Mad Dogs and Panameños!

Using the Leveraged Split Dollar Rollout (LSD™ Rollout) to Terminate Loan Regime Split Dollar™ Plans

Over the last several weeks, I have written a series of articles focusing on the planning utility and financial and tax leverage of the Loan Regime Method of Split Dollar™ life insurance. I have highlighted the timeliness of this planning technique considering the current low interest rate environment. The long-term applicable federal rate (AFR) for August 2020 is 1.12 percent.

I have shown how corporate or individually owned policies can be converted into the Loan Regime Method of Split Dollar™ (Late Start Split Dollar). I have also shown how Collateral Assignment Split Dollar Arrangements using the Economic Benefit Regime can be "switched" into the Loan Regime Method of Split Dollar™ (Switch Dollar). In these articles, I have loosely referenced in some planning examples the use of the Leveraged Split Dollar™ (LSD™ Rollout) technique to terminate the Split Dollar Arrangement. This article will focus on the LSD™ Rollout Method.

In these articles, I have also taken you down memory lane providing you with my own unique version of the Wonder Years (Estilo Panameño) because of my experience growing up in the Panama Canal Zone. It was an "outside looking in" American childhood experience with many of the vestiges of growing up in America but situated in the tropics. I always liked Joe Cocker and recently renewed my enthusiasm after viewing his documentary on Netflix, as the best white soul singer in Rock and Roll history. When Ray Charles says that you have "Soul," you have Soul! Joe Cocker's signature album was called *Mad Dogs and Englishmen*. Hence, the basis for the title of this article but with the twist of my childhood experience in Panama.

Our " Wonder Years," always include stories about our childhood pets. While I did have a neighbor that had an ocelot and a sloth, most of us in the Canal Zone grew up with dogs and cats. My family had two dogs - Snoopy, a mutt and Fritz, A German Short-Haired Pointer. Fritz's AKC registered name was Schumachers's von Fritzel. Fritz always enjoyed special status with my German father (of blessed memory) because he was German. My father could always, speak to Fritz in German. It was their thing! He even survived the death penalty with no penalty, after devouring my Dad's order of German sausages from Usinger's in Milwaukee, on the day that they arrived. Snoopy would not have enjoyed the same result. Snoopy used to run the streets of our neighborhood with her pal, a black lab named Mingo.

The tropics are no friend to Man's Best Friend. Fritz met his end way too soon after being bitten by a poisonous snake in the field by our house. A virus several years later would kill most of the pets in the Canal Zone. My brother and I cried like we had never cried before! My mother said that my father also cried like a child when he heard the news about Fritz from the neighbor who found him. The Wonder Years!

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 hold 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

Hector Heathcoat (Heathcoat), age 51, is the majority shareholder in Acme Technology, Inc. Acme is a privately held, C corporation. Heathcoat 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 Heathcoat 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 Heathcoat, 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. Heathcoat'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

I have been ranting for weeks that the reports of the demise of Split Dollar life insurance have been greatly exaggerated. The chaos and economic malaise have created planning opportunities for financial advisors. The Loan Regime Method of Split Dollar™ is one of those planning opportunities. The Leveraged Split Dollar™ Rollout is the bomb! It provides an exciting opportunity to terminate Split

Dollar arrangements at a significant discount on top of the existing financial and tax leverage of the Split Dollar arrangement itself. In my view, the proposed Split Dollar arrangement is markedly different than Intergenerational Split Dollar which was a private Split Dollar arrangement using the Economic Benefit Regime. Business Split Dollar has a five-decade experience using restricted collateral assignments in Split Dollar arrangements. The tax audit profile for businesses is dramatically different than the estate and gift tax audit rate for large estates. Gentlemen (and Ladies), start your engines!