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THE WAY WE WERE

Using Loan Method Split Dollar to Recreate the Benefit of Tax Deferral for Carried Interest

One of the things that Mrs. Nowotny (aka Long Suffering) and I enjoy doing is watching movies. We like foreign films. I caught the foreign film "bug" as a double major in Spanish and Portuguese in college. They were the friendliest departments at a military school which is the oldest engineering school in the country. Following graduation and reporting to my Officer Basic Course at Ft. Eustis, Virginia, I spent some time in New York.

While my wife worked at her alma mater in the Admissions Department, I killed some time and watched a foreign film called *Les Uns et les Autres'* (Bolero). It is possibly one of the most wonderful and deeply moving films, I have ever seen. It is a film about humanity, about love, war, loss, and redemption. From that time on, I embraced foreign films. One of Mrs. Nowotny's favorite movies is *The Way We Were*. She has seen it ten-twelve times. It is a good movie but probably more of a Robert Redford thing if you ask me!

Hedge Fund managers previously had an unprecedented ability to defer their carried interest in the offshore hedge funds that they manage. IRC Sec. 409A put an end to those deferrals and required hedge fund managers to repatriate their offshore carried interest no later than December 31, 2017. On a personal level, I was aware of small hedge fund managers with $30-50 million of deferred carried interest. On the flip side of things, I was aware of large fund managers with $750 million to $1 billion of deferred carried interest. Undoubtedly, retirement would be looking attractive looking through those lenses!

These deferred funds were in the hedge fund manager's taxable estate and subject to ordinary income taxation. The combination of income and estate taxation much like qualified retirement plans would have resulted in a 70-80 erosion due to taxes. The deferrals were usually ten-year deferrals with no taxation during the deferral period. The deferred fee income exploded in growth earning the investment return of the hedge fund manager's funds that they managed.

But when all the laughter dies in sorrow, and the dust finally settles, we need a tax solution to solve the problem. In my view, the Loan Regime Method of Split Dollar could be that solution. Since that time

hedge fund managers have lacked an effective compensation strategy to replicate the way things were in the time of wine, women, and song.

This summary outlines the power of Loan Method Split Dollar as compensation technique for hedge fund managers that in the current environment is arguably a better solution than the prior deferral strategy after consideration of income, and estate taxation as well as asset protection.

Overview of Loan Regime Split Dollar

a. **Loan Regime Split Dollar Basics**

The primary planning objective of the Loan Regime Method of Split Dollar is to provide the hedge fund manager with low-cost death protection and equity buildup in the cash value. In the Loan Regime, the hedge fund manager is the applicant, and owner of the policy and collaterally assigns an interest in the policy cash value and death benefit to the employer equal to its cumulative loans plus any accumulated interest payments. Better yet, a family trust (Irrevocable) established in a jurisdiction like Nevada, South Dakota, Wyoming, or Alaska is a better solution for asset protection purposes. Ownership within the Trust removes the policy from the reach of personal and business creditors.

In the Split Dollar realm, the offshore fund which is typically structured as a corporation in a foreign jurisdiction, provides a series of loans to the trustee of the family trust to all or most of the premiums. The loans are not treated as taxable to the hedge fund manager provided the loan terms are arms-length in nature. The loans are not taxable gifts where the loans are extended to the trustee of a family trust providing that there is an adequate interest rate. In this scenario, investors in the offshore fund might agree to an initial loan averaging the amount of carried interest over the last three to five-year period.

b. **The Impact of Below Market Rate Loans**

Below-market rate or interest-free loans are sometimes used in Loan Regime Split Dollar where the Employer desires to provide premium financing to the executive through a loan with little or no interest. When no interest is charged by the Employer as a lender, the rules for below-market or interest-free loans follow under IRC Sec. 7872 apply. Under Sec. 7872, if no interest or an inadequate rate of interest is charged on a loan, the IRS recharacterizes the loan into an “arm's length” transaction and imputes an interest rate equal to the applicable federal rate based upon the term of the loan that is deemed to have been received by the lender and paid by the borrower. The long-term applicable federal rate in September 2020 is 1.0 percent per year.

c. **Additional Loan Considerations**

In order to avoid the application of the below-market rate loan rules in a Loan Regime Split Dollar loan, the parties should agree upon a stated interest at or above the appropriate applicable federal rate Demand loans may be used in Split Dollar plans. If the Split Dollar loan is a nonrecourse loan,

meaning the policyholder is not personally liable, and is payable only from values in the policy with no further recourse to the borrower, the parties must represent in writing and attach to their tax returns in the first year of the plan that a reasonable person would expect that all payments under the loan will be made. To avoid these rules, most Split Dollar loans are made on a recourse base so that the borrower is personally liable for repayment of the loan.

d. ERISA Considerations

Split Dollar plans require a fiduciary (plan administrator) and a claims procedure. If a plan is contributory it will not qualify for the select group of management/highly compensated employee exemption that applies to non-contributory welfare benefit plans. If the Business owner is required under the terms of the plan to contribute any part of the premium, the plan administrator must provide a summary plan description (SPD) to each participant and the Department of Labor (DOL), as well as provide other plan documents to the DOL upon request.

e. Accounting Considerations

The Financial Accounting Standards Board (FASB) has determined that employers who agree to provide a post-retirement death benefit to employees by means of a Split Dollar life insurance arrangement should accrue a liability on its books annually to reflect the employer's obligation. This requirement applies Loan Regime (Collateral Assignment) Split Dollar Arrangements.

In general, an employer should account currently for a post-retirement benefit related to an endorsement or Collateral Assignment Split Dollar Arrangement in accordance with FAS 106 if, in substance, the plan provides a post-retirement insurance death benefit or in accordance with APB 12 if, in substance, the plan provides an individual death benefit in the nature of deferred compensation.

If FAS 106 applies, the annual accrual is based upon the future cost of the life insurance (generally the cumulative premiums paid). If APB 12 applies, the accrual is based upon the present value of the future cost of the death benefit.

f. The Application of IRC Sec 409A

New deferred compensation plans must meet the requirements of Section 409A. IRS Notice 2007-34 describes the application of Section 409A to certain Split Dollar life insurance plans. In general, Section 409A does not apply to non-equity endorsement or non-equity Collateral Assignment Split Dollar plans or Loan Regime Collateral Assignment Split Dollar plans, unless the employer agrees to forgive the loan, waive payments, etc. for purposes of bringing that plan into compliance with 409A without losing the Split Dollar grandfathering.

Case Study - Facts

Sid Finkelstein, age 50, is the principal of an investment management firm in Greenwich that manages several hedge fund strategies. He is married and has two children. Finkelstein has a personal net worth of $40 million and is married with two children. His investment management firm has a management agreement with each domestic and offshore fund that it manages that provided for a management fee of two percent and an incentive fee of twenty percent after providing investors a return of their investment with a five percent return. The firm is no longer able to defer incentive fees from the management activities of their offshore fund and would like to implement a strategy that can provide a vehicle can provide a significant but tax efficient benefit to Sid. The investors agree to arrangement whereby the offshore fund agrees to provide a one-time loan to Sid in lieu of 50 percent of the incentive fee in 2020. The agreement provides that the loan amount will be at least $10 million.

The Planning Strategy:

Sid's offshore fund is structured as a Cayman corporation ("Corporation") and is not subject to corporate taxation in Cayman or the United States. The investment management company ("Management Company") and the offshore fund (investors) agrees to an arrangement whereby the Management Company agrees to forego fifty percent of any incentive fees earned in 2021 in exchange for an arms-length loan between the Corporation and Sid personally or alternatively, his family trust, the Finkelstein Family Trust. The projected loan amount is $10 million. The loan will be an arms-length loan at the current long term AFR of 1.0percent. The loan is a recourse loan between the Corporation and the Sid's Trust.

The trustee of an Irrevocable Trust created by Sid's wife is the applicant, owner, and beneficiary of a PPLI policy insuring Sid's life. The policy has a $30 million death benefit and projected premiums of $2.5 million per year for four years. The Corporation will have a collateral assignment interest in the cash value and death benefit equal to the amount of the loan plus any accrued interest. The Trust will own the excess cash value and death benefit in excess of the collateral assignment interest in the policy. The policy is a non-modified endowment contract which means that loans and withdrawals from the policy will receive tax-free treatment to the trustee of the Finkelstein Family Trust.

Acme Life, a specialty life insurer in Bermuda, issues a Private Placement Life Insurance (PPLI) contract featuring a separately managed account. Hector Heathcoat, an established money manager and friend of Sid's, is appointed by Acme to manage the investment account within the policy. The trustee transfers the entire amount of the loan to Acme who maintains the premiums for future years in a premium deposit account.

The Trustee has the discretion as trustee to request policy loans and withdrawals and distribute the proceeds to Sid on a tax-free basis. The policy within the Trust is beyond the reach of Sid's personal and business creditors. The policy death benefit will receive income and estate tax-free treatment. The proceeds will also be multi-generational. The trustee pays the annual interest on the $10 million loan at

a rate of 1.0 per year. The annual interest payment is $100,000. The loan term is thirty years. The projected growth rate within the policy is 8 percent.

The chart below projects the benefits to Sid under the arrangement.

Year	Accumulated Loan	PPLI CV	PPLI DB
10	$10 million	$26.25 million	$30 million
20	$10 million	$56.67 million	$65.17 million
30	$10 million	$122.35 million	$128.47 million
40	$10 million	$264 million	$277.2 million

The planning provides additional death benefit only (DBO) option for provides that the offshore fund will make a lump sum payment to Sid's family trust if Sid dies while the Split Dollar plan is in effect. The amount of the DBO benefit is equal to the amount that the Corporation receives from the death benefit portion of its collateral assignment interest in the policy. The payment from the Corporation to the Trust is treated as taxable income. Nevertheless, it is a substantial benefit.

The planning also calls for a termination or rollout of the Split Dollar plan after the policy is funded 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 purchases. Due to the restriction, the receivable is likely to be discounted. These discounts depend upon a variety of a variety of actuarial and financial factors but generally average between 65-95 percent largely driven by the age and life expectancy of the insured. 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.

Following the termination of the Split Dollar Arrangement, the policy is wholly owned within the Trust beyond the reach of personal and business creditors. The trustee may tax-free loans and withdrawals and provide tax-free distributions from the trust to Sid and his family. The death benefit will receive income and estate tax-free treatment at Sid's death.

Summary

Sometimes a desire for things to return to the way things were misses the possibility that maybe the planning opportunities available now might be better than the planning utilized in the past. Split Dollar life insurance provides a combination of tax and planning benefits that prior deferred compensation arrangements never provided:

1) Asset Protection
2) Tax-free accumulation
3) Tax-free income during lifetime
4) Income and estate tax free benefits at death
5) Multi-generational benefits for the family

The current low interest environment provides an exceptional opportunity. If you are asking me, I would rather have things the way they are versus the way things were!