led to his return to the Panama Canal Zone where he lived and worked for twenty-five years. He had a good career with the federal government and had a long and comfortable retirement traveling to every continent and making it to the South Pole a year before his passing.

While I was growing up, he rarely discussed his childhood. He lost his father during WWII and saw a lot of horrible events during and after the war. I was fortunate to hear the stories of the "lost" years of the war and after the war in the years before he died. As a German's German, he was heavy on discipline and short on patience, but left with me with an eternal view that Father did know best, at least most of the time.

In the Canal Zone, we had little American TV limited to a few hours per day on the military TV channel. Most of the classic shows of the 1950's and 1960's like *The Adams Family*, and *Father Knows Best* were only available dubbed in Spanish. I did not see these shows until I came to the United States for my last two years of high school. In the show *Father Knows Best*, the character of the father, Jim Anderson, Sr, is a life insurance agent for the General Insurance Company. The character of Ward Cleaver, Beaver's father, in *Leave It to Beaver*, was also a life insurance agent.

So, this article follows the idea that two of the idealized fathers in American popular TV from the 1950's and 1960's, both life insurance salesman, knew what is best. This article focuses on the resurgence of Split Dollar in the current low interest environment and specifically Loan Regime Method Split Dollar Life Insurance™. The declaration of its demise in 2003 has been greatly exaggerated.

## **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.

#### **d. ERISA Considerations**

Most Split Dollar plans require a fiduciary (plan administrator) and a claims procedure. If a plan is contributory it will not qualify for the select group of management/highly compensated employee exemption that applies to non-contributory welfare benefit plans. If the Business owner is required under the terms of the plan to contribute any part of the premium, the plan administrator must provide a Summary Plan Description (SPD) to each participant and the Department of Labor (DOL), as well as provide other plan documents to the DOL upon request. If the Split Dollar plan is an Employer-Pay-All plan, the administrator is not required to file any plan documents with the DOL unless so requested by the DOL; however, a Summary Plan Description (SPD) must be made available to each participant, the business owner or key executive who participates under the Plan.

#### **e. Securities Law Considerations**

If Variable Universal Life Insurance (VUL) such as PPLI is used as the funding instrument in a loan-based Split Dollar plan or other premium financing arrangement, the effect of Section 11(d) of the Securities Exchange Act of 1934 on the transaction is unknown. However, it appears that as long as the broker (agent) is not involved in arranging the financing of the VUL policy, Section 11(d) should not apply. In the proposed structure, the financial advisor is not involved in arranged the loan as the loan would typically be made by the employer rather than a financial institution.

#### **f. Accounting Considerations**

The Financial Accounting Standards Board (FASB) has determined that employers who agree to provide a post-retirement death benefit to employees by means of a Split Dollar Life Insurance arrangement should accrue a liability on its books annually to reflect the employer's obligation. This requirement applies to both economic benefit (endorsement) or loan regime (collateral assignment) split dollar arrangements. If the Split Dollar arrangement terminates at or before retirement and does not provide post-retirement insurance or death benefits, these Split Dollar accounting rules do not need to be observed.

In general, an employer should account currently for a post-retirement benefit related to an endorsement or collateral assignment Split Dollar arrangement in accordance with FAS 106 if, in substance, the plan provides a post-retirement insurance death benefit or in accordance with APB 12 if, in substance, the plan provides an individual death benefit in the nature of deferred compensation.

If FAS 106 applies, the annual accrual is based upon the future cost of the life insurance (generally the cumulative premiums paid). If APB 12 applies, the accrual is based upon the present value of the future cost of the death benefit. These accounting rules are effective for calendar year companies beginning in 2008. For employer-sponsored Split Dollar plans that provide post-retirement benefits and are in effect on the effective date of these accounting rules, an adjustment must be made to reflect the obligation from the start of the arrangement.

**g. The Application of IRC Sec 409A**

New deferred compensation plans must meet the requirements of Section 409A. IRS Notice 2007-34 describes the application of Section 409A to certain Split Dollar Life Insurance plans. In general, Section 409A does not apply to non-equity endorsement or non-equity collateral assignment Split Dollar plans or Loan Regime Collateral Assignment Split Dollar™ plans, unless the employer agrees to forgive the loan, waive payments, etc. for purposes of bringing that plan into compliance with 409A without losing the Split Dollar grandfathering.

**h. The Application of IRC Sec 101(j)**

Section 863 of the Pension Protection Act added IRC Sec 101(j) and IRC Sec 6039I. If proper notice and consent is given, death benefits payable to the Company and family members of the insured under a Split Dollar arrangement are exempt from the COLI income inclusion rules of Section 101(j)(1). However, if the notice and consent requirements are not met, any death benefit payable to the Company (or a party related to the company, such as a greater-than-50% shareholder of the Company) in excess of its premiums paid, would result in making that excess amount taxable. This means that most employer-employee economic benefit Split Dollar arrangements would need to meet the notice and consent requirements. If the employer's interest in the death benefit never exceeds its premiums paid, no part of the death benefit the Company receives will be taxable. In any event, the reporting requirements of IRC Section 6039I must be met.

Split Dollar life insurance arrangements in which a business is the “owner” of the contract for Split Dollar purposes is also subject to the legislation. Some authorities include any kind of employer-sponsored Split Dollar life insurance and life insurance owned by co-shareholders and partners for buy-sell purposes within the scope of IRC Section 101(j), although this application of the law is not entirely clear. As a practical matter, though, only a Split Dollar plan in which the employer's interest was in excess of its cumulative premiums would be subject to this legislation.

Most certainly, any kind of personally owned life insurance or life insurance owned by a trust or family member that is not connected to a business is beyond the scope of this legislation. Neither would life

insurance owned by a charitable organization on the life of a non-employee donor or life insurance purchased by a creditor to secure a bona fide loan be subject to IRC Section 101(j).

#### **i. Exit Strategy Considerations – Introducing the Leveraged Split Dollar™ Rollout**

An important consideration in any Split Dollar is its termination. Specifically, when does the policyholder terminate the Split Dollar arrangement and reimburse the Employer for its loans including any accrued interest. The policyholder may use personal funds to repay the loans from the employer. Alternatively, the policyholder borrows against the policy or surrenders a portion of policy values to repay the loans from the employer. The employer may also forgive the loan. When this occurs, the executive typically borrows against the policy or surrenders a portion of policy values to offset the income tax on the bonus resulting from the forgiveness of the loan. Lastly, the employer may forgive the loan and bonus an amount to offset all income taxes.

The Leveraged Split Dollar Rollout™ (“LSD™ Rollout”), is unique method to terminate a Loan Regime Split Dollar agreement. Under the LDS™ Rollout, the employer retains a collateral assignment interest in the policy that is restricted and limited to a reimbursement at the earlier of the death of the insured, termination of the policy, or surrender of the policy. The valuation of the collateral assignment receivable is heavily discounted due to this restriction which has a legitimate business purpose apart from creating a valuation discount. Split dollar planning has always utilized this restriction in Split Dollar planning in Split Dollar arrangements involving controlling shareholder.

The valuation of the Split Dollar receivable is determined based upon present value of the life expectancy of the insured using a discount rate which is based on policy discounts in the life settlement market. Depending upon these factors, the valuation discount of the receivable may be as large as 65-95 percent. The LDS™ Rollout provides a unique opportunity to transfer wealth to the policyholder at a significant discount. The purchase price can be executed as an installment sale or as a self-canceling installment note or even a private annuity with deferred payments. The policyholder can use tax-free withdrawals and loans to make these payments.

#### **Strategy Example Facts**

Hector Heathcoat (Heathcoat), age 45, is the majority shareholder in Acme Technology, Inc., Acme is a privately held, C corporation that would like to provide Heathcoat with the opportunity to participate in a Split Dollar Life Insurance program. Acme will lend Heathcoat \$7 million dollars to use as premium payments for a policy issued by Palm Tree Life, a specialty life insurer in the private placement life insurance (PPLI) industry. The projected premiums are \$1 million per year for seven years. The loan payment is made in a single payment.

The excess loan is maintained in a preserve reserve account maintained by Palm Tree Life. The terms of the loan provide for a loan rate of 1.12 percent for a loan term that is expressed as the earlier of Heathcoat’s death or 55 years.

The policy issued by Palm Tree Life is a PPLI policy. The policy death benefit is \$22 million using Option B. Option B provides for a death benefit that is equal to the initial death benefit of \$22 million plus the policy account value.

### **Strategy Example Solution**

Heathcoat's Family Irrevocable Trust. Heathcoat is the settlor of the Trust. His wife Maria Caracoles Heathcoat is the beneficiary of the Trust. The trustee is the applicant, owner, and beneficiary of the PPLI policy insuring Heathcoat's life.

The Trust is a spousal lifetime access which provides Maria with discretionary distributions of income and principal. The Trust provides the ability for the trustee to take policy loans and withdrawals on a tax-free basis to distribute to Maria Caracoles during her lifetime. The policy is outside of the reach of Heathcoat's personal and business creditors. He enjoys the benefits to the policy through his wife. Alternatively, the spousal lifetime access trust can be structured so that Heathcoat is the beneficiary during lifetime. At Heathcoat's death, the trust provides for Heathcoat's children and descendants. Income and principal can be distributed based upon the discretion of the trustee based upon the health, education, maintenance, and support needs of the beneficiary.

The trustee enters into a Split Dollar agreement with the trustee that provides for a collateral assignment of the policy cash value and death benefit equal to the amount of the loan plus any accrued interest. In Year 20 without any interest payments, the accrued loan is \$8.56 million. The total cash value in the policy is \$19 million. The total death benefit at this point is \$40 million. The trustee may take a policy loan to reimburse Acme for the loan. In Year 8 of the policy, Heathcoat, and Acme agreement to terminate the policy using the LSD Rollout. Heathcoat's life expectancy at that point is 31 years using the mortality tables in IRC Sec 72. The cash value is \$8.13 million.

The trustee enters into an agreement to purchase the Split Dollar receivable from Acme for \$423,000, the present value of the policy value discounted at a ten percent interest rate and Heathcoat's life expectancy, 31 years, at that point. 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.

### **Summary**

The Loan Regime Method of Split Dollar™ combined with the LSD™ Rollout provides for an unparalleled transfer of wealth with great financial and tax leverage in the current low interest rate environment. The current top marginal tax bracket for corporations of 21 percent has created a resurgence in small businesses making the election to be taxed as corporations. These factors point strongly in the direction in the use of Split Dollar as a planning technique.

Future articles will focus on creative planning scenarios how to use Split Dollar.