



LAW OFFICE OF GERALD R. NOWOTNY, PLLC

Switch Hitter!

Maximizing the Flexibility of Split Dollar Life Insurance to Create Maximum Financial and Tax Leverage

Growing up in the Panama Canal Zone, I always wondered how competitive Zonians might be with Stateside teams. We played all the popular American sports - football, baseball, basketball and track and field, et al. During those "Wonder Years", Panama had five world champion boxers and several Panamanian members of the world champion Pittsburgh Pirates (Manny Sanguillen and Rennie Stennett). Of course, Panama also had Rod Carew to offer, a Panamanian by way of New York City.

Several Canal Zone kids over the years made it into minor league system in the Pirates. Herb Raybourn, a longtime Zonian, and a major league baseball scout is well known for signing Mariano Rivera. He also signed some Zonians during his time in the Canal Zone. One of my brother's classmates and teammates, Jaime Cocanower, pitched Baylor to the NCAA Championship and then pitched five years for the Milwaukee Brewers. We played in several American Legion tournaments in the U.S. during the summers with the disadvantage of playing teams coming off an eighty-game season while we are playing our first few games of pre-season.

In youth football we played an all-star team from Miami every year. The team was coached by a former Zonian. We always fared well. One of my high school classmates, a white kid with flaming red hair, ran the 100-yard dash in 9.4 on a cinder track. In high school my brother kicked a 44-yard field goal and I kicked a 41-yard field goal in the pouring rain in the 10th grade. I finished my last two years of high school at Culver Military Academy. At Culver I had the good fortune of sitting behind Jennifer Steinbrenner, the daughter of New York Yankee owner, George Steinbrenner, in Latin class. She was a top student and a genuinely nice person. It was also the height of the Billy Martin saga.

Thinking of the Yankees, it surprised me in my research that Mickey Mantle is considered the greatest switch hitter in the history of major league baseball. This article focuses on the planning power and potential of Switch Dollar Life Insurance, a planning concept that also not well known or appreciated. This article shows how an endorsement or collateral assignment Non-Equity Split Dollar can be converted into the Loan Regime Method of Split Dollar Life Insurance™.

A High-Level View of Split Dollar Life Insurance

The planning goal of a Split Dollar Arrangement is to provide a business owner or executive with a low-cost executive benefit. From the perspective of the business owner, cost can be measured in two ways, the

financial and tax cost. The financial cost relates to the out-of-pocket premium expense and the tax cost to the business owner relates to the economic benefit as a result of the employer paying all or most of the policy premium. The business owner's tax cost is not measured by the amount of the premium paid by the employer, but rather the value of the economic benefit of the death protection payable to the business owner's beneficiary. The measurement of this economic benefit for tax purposes is the one-year term insurance cost for the death benefit allocated to the business owner under the Split Dollar Arrangement.

In the Economic Benefit Regime in either the Endorsement Method or the Collateral Assignment Method, the economic benefit cost to the executive is measured by the lesser of the insured's annual renewable term cost or the Table 2001 cost. Life insurers typically maintain a low cost annual renewable term policy on the books for this purpose. The rate increases as the insured ages. Eventually, it reaches a point where the business executive says "ouch." In the meanwhile, the employer owns the policy cash value and a death benefit equal to the cash value.

Once the policyholder reaches the point where the executive starts to feel the financial pain of the level of the economic benefit, it might become financially viable to use the Loan Regime Method of Split Dollar™ where the interest component remains the same rather than increase each year like the Economic Benefit Regime because the cost of annual renewable term increases each year. Switch Dollar Life Insurance is a method of switching from the Endorsement Method or Collateral Assignment Method to the Loan Regime Method. With interest rates at a historic regime, this is a planning option that should be considered in every existing Split Dollar Arrangement or every new Split Dollar Arrangement being contemplated.

Overview of Switch Dollar Life Insurance

A "Switch Dollar" Plan allows a business owner who has an Economic Benefit Non-Equity Limited Collateral Assignment Split Dollar or Endorsement Split Dollar plan to switch to a Loan Regime Collateral Assignment Split Dollar™ plan at a time when it is more advantageous to have a Loan Regime plan instead of an Economic Benefit plan.

In an Economic Benefit Non-Equity Limited Collateral Assignment Split Dollar plan, the business owner owns the policy, or the trustee of the business owner's trust owns a life insurance policy on the life of the Executive. According to the Agreement, the Policyowner, the business owner or the trustee of a family trust, assigns the greater of premiums paid or all policy cash values to the Corporation and designates the remainder of the policy's death proceeds to the Trust for the benefit of Trust beneficiaries.

The Economic Benefit Regime Method of Split Dollar works well for younger insureds. In the early years of the Agreement, the policy cash values are less than the premiums paid on a retail life insurance contract. Consequently, there is no equity (cash values more than premiums paid) in the policy. Economic Benefit Non-Equity Limited Collateral Assignment Split Dollar plans are designed to keep all cash values, including any equity that may build-up, in the ownership of the Employer. As a result, this type of arrangement does not provide the business owner with the opportunity to use the policy cash value as a vehicle for supplemental retirement income.

Switch Dollar Life Insurance allows the business owner to reposition the life insurance policy in a Split Dollar Arrangement to a Split Dollar Arrangement using the Loan Regime Method of Split Dollar™ without taxation, to maximize the growth of the cash value for supplemental retirement income purposes. A business owner can enjoy the benefit of the economic benefit for tax purposes in the early years followed by a switch to the Loan Regime Method while locking in the current low interest rate of 1.12 percent in August 2020. After the “switch,” the business owner will own all the policy cash value in excess of the premiums plus accrued interest after the switch. The annual interest can be accrued. The LSD™ Rollout Method can be used to terminate or rollout out the employer's interest at a 65-95 percent discount. If you own a Split Dollar plan, this is the time to be a switch hitter.

In a Loan Regime Limited Collateral Assignment Split Dollar™ plan, the business owner or a family trust is the owner of the policy, and all equity in the policy builds tax-free for the benefit of the Trust. Instead of paying for the cost of the insurance death benefit in excess of the Employer's interest in the policy, as in an Economic Benefit Non-Equity Limited Collateral Assignment Split Dollar plan, the Loan Regime plan requires the parties to treat the Employer's cumulative premium payments as loans and the Executive to pay or include in income interest on the loan annually.

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 would like to provide Heathcoat with a significant executive benefit, participation in Split Dollar Life Insurance plan.

The company will provide premium payments on a new equity indexed Universal Life Insurance policy with a face amount of \$22 million. Acme agrees to pay premiums of \$1 million per year for seven years.

The policy is structured as a Collateral Assignment Non-Equity Split Dollar Arrangement. Heathcoat’s family trust will be the applicant, owner, and beneficiary of the policy. The policy death benefit uses Option B, the initial face amount plus the account value. Acme will have a collateral assignment interest in the policy cash value and death benefit equal to the entire cash value. Acme’s access to its interest is limited to the earlier of Heathcoat’s death or termination of the Split Dollar Arrangement. The projected tax income and gift tax consequences in the first seven years can be seen in the chart below.

Year	Economic Benefit for Income and Gift Tax Purposes
1	\$709
2	\$784
3	\$760
4	\$733
5	\$752
6	\$773
7	\$793

Strategy Example Solution

In the beginning of Year 8, the trustee of Heathcoat's Family Irrevocable Trust enters into an agreement with Acme to "switch" the Split Dollar Agreement from a Collateral Assignment Non-Equity Split Dollar Arrangement into a Loan Method Split Dollar AgreementTM. Acme approves a corporate resolution authorizing the change. Under the switch, the existing cash value is converted into a loan equal the premiums paid to date plus any accrued interest. Any cash value more than the accumulated loan for Acme, accrues for the benefit of Heathcoat.

Heathcoat's Trust is a spousal lifetime access which provides Maria Heathcoat 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 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.

In Year 8 without any interest payments, the accrued loan is \$7.8 million. The trustee may take a policy loan to reimburse Acme for the loan. In Year 8 of the policy, Heathcoat, and Acme agree to terminate the policy using the LSDTM 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 in Year 8 prior to the rollout.

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

Switch Dollar Life Insurance provides an exciting technique to convert "old and cold" Split Dollar Arrangements into something new that is living and breathing. The current low interest rate environment provides a method for the policyholder to turn the tables in the arrangement so that the policy cash value becomes accessible the business owner on a tax-free basis. Life insurance agents have always sold on the basis that life insurance is a unique investment asset that can provide for tax-free growth and income. We can structure the policy ownership so that it is beyond the reach of creditors while receiving tax-free distributions from the policy. Switch Dollar creates a reason for life insurance agents and Split Dollar participants to dust off the Split Dollar Arrangement and determine how to tip the scale of the plan back into the direction of the business owner with increased financial and tax leverage.