



LAW OFFICE OF GERALD R. NOWOTNY, PLLC

HEAVEN CAN WAIT

Using Loan Method Split Dollar in the After Life!

I spent the summer of 1980 before entering my sophomore (Yearling) year at West Point at Camp Buckner which is about eight miles from the main base. This summer is dedicated to military training – field artillery, armor, and infantry. It was a rigorous summer. Reveille every morning was at 0430 hours and Taps was at 2100 (9:00) hours. My highlight of the summer was falling into an eight-foot large ditch full of rocks headfirst at night in the rain. Somehow, I was not knocked unconscious and managed to crawl out and walk about 200 meters to the infirmary. The first question was, “Were you drunk,” and not “Are you OK.” Fortunately, I did not receive a concussion or fractured skull but did manage to knock out several teeth out.

Every night we had a movie that we could watch. Normally, I am not a fan of dramatic “soapy” love stories but somehow the film *Heaven Can Wait* featuring Warren Beatty and Julie Christie managed to hook me. I am not certain why, but it did. The movie’s plot deals with a fantasy afterlife where mistakes in life are made and worthy characters get do-overs. It is a timeless story about love, redemption, football, and shady business deals. In Post-Mortem Split Dollar, taxpayers have an opportunity to utilize a Split Dollar technique to transfer wealth more efficiently in a Dynasty Trust.

This article focuses on the ability to use Split Dollar, a technique normally used in inter vivos planning rather than post-mortem planning. The article focuses on the idea that a inter vivos planning technique can also be used in post-mortem planning using assets from a Marital Trust or QTIP Trust to sponsor a Split Dollar life insurance arrangement with a Dynasty Trust to transfer wealth in a manner that functions in some manner as an effective estate freeze technique.

Non-Grantor Trusts

Marital Trusts and Credit Shelter Trusts are typically taxed as Non-Grantor Trusts for income tax purposes. Investment in alternative strategies such as hedge funds and fund-of-funds has become very mainstream in asset allocation to provide non-correlated investment returns. The trade off in the pursuit of these investment objectives is short term capital gain taxation taxed at ordinary rates. For the New Yorker or Californian, this means Marital Trusts and Credit Shelter Trusts could be taxed at rates as high 55-57 percent.

Trusts that are not taxed as Grantor Trusts are taxed as separate taxable entities. Unfortunately, it takes little investment income to push a Non-Grantor Trust into the top marginal tax bracket-\$12,950. A Non-Grantor Trust is a trust that does not fall within any of the provisions of IRC Sec 671-679. Unfortunately, the Non-Grantor is taxed in the same manner as a high net worth taxpayer in the top marginal tax bracket.

Split Dollar Life Insurance in the After Life

The unlimited marital deduction allows a married couple to defer the payment of federal estate taxes until the death of the surviving spouse. Depending the length of the over-life, i.e. the time between the death of the first spouse and the surviving spouse substantial appreciation in Marital Trust assets can take resulting in a much larger estate tax bill at the death of the second spouse. Adding further insult, the Marital Trusts are taxed as Non-Grantor Trusts.

Split Dollar life is a contractual arrangement between two parties to share the benefits of a life insurance contract. In a corporate setting, Split Dollar life insurance has been used for 55 years as a fringe benefit for business owners and corporate executives. The Postmortem Split Dollar technique in the article envisions a Loan Method Split Dollar arrangement between the Marital/QTIP Trust and a Dynasty Trust which is designed to perpetuate wealth for multiple generations within a family. Additionally, the Marital Trust creates a new investment limited liability company (LLC) as the sponsor and lender to the Dynasty Trust.

The Loan Method uses the Collateral Assignment Method of Split Dollar. In the Collateral Assignment Method, the Trust (in our case) is the applicant, owner, and beneficiary of the policy. The Marital Trust makes a one-time loan using the long term applicable federal rate which is 1.12% in October 2020. This rate is fixed for the term of the loan. The loan proceeds of the Marital Trust are used to pay premiums on a Non-Mec basis to preserve tax-favored treatment on loans and withdrawals from the policy for Dynasty Trust beneficiaries. The LLC within the Marital Trust retains an interest in the policy's cash value and death benefit equal to the value of the loan plus any accrued interest. The Dynasty Trust collaterally assigns an interest in the policy to Marital Trust LLC for its contributions and interest in the policy.

The Postmortem Split Dollar technique envisions underwriting life insurance on members of the second or third generation in the family. The Dynasty Trust retains the excess cash value and death benefit is paid to the Dynasty Trust during the arrangement. The technique also uses a restricted collateral assignment. Restricted collateral assignment is the classical form of Split Dollar arrangement utilized by the majority shareholder of a closely held business.

Under restricted Collateral Assignment Split Dollar, a restriction is added to the Split Dollar agreement which "restricts" the company's access in the policy under the Split Dollar arrangement (greater of cash value or premium). The "restriction" limits the company's access until the earlier of the death of the insured, termination of the Split Dollar agreement, or surrender of the policy.

The owner's business purpose is driven by concerns of the estate tax inclusion of the death proceeds for the business owner under IRC Sec 2042. The incidents of ownership under IRC 2042 over the policy would be imputed to the business owner due to the owner's control of the business as the majority shareholder. The proposed Private Split Dollar arrangement would contain the same type of restriction contained in the classical Split Dollar arrangement.

The trustees of the Marital Trust and Dynasty Trust may elect to terminate the Split Dollar arrangement prior to the death of the insured using the Leveraged Split Dollar Rollout™ technique.

The Leveraged Split Dollar Rollout™ is a method to terminate an existing Loan Regime Split Dollar arrangement at a significant discount. In the Loan Regime, the business as the lender 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 discounted due to this restriction.

At some point, the policyholder decides to terminate the Split Dollar arrangement by purchasing the lender's restricted Collateral Assignment interest in the policy. A valuation specialist value the note receivable for valuation purposes. 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 uses a tax-free policy loan or withdrawal to purchase the note from the lender.

A decent amount has been written about Intergenerational Split Dollar life insurance following recent Tax Court litigation in the Cahill, Morrisette, and Cahill cases using 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 on principle alone? These cases were ultimately about valuation issues versus whether the arrangements were valid Split Dollar arrangements. 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 a business 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. In the early days, planners did not realize the valuation planning opportunities created by the restriction. Valuation in tax planning became much more mainstream in the decade of the 1980's and 1990's.

Second, the 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. The IRS has seen and ruled favorably on the use of restricted Collateral Assignments for controlling shareholders for at least five decades for these non-tax driven purposes. Lastly, the Tax Court cases almost exclusively used the Economic Benefit Method of Split Dollar instead of the Loan Regime.

To implement the Leveraged Split Dollar Rollout™ strategy, the trustee of the Dynasty Trust at his discretion may decide to transfer by sale their interest in the Split Dollar arrangement, aka the Split Dollar receivable. The Split Dollar receivable is valued based upon a third-party valuation. The right of recovery under the Split Dollar arrangement is limited until the death of the insured, or the termination of the Split Dollar arrangement. The sales price based upon an independent valuation provides for a heavily discounted sales price – 75-90 percent.

Strategy Example Facts

Jane Smith, age 75, is a widow. Her husband Bob was a wealthy business owner who died of prostate cancer two years ago. His estate plan provided for a traditional distribution - a Credit Shelter Bypass Trust for an amount up to the exemption equivalent and a Marital General Power of Appointment Trust. The Marital Trusts currently have \$15 million of assets - mostly investment assets that are generating a substantial income to the trust. Additionally, the assets are appreciating at a rate that exceeds the rate of inflation. Jane's children and grandchildren are beneficiaries of the trust.

The trustee would like to minimize the tax impact of current income to the trust. The income is mostly short-term capital gain income and interest income.

Strategy Implementation

Acme Trust Company serves as the trustee of the Delaware trusts. The trusts are Non-Grantor Trusts for federal income tax purposes. The trustee implements a strategy that utilizes Private Placement Life Insurance (PPLI). The trustee is the applicant, owner, and beneficiary of a PPLI contract issued by Corona Life, a Delaware based life insurer. The PPLI contract insures the lives of Jane's son, Bobby and her daughter-in-law, Penny. The policy is a Second-to-Die policy

with an annual premium of \$1 million per year for a five-year period. The death benefit is \$25 million.

The policy will be structured as a Split Dollar arrangement between the Marital Trust and a Dynasty Trust using the restricted Collateral Assignment technique described above. The Marital Trust will pay the premiums and have an interest in the policy death benefit and cash value equal to the amount of the Split Dollar loan plus any accrued interest on the loan. The right to reimbursement is the earlier of the death of the insureds or termination of the Split Dollar arrangement.

At the beginning of Year 6, the trustee of the Marital Trust proposes to sell its interest in the Split Dollar arrangement, i.e. the right to recovery at the death of the insureds who are 55 at the time. A valuation specialist values the Split Dollar receivable at \$1.25 million. The trustee of the Credit Shelter Bypass Trust purchases the Split Dollar receivable in a single payment. At the time of the transfer, the policy cash value is \$7.5 million, and the death benefit is \$25 million. As a result of the transfer, the value of the Marital Trust is reduced by \$6.25.

The Dynasty Trust's value is increased by the additional cash value that was previously collaterally assigned to the Marital Trust LLC. The PPLI contract is unencumbered within the Dynasty Trust and growing on a tax-advantaged basis. The ultimate death benefit will also be income and estate tax free. The policy cash value is also available to the trustee to take tax-free loans for distribution to trust beneficiaries.

Summary

Higher tax rates not only create a problem for high net worth individuals but also Trusts - Grantor or Non-Grantor. I am virtually certain that client advisors have never considered the possibility of leveraged Dynasty Trust assets using a Split Dollar arrangement with a Marital Trust. A combination of the Leveraged Split Dollar Rollout™ and low interest rates make this a very novel strategy where the exemption amount for gift and estate taxes is under siege under once again. The benefits are substantial. Life insurance provides for tax-advantaged accumulation and tax-free loans and withdrawals for beneficiaries of the Dynasty Trust. The death benefit payable to the Dynasty Trust is income and estate tax-free. The assets are protected from the claims of the beneficiaries' creditors. The allocation of the GST exemption ensure that the assets will continue for multiple generations. Tax planning opportunities missed in the taxpayer's lifetime can be rediscovered in the afterlife.