LAW OFFICE OF GERALD R. NOWOTNY, PLLC

# THE SPLIT DOLLARMINATOR!

## Using Commercial Lending to "Juice" the Funding of Loan Method Split Dollar Arrangements

In past articles, I have vigorously defended the notion that I know "Squat." Most readers would view such a claim as sheer lunacy and maybe in certain circles it would be a great insult. However, as a lifetime lover of the Iron Game (weightlifting), the "squat" is a critical part of any lifter's DNA. The declaration of knowing "squat" would make them proud!

My passion started early. Even as I get "longer in the tooth," I can still trace the steps of my weightlifting passion. It started at around age six in the weight room of Balboa High School in the Panama Canal Zone when I lifted a 50 lb. dumbbell. About eight years later, I suffered a serious knee injury playing football and the coach at the junior college (Canal Zone College), Morris Finkelstein (of blessed memory), personally took it upon himself to help rehabilitate me in the weight room with Mr. Johnson, the Jamaican trainer. After recovering, I became a member of the Balboa YMCA which had the only complete weight room in the Canal Zone.

The YMCA became my Mecca where I spent hundreds of hours perfecting the squat and a few other lifts. My neighbor and childhood friend, Mark Givens had the best collection of lifting magazines from York Barbell - Strength and Health, and Muscle Development, in the Canal Zone. He gravitated towards bodybuilding while I gravitated towards powerlifting. In high school I had an opportunity to visit York Barbell which was the weightlifting equivalent of a pilgrimage to Mecca for a weightlifting enthusiast.

During that era, Arnold Schwarzenegger became the face of bodybuilding and went on to a substantial career in business, acting and politics. His Terminator series made him a Hollywood icon. Personally, my favorite Arnold movie was *Conan The Barbarian* probably because I enjoyed Hercules" movies as a child featuring Reg Park (a former Mr. Universe) as Hercules.

This article focuses on how a business can use a commercial loan to help finance a business' obligation in a Loan Regime Split Dollar Arrangement and deduct the interest payments for its tax purposes, without running afoul of the limitations of IRC Sec. 264. The use of commercial lending provides an additional source of funding and leverage on an after-tax basis to provide funding for the purchase of life insurance policyholder using Loan Regime Split Dollar Arrangement.

**Loan Regime Method of Split Dollar Review**

I have been on a rant for weeks about the magic of the Loan Regime Method of Split Dollar life insurance due to the current loan interest rate environment. The current long term AFR in August 2020 is 1.12 percent. In the loan regime method of split dollar, the policyholder is typically the business owner or key executive. Alternatively, an irrevocable trust may own the policy for the benefit of the business owner.

The Trust removes the policy from the reach of personal and business creditors while allowing the business owner to remain as a discretionary income beneficiary of the Trust. The Trustee may use request tax-free loans and withdrawals from the policy for tax-free distribution to the business owner. The policy death proceeds are received income and estate tax-free. The Trust may also be multi-generational.

In the Loan Regime Method of Split Dollar, the business makes a one-time loan locking in the long-term AFR. The policyholder funds the policy using the loan proceeds to fund the policy on a non-MEC basis. The business receives a collateral assignment in the policy cash value and death benefit equal to the loan plus any accrued interest.

What if the business has a better use of its existing capital which would allow it to receive a higher rate of return on business operations? In those circumstances, a business can obtain a commercial loan from a bank for its business operations or alternatively use some or all of the proceeds from the commercial bank loan to extend to the policyholder as part of the Split Dollar Arrangement.

**Overview of Borrowing to Purchase Life Insurance**

Several decades ago, leveraged Corporate Owned Life Insurance (aka COLI) was the best corporate tax shelter on Planet Earth. Members of the Fortune 500 could not buy enough of it! Congress shut this down so tightly that is largely believed that the deductibility of any loan interest from any lending used to purchase life insurance directly or indirectly was impossible. Furthermore, by extension, most advisors still believe that the interest could never be deductible under any circumstance. It all depends on how carefully a policyholder can balance himself while walking on a tightrope.

Generally, the interest on a straight commercial loan between a commercial bank and corporation is fully deductible under IRC Sec. 163. In the planning circumstance intended, the loan transaction is structured as a recourse loan to the corporate borrower and is a loan with economic substance. The proposed use of a commercial loan does not rely on any borrowing from the life insurance policy itself.

The corporation's use of the loan proceeds to provide a Split Dollar loan does not violate the rules regarding the systemic use of borrowing from the policy cash value under IRC Sec. 264. Instead the " 4 out of 7" exception provides that the general rule denying the deduction of loan interest will not apply if no part of four of the annual premiums during the initial seven-year period is used by means of indebtedness. The policyholder uses the loan proceeds to fund the policy at the maximum non-MEC level in the first three years to fall within this exception. Consequently, the business can fully deduct the interest on its corporate tax return.

In my own experience from trial and error evaluating life insurance illustrations, four years of maximum funding seems to be the ideal timeframe to fund the policy on a non-MEC basis while maintaining a relatively reasonable face amount for financial underwriting considerations. The proposed use of a commercial loan does not preclude the use of the proceeds for the purchase of life insurance and the ability to deduct the interest associated with the commercial loan.

**Strategy Example Using Commercial Lending**

Hector Heathcoat (Heathcoat), age 51, is the majority shareholder in Acme Technology, Inc. Acme is a privately held, C corporation. Acme enters into a commercial lending arrangement with Amalgamated National Bank and borrows $1.5 million for fifteen years. The interest is a fixed rate at 3.5 percent per year. This loan may be used for any legitimate business purpose.

Heathcoat would like to purchase additional life insurance policy within an Irrevocable Life Insurance Trust (ILIT) for the benefit of his family. He is purchasing a new Equity Indexed Universal Life Insurance policy. The policy has a face amount of $6.6 million. The projected premiums are $485,608 per year for the next a seven-year period.

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 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.

Acme is making a single loan of $3,399,256 to the Trust at the current AFR of 1.12 percent. The trustee will accrue interest on the policy. The policy is using Option B, the increasing death benefit option. Part of the loan will consist of the loan proceeds from Amalgamated ($1.5 million). The Trustee of the Family Trust will use these proceeds to fund the first three years of premiums. The balance of the loan, $1,899,256, represents the unborrowed funds that Acme contributes as part of the Split Dollar funding to the Split Dollar program. Acme assigns its collateral assignment interest in the Split Dollar Arrangement to Amalgamated as collateral for the commercial loan.

**Summary**

The key point to highlight is the use of a commercial loan to help finance corporate matters including the funding of a life insurance policy while deducting the interest expense as a business interest. Normally the life insurance rules would preclude interest deductibility where loans are used directly or indirectly to purchase life insurance. In this case, the interest is fully deductible as business interest and falls within the " 4 out of 7" exception of IRC Sec. 264 by using the loan proceeds to over-fund the policy in the first three years of the policy on a non-MEC basis. The Company uses its own funds to finance the balance of the premium obligations in the Split Dollar Arrangement. The deductibility of the interest lowers the cost of the loan and allows the Company to reinvest within the business. This financial and tax leverage is further extended through the loan arrangement from the business to the policyholder in the Split Dollar Arrangement and the tax-advantaged buildup of life insurance.

Hasta la vista, Baby!