LAW OFFICE OF GERALD R. NOWOTNY, PLLC

WHERE HAVE YOU GONE, CHIP HILTON?

Using a Combination of Deferred Compensation and Loan Method Split Dollar in Tax Planning for Professional Sport Signing Bonuses

As a child growing up in the Panama Canal Zone my connection to the professional sports in the United States came primarily through the military's AFRTS television and radio programs. College and professional sports events were shown two weeks after the fact on TV and live on the radio. Since Panama had several players on the world champion Pittsburgh Pirates (Manny Sanguillen and Renny Stennet), Zonians were frequently Pirate fans and Steeler fans by default.

I recall hearing Franco Harris' " immaculate reception" live on AFRTS radio. I will remember that event as long as I live. Like any youngster growing up in suburbs in the States, I dreamt about being a college and professional athlete. I was a fairly good athlete but ended up liking the weight room more than the sports that I played. It was probably the result of an overdose of Hercules movies. My father had an employee whose son was the Pan American super heavyweight Olympic weightlifting champion at a time when Cuba had great lifters. The offer to train with him was, there but the gym was in a dangerous neighborhood where American kids did not belong. I settled for powerlifting in college and beyond. Remember, I do know Squat.

My image of the scholar-athlete was fueled by the Chip Hilton sports fiction series written by Clair Bee. I had the entire series of twenty-four books and read each one numerous times. Chip Hilton was the All-American kid, a tremendous three sport athlete (football, basketball, and baseball). He was raised by his mother who was widowed and was the perfect role model of the dutiful son who worked part-time as a soda "jerk" to help support his mother. He excelled in the classroom and on the playing field. He was the captain of every team he played on and was a leader on the field and off the field admired by colleagues and their parents for his stellar character. In college, he was an All-American in all three sports in college. He was an example of what I strived to become!

In the modern era, we ask ourselves, " Where have you gone, Chip Hilton?" In my mind, Tim Tebow is probably the best example of who comes to mind in recent times to personify the character and athletic talent of Chip Hilton. He is an exceptional role model and athlete. An intelligent NFL team would always be very well served to have a leader and role model in their locker room. Chip may have been stronger in the classroom, but Tim also married Miss Universe who is also a Christian.

The current social unrest has collided within every segment of American society including college and sports. In my view, civil liberties for all is the hallmark of American freedom, but the emphasis in college sports has become too much about winning and not enough about developing athletes who can "win" at life while marrying, and building and sustaining a family. I have long thought that Division I schools should lose a scholarship for each athlete that leaves school or who does not graduate.

This article focuses on tax planning for professional athletes who receive substantial one-time signing bonuses. The sad reality is that most professional athletes will never have another opportunity to earn that level of income money beyond their playing days. A combination of misspending and heavy taxation places many professional athletes in a difficult situation in retirement to match their debilitating physical ailments. The planning goal in this article is that if advisors provide a better mechanism to reduce and defer taxation on large signing bonuses, the money will be there when the professional athlete retires.

Strategy Overview

The proposed strategy allows the professional athlete to defer his signing bonus through a non-qualified assignment of the signing bonus. The signing bonus is not currently taxable to the professional athlete relying upon the provisions of the U.S.-Swiss Income Tax Treaty which was ratified in 1996 and amended in 2009. The special purpose vehicle (SPV) which holds the deferred signing bonus relies on the provisions of the Treaty.

Under the Treaty, investment income such as interest income is exempt. Short-and long-term capital gain income is exempt. Qualified dividend income is subject to a 5 percent withholding tax. Royalty income is not subject to any withholding tax. Nevertheless, an investment advisor may desire to invest deferred fee income in the SPV into assets classes which are subject to withholding taxes.

The proposed strategy provides a lending structure which allows the athlete to borrow up to 75 percent of the signing bonus at an exceptionally low interest rate in the current environment. The deferred income is ultimately taxed as ordinary income rates. The use of the Loan Method of Split Dollar provides for a conversion of tax deferred dollars into tax-free dollars.

The SPV held by the assignment company enters into a Loan Method Split Dollar arrangement with a trust established for the professional athlete. The trustee is the applicant, owner and beneficiary of a life insurance policy insuring the athlete's life. Trust ownership of the policy protects the policy from the personal creditors of the athlete. The importance of this planning benefit cannot be over-emphasized. The loan is a one-time loan for the duration of the Split Dollar arrangement at the long term AFR which is 1.0 percent in September 2020.

The trustee uses the loan proceeds to fund the policy on a non-MEC basis. The trustee collaterally assigns an interest in the policy cash value and death benefit equal to the amount of the loan and any accrued interest. The collateral assignment is restricted until the death of the insured. The trust is entitled to the excess cash value and death benefit.

In a few years, the trustee and SPV agree to terminate the Split Dollar arrangement through the trustee's repurchase of the Split Dollar receivable. Based upon an actuarial valuation, the receivable is discounted 80-90 percent. Following the termination using the Leveraged Split dollar Rollout™ method, the policy is owned within the Trust unencumbered and protected from personal creditors growing on a tax-free basis. The trustee may take tax-free loans and withdrawals to provide tax free income to the athlete.

Case Study

Chip Hilton, age 22, is the recent Heisman Trophy winner and top quarterback prospect in this year’s NFL’s draft. He is expecting a signing bonus of $25 million. Before the ink is dry, Chip enters into an assignment arrangement with Acme Assignment located in Barbados to defer the entire $25 million signing bonus. Acme is located in Barbados.

Under the terms of the assignment agreement, Acme Assignment agrees to pay Chip $600,000 per year beginning at age 30 for his lifetime. The annuity is structured to use $9.2 million of the deferred signing bonus assuming an investment return of 7.5 percent per year to provide this increasing by three percent per year for inflation. The manager of the special purpose vehicle (SPV) which is the investment vehicle within the deferred structure may also provide a loan of SPV assets up to 75 percent of the net asset value of the SPV.

The SPV decides to allocate some of the SPV investment funds to a Split Dollar arrangement insuring Chip’s life. The manager of the SPV will provide a one-time loan of $10 million dollars to the Chip Hilton Family Trust, a Nevada Trust. The loan is a long-term fixed rate loan of one percent which is repayable at Chip’s death. Chip is an income beneficiary of the Trust.

The trustee of the Trust is the applicant, owner, and beneficiary of a new private placement life insurance (PPLI) policy insuring the life of his wife, Mitzi. The trustee will fund the policy over fours year at the highest level ($2.5 million per year) so that the policy remains a non-MEC. The policy issued by Lombardi Life provides customized investment options within the policy.

The policy within the Trust is outside of the reach of personal and business creditors. The trustee may take policy loans and withdrawals to make tax-free distributions to Chip and his family.

The Split Dollar arrangement provides the SPV with a collateral assignment in the policy equal to the amount of the loan plus any accrued interest. This collateral assignment interest is restricted until the earlier of the death of the insured, termination or the Split Dollar arrangement or surrender of the life insurance policy.

The Trustee of the Trust owns the excess cash value and death benefit. The death benefit will receive tax-free treatment for income and estate tax purposes. Loans and withdrawals will receive income tax-free treatment at the trust and beneficiary level.

In Year 5, the trustee of the Trust terminates the Split Dollar arrangement using the Leveraged Split Dollar Rollout™ which allows the trustee to purchase the Split Dollar collateral assignment receivable at a discount. Based on the insured's youth, the transfer provides for a valuation discount of 90 percent. The Trustee will pay the SPV $1 million by taking a policy loan to reimburse the SPV.

Summary

In summary, the professional athlete has an unprecedented opportunity to defer taxation on his signing bonus and convert the tax deferred income into tax-free income using a combination of a tax structure for the deferral of the signing bonus followed by a Split Dollar arrangement. The combination of the two planning structures has the effect of converting the deferred income into tax-free income in a trust which places the policy beyond the reach of the athlete's personal creditors. In my view this planning dramatically enhances the planning result for professional athletes. It is not what you make, but rather what you keep!