



Below is a view of the Workbook Main Window from the Leveraged Executive Bonus module in our Leveraged Compensation System used for Blog #204 along with a description of its contents.

Leveraged Executive Bonus

Proposal Description	Sales Concept	Policy Data (if applicable)			
		Policy Notation	Initial Premium	Death Benefit	Name of Product
Proposal 1	Leveraged Executive Bonus	Blog #204 (Tony Jamison ...)	\$250,000	\$5,781,708	Indexed UL

Workbook file: Blog #204 (LEB).!lc Import this digital workbook file into your Leveraged Compensation System to see precisely how to enter data to create the evaluations in Blog #204. We strongly recommended that you read [Blog #204](#) before proceeding as it will ease your understanding of the design descriptions below.

A Leveraged Executive Bonus involves the combination of a bonus paid to an executive with the income tax on the bonus covered by a split-dollar loan. Example: \$100,000 bonus generates a \$32,000 tax bill for an executive in a 32% marginal income tax bracket. Instead of generating a gross-up bonus to account for the tax, use a \$32,000 split-dollar loan to the executive.

Proposal 1. The simplest way to enter data in this module is to download Blog #204 (LEB).!lc from my Blog #204, and study each entry to see how I entered answers to all the prompts. Then, copy Blog #204 (LEB).!lc using “Save As” available from the drop-down available under Client Workbook in the upper left corner of the Workbook Main Window. Give it a name that reflects your case. This procedure also saves Blog #204 (LEB).!lc since you may want to review it again

Important Note: The two most important considerations when constructing a Leveraged Executive Bonus are:

1. The Premium Pattern of your policy: Whenever you are using loan regime split-dollar, you should select the shortest possible premium paying years that avoid classification as a [modified endowment contract \(MEC\)](#). (In my example in Blog #204, I used indexed universal life and discovered I could illustrate a four-pay to satisfy this requirement.)
2. The Applicable Federal Rate (“AFR”) you choose that applies to your split-dollar arrangement.

Here are the AFR options for August 2020:

Applicable Federal Rates in effect for August 2020

- Long-term loans (over 9 years): 1.12%
- Mid-term loans (over 3 years; not over 9): 0.41%
- Short-term loans (3 years or less): 0.17%
- Demand loans (blended annual rate): 0.89%
- Use this rate: %
- Schedule the Applicable Federal Rate:

- Ignore demand loans (blended annual rate) as they change annually, a scenario that is impossible to forecast sensibly.
- The short-term rate of 0.17% is tempting until you realize it has to be recast every three years at the new short-term rate. With the skyrocketing debt of the U.S. government, we will ultimately see steeply-rising AFRs affecting many of the years of split-dollar loans.
- A similar problem exists with mid-term loans. Select this AFR if you want to risk a severe increase every nine years. If you expect to unwind the split-dollar arrangement no later than the beginning of year 10, select this option.
- In the absence of a loan rollout in year 10, that leaves the long-term loan AFR as one that never requires an increase once made. With four premiums, this AFR is my preferred choice.

Do you think AFRs will spike over the next four years? On Wednesday, June 10, 2020, Fed Chairman Jerome Powell “committed the Fed to do whatever we can for as long as it takes to support the economy.” Fed officials projected no plans to raise interest rates through 2022. This commitment means the AFRs will likely remain low for several years. I prefer illustrating a small, potential increase in the long-term AFR over the remaining premium-paying years for Tony’s plan, as shown in Table 1.

Table 1

Year	Age	Assumed AFR
1	45	1.12%
2	46	1.25%
3	47	1.37%
4	48	1.50%

Schedule the Applicable Federal Rate. In Table 1, I scheduled a slightly increasing assumption for the long-term AFR over the beginning four years of the split-dollar loans that fund Tony’s plan. So long as the loan interest rate on each loan is equal to or greater than the long-term AFR established under IRC Secs. 7872(f)(2)(A) and 1274(d) at the inception of the loan, no further interest is imputed to the executive.

With a four-pay premium, the long-term AFR freezes on all loans after four years. Too conservative? Maybe. Too liberal? Maybe. The best authorities to decide are a client’s legal and tax advisers; however, I stand by my selections for Tony’s plan in Table 1 in Blog #204 as reasonable projections. I recommend selecting the long-term AFR coupled with the shortest premium-paying period that avoids a MEC.

I believe the U.S. Treasury Department decided to make loan regime split-dollar as complicated and challenging as possible in line with their dislike of split-dollar ever since Rev. Rul. 55-713 first appeared 65 years ago. But it backfired on them. I believe a correctly constructed loan regime split-dollar is more effective than the pre-2000 equity split-dollar. The only variable is the unknown future AFRs, so select long-term rates using reasonable projections coupled with the fewest number of premiums possible.

You have one last consideration: how to arrange the most efficient out-of-pocket costs for the insured executive. Click here to review how each one works out for Tony Jamison, our insured executive.

Loan Interest Payment Options

- Accrue loan interest
- Out-of-pocket expense
- Impute loan interest - Pay tax out-of-pocket
- Impute loan interest - Single bonus for the tax
- Impute loan interest - Gross-up bonus for the tax
- Impute loan interest - Special bonus schedule unrelated to repayment or loan interest or principal Schedule...

- **Accrue loan interest**

This selection is tempting — it eliminates all costs for Tony. However, it increases the cumulative split-dollar loan, which, in turn, requires more invasive access for a policy loan to repay Town and Country's premium loans. This result, of course, reduces cash values that are the source of Tony's after-tax retirement cash flow.

That said, "accrue loan interest" results in the most straightforward plan administration. Its significant negative is its effect on Tony's retirement cash flow.

- **Out-of-pocket expense**

This selection produces the highest cost for Tony.
Example for year 1:

$\$80,000 \text{ split-dollar loan} \times 1.12\% \text{ AFR} = \$896.$

- **Impute loan interest - Pay tax out-of-pocket**

This is a tempting option, and I usually select it. Tony pays tax on the \$896 noted above.

$\$80,000 \text{ split-dollar loan} \times 1.12\% = \$896 \text{ of imputed income;}$

$\$896 \times 32.00\% \text{ (Tony's tax bracket)} = \$287.$

[Click here](#) to show the overall results for Tony.

- **Impute loan interest - Single bonus for the tax**

Example for year 1:

\$80,000 premium x 1.12% = \$896 of imputed income;

\$896 x 32.00% (Tony's tax bracket) = \$287;

\$287 x 32.00% (Tony's tax bracket) = \$92.

- **Impute loan interest - Gross-up bonus for tax**

Example for year 1:

\$80,000 premium x 1.12% = \$896 of imputed income;

\$896 x 32.00% (Tony's tax bracket) = \$287;

\$422 gross-up bonus provides Tony with \$287;

\$287 - \$287 = \$0.00 out-of-pocket for Tony.

With loan regime split-dollar, there is a practical reason to impute loan interest. Historically, it has been common practice to illustrate bonuses to assist in the payment of loan interest or loan repayment. This strategy conflicts with this often overlooked prohibition:

If bonuses help pay loan interest or repayment of the employer's loans, do not have the employer directly or indirectly make these payments on behalf of the executive. The purpose of this is to comply with the prohibition against the employer making such payments as provided in the split-dollar final regulations issued in 2003 (TD 9092, 9/11/03 and Rev. Rul. 2003-105).

If, however, imputed loan interest is selected, using a bonus to offset the income tax on the imputation is a suitable option. Leveraged Executive Bonus is usually more efficient for all parties than either an executive bonus plan or loan regime split-dollar plan used separately.

Imputed loan interest is often misunderstood by some commentators. [Click here](#) for an analysis by [Michael Tuchman, Esq.](#), Partner - Levenfeld Pearlstein, LLC, Chicago, Ill.

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Important Note #1: The hypothetical life insurance illustration referred to in this report assumes the nonguaranteed values shown continue in all years. This is not likely, and actual results may be more or less favorable. Actual illustrations are not valid unless accompanied by a basic illustration from the issuing life insurance company.

Important Note #2: The information in this report is for educational purposes only. In all cases, the approval of a client's legal and tax advisers must be secured regarding the implementation or modification of any planning technique as well as the applicability and consequences of new cases, rulings, or legislation upon existing or impending plans.