It's (Not) Too Late, Baby!

Using Late Start Split Dollar to Create Financial and Tax Leverage

I have mentioned in prior articles that I am not particularly a fan of folk music and ballads. Nevertheless, I have always been immensely impressed by the song-writing collaborations that created some of the great songs of our generation such as Bachrach and David and Paul Williams. The documentary on his life, "Still Alive" is a must-see. Carole King and her ex-husband, Gerry Goffin, were another tremendous song-writing collaboration.

As I have written in the past, as a Zonian, I am a man without a country. Oddly enough, in the Panama Canal Zone, our musical connection to the music of the day, was maintained by listening to Casey Kasem's American Top 40 on the military radio station every Saturday night. Several bands were Canal Zone favorites such as Santana. Oddly, the band Rare Earth had a lot of popularity in the Canal Zone. The group was one of the few white groups signed at Motown Records. You can still hear them occasionally on Sirius Radio and you have to admit that their rendition of "I Just Want to Celebrate" and " Get Ready." are an excellent part of the musical fabric from the time period.

I have been writing for several weeks on Split Dollar Life Insurance and specifically the Loan Regime Method of Split Dollar™. The Loan Regime Method of Split Dollar™ is a planning strategy that should be on the top of the planning list for financial advisors and life insurance agents. Even if you don't like Private Placement Life Insurance (PPLI), a retail Variable Universal Life Insurance or Equity Indexed Universal Life Insurance policy in a Split Dollar Arrangement, can transfer a tremendous amount of wealth with little or no tax cost to the policyholder, while providing the policyholder with the ability to use loans and withdrawals as a source of tax-free supplemental retirement income and a tax-free death benefit.

Overview of "Late Start" Split Dollar

"Late Start" Split Dollar is a planning concept designed to convert a corporate owned policy or an individually owned policy into a policy that is part of a Split Dollar plan. This change can be made after the policy has been issued without any taxation to the business or business owner. In the current low interest environment, the strategy is to convert an Endorsement Method Split Arrangement where the business is the owner of the policy into a Loan Arrangement Split Dollar

Arrangement where the business owner or a family trust is the owner of the policy. Alternatively, a policy that is individually owned can be converted after the fact into a Split Dollar Arrangement using the Loan Method of Split Dollar™ which allows the business to make tax-free loans that can used as premium payments into the policy.

The planning goal of the "Late Start" Split Dollar Arrangement is to maximize the financial and tax leverage of the Loan Regime Method of Split Dollar™. The conversion allows the business to provide tax-free loans to the policyholder to make premium payments maximizing the benefit of the historically low interest rate environment. The arrangement creates financial and tax leverage through the vehicle of permanent life insurance and the split dollar arrangement. The life insurance policy enjoys the tax-free buildup of the cash value, tax-free loans and withdrawals and an income tax-free death benefit.

The current interest rate environment is uniquely positioned for the Loan Regime Method of Split Dollar™. The long term applicable federal rate for a loan exceeding nine years is currently 1.12 percent for August 2020. This provides tremendous leverage to transfer wealth at an exceptionally low cost through the tax advantage and efficiency of permanent life insurance.

It's time to look at all of your client's existing corporate and individual policies to see if this strategy can add value.

Strategy Examples Using "Late Start" Split Dollar

Example 1

Hector Heathcoat (Heathcoat), age 45, 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 purchased the policy six months ago. The policy has a face amount of $22 million. The projected premiums are $250,000 per year for the next twenty-five-year period. Alternatively, he could fund the policy more quickly over seven-years paying a premium of $1 million per year for seven years.

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 makes a one-time loan of seven million dollars to the Trust at a rate of 1.12 percent which is repayable at the earlier of the death of Heathcoat or termination of the Split Dollar Arrangement. The interest may be accrued on the loan.

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 with the accrual of annual interest, the accrued loan is $7.8 million. In Year 8 of the policy, Heathcoat, and Acme agreement to terminate the policy using the LSD™ ("Leveraged Split Dollar") 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.

Example 2

Heathcoat purchased a PPLI policy six months ago. The policy is owned by a family trust that is a non-grantor trust for income tax purposes. The policy has a face amount of $22 million. The projected premiums are $250,000 per year for the next twenty-five years. Additionally, Heathcoat is a limited partner in several hard money and direct lending investments that generate ordinary income. The portfolio is worth $2.5 million. The funds have an average investment return before taxes of 12 percent per year. Heathcoat is in a combined marginal tax bracket of 45 percent.

Acme enters into a "Late Start" Split Dollar Arrangement with Acme to provide a five-million-dollar loan at an interest rate of 1.12 percent which is payable at the earlier of Heathcoat's death or the termination of the Split Dollar Agreement. Separately, Heathcoat enters a securities loan arrangement to lend his limited partnership interests to the Good Investment Insurance Dedicated Fund within the PPLI policy. The loan will be an eight-year loan at the mid-term applicable federal rate of 0.43 percent and by the LP interests. The investment income from the portfolio is payable within the PPLI policy enjoying the inside buildup of life insurance.

Summary

"Late Start" Split Dollar Life Insurance is an excellent planning strategy to enhance an existing personal or business life insurance arrangement after the fact. My recommendation is to convert into a Loan Method Split Dollar™ Arrangement in this current low interest rate environment. The financial and tax leverage enhances the value of the life insurance planning proposition. The evaluation of this strategy creates an opportunity to bring a value-added idea to a client or prospect. The Carole King song may state that "It's too late, Baby" but when you use Late Start Split Dollar, it is never too late!