

# Black Family Partners

Apollo Management  
9 West 57<sup>th</sup> Street  
New York, New York 10019

Ada Clapp  


To: Leon D. Black  
From: Ada Clapp  
Date: December 11, 2013  
Re: Status of Split Dollar Insurance Proposals

---

This memorandum provides a summary of the history of your split dollar arrangements and the status of the proposals to unwind them. Attached is a chart comparing the various proposals.

## A. Background.

In 1999, you created two insurance trusts (Trust #1 and Trust #2, collectively, the “Trusts”) with Norman Brownstein as Trustee. Trust #1 purchased \$50 million of insurance on your life. Trust #2 purchased \$100 million of insurance on the joint lives of you and Debra. Thereafter, the Trustee entered into a split dollar agreement (the “Agreements”) between each Trust and AIF IV Management Inc. (“AIF”), as your employer.<sup>1</sup> The Trusts may terminate the Agreements at any time. AIF has no right to terminate.

Under the terms of the Agreements, each year, AIF must pay the premiums on all policies (the “Premiums”). You or the Trusts must repay AIF for the annual cost of current life insurance (the “Employee’s Portion”). AIF has paid Premiums of roughly \$1.8 million each year. Each year the Employee Portion is taxed to you as both compensation income and a deemed gift to the Trusts. For 2012, the Employee Portion was \$104,132. When the policies mature by reason of the death of the insured(s), AIF is entitled to a refund of the Premiums advanced. If, however, the Agreements terminate prior to the death of the insured(s) (e.g. because the Trusts elect to terminate them), the Trusts must repay AIF the lesser of Premiums advanced or the then cash surrender values of the policies.<sup>2</sup> To secure the repayment obligation, the Trusts assigned their insurance policies to AIF as collateral.

---

<sup>1</sup> As you know, AIF (a subchapter S corporation) was formed in 1997 as the original general partner of Apollo

<sup>2</sup> As of September 30, 2013, (i) Premiums advanced to Trust #1 totaled about \$10.5 million and the net cash surrender value of the single life policies was about \$8 million, and (ii) Premiums advanced to Trust #2 totaled approximately \$12.5 million and the net cash surrender value of the joint life policies was approximately \$16.7 million. See attached Summary of Coverage.

**B. Review of Split Dollar Arrangements.**

As you recall, the original rationale for implementing a split dollar insurance plan was to provide a tax efficient means by which funds could be available to satisfy a significant portion of the debts (related to your art collection) and estate taxes payable upon the death of the survivor of you and Debra. The original 1999 proposal by Roger Cammon of the Bryant Group anticipated retention of the policies until the death of the insured(s) and projected that the policies would be self-funding by 2011. However, the policies have not performed as projected. In 2010 they were “under water” (Premium advances exceeded cash surrender value) and absent a substantial (taxable) gift from you to the Trusts, Roger projected that Premium payments would need to continue for at least 10 more years for the policies to be self-sustaining. Since that time, performance in the joint life policies owned by Trust #2 has improved but Premiums will still be required for a much longer period than originally projected. In addition, continuation of the Agreements requires you to continue to pay income and gift tax on the Employee Portion, which amount will increase each year.

In addition to poor performance, it became clear that there were other reasons to consider terminating the Agreements. First, they no longer achieved their original objective and therefore, do not warrant the additional expense required to maintain them. The \$150 million of death benefit will no longer come close to satisfying a substantial portion of the debts and estate taxes anticipated on the death of the survivor of you and Debra.

Second, a conclusion to terminate the Agreements is supported by AIF’s conversion from a general partner in Management IV to a limited partner. Because the Agreements were entered into prior to 2003, they are afforded special tax treatment under the Internal Revenue Code and IRS Regulations—provided that they are not “materially modified” after 2003. There is some concern that the IRS will argue that AIF (which received no distributions from Management IV after the conversion) ceased business operations in 2007. Such event would terminate (or materially modify) the Agreements, with the risk that income and gift tax is imposed on any equity build-up in the policies (*i.e.*, net cash surrender value in excess of Premiums advanced). It would also mean that a different tax regime (“loan treatment”) would have applied to Premium payments from 2007. Under this regime, income and gift tax on the Premiums are likely to have been higher than the tax you paid on the Employee Portion. As a result, there is a risk of the imposition of additional income and gift tax to you the longer the Agreements remain in place.

For the foregoing reasons, it was concluded that the Agreements should be terminated, or “rolled-out”.

**C. Various Proposals to Roll-Out the Agreements.**

1. 2010 Proposal. Carlyn’s first proposal (August 2, 2010), involved the Black Family 1997 Trust (the “1997 Trust”) purchasing the policies from the Trusts at their cash surrender values. The Trusts would thereafter use the sale proceeds to repay AIF for Premium advances. This proposal was not implemented principally because there was insufficient cash in the 1997 Trust to acquire the policies and pay Premiums going forward. There were also unresolved tax issues and with the economy in recovery it seemed advisable to wait and see how this would affect the policies.

2. 2011 Proposal. Roll-out discussions resumed when it became clear that, even though policy performance had improved, Premium payments would still be required for too many years to merit keeping the arrangements. In addition, funds became available in the Black 2006 Family Trust (the “2006 Trust”) to purchase the policies from the Trusts and pay premiums going forward. Accordingly, we reached out to Carlyn to implement the 2010 roll-out proposal. In response, Carlyn instead proposed a new roll-out plan (Proposal Four on the attached chart). The principal advantage of this plan was Carlyn’s assumption that rights under the Agreements could be purchased from AIF for a significant discount to the net cash surrender values of the policies. Because the plan involved the 2006 Trust, it was decided that roll-out should wait until the accounting and settlement agreement with respect to the 2006 Trust was completed.

3. 2013 Proposals.

When roll-out discussions resumed, we asked Carlyn if she still recommended her 2011 proposal in light of a 2012 U.S. Tax Court case.<sup>3</sup> The *Neff* case addressed a split dollar roll-out plan in which rights under a split dollar agreement were sold at a value substantially lower than the policies’ cash value. The decision was not favorable to the taxpayer. Carlyn noted the differences between her proposal and the *Neff* case, but agreed that the IRS would be tempted to apply the rationale of *Neff* to her 2011 proposal. She asked for some time to rethink that plan and to consider the alternative proposal we made.

Instead of commenting on our proposal, Carlyn’s response was to suggest another new roll-out plan (Proposal Three on the attached chart). This plan affirmatively asserted that the Agreements terminated in 2007 (as a result of AIF’s conversion). This Carlyn believed would trigger a provision in the Agreements allowing AIF to take ownership of the policies on roll-out, thus avoiding the imposition of income and gift tax on the equity build-up. We raised certain questions regarding the proposal and, because we were not convinced that this plan was well thought out, we asked Carlyn to prepare a memorandum outlining the risks of this plan.

Rather than providing the memorandum, Carlyn suggested yet another entirely new roll-out plan (Proposal Two on the attached chart). Upon further discussion and consultation with McDermott’s tax and employment law partners, it became clear that this last proposal (and her earlier 2013 proposal discussed immediately above) raised more risks than solutions. In addition to raising the tax risks noted in Section B of this memorandum in the event of a material modification, Carlyn’s latest proposal is the most complicated and involves valuation discounts—both of which were deemed likely to increase audit risk.

Carlyn and her legal team then reviewed the pros and cons of the alternative proposal we made. It was agreed that because the plan fit within an IRS Notice addressing roll-out of pre-2003 split-dollar arrangements, and was simple and straight forward, that it was the best and least risky way to terminate the Agreements and preserve the special tax treatment. This proposal is illustrated as Proposal One on the attached chart.

---

<sup>3</sup> *Neff v. Comm’r*, T.C. Memo. 2012-244 (TC 2012).

## Comparison of Split-Dollar Insurance Proposals

December 11, 2013

<b>Proposal One—Rollout without Using Policy Values</b>	
<b>Steps Trust #1:</b>	<ol style="list-style-type: none"> <li>1. Trust #1 notifies AIF that it is terminating the Agreement and waiving its 90-day right to request release of the collateral assignment. It also informs AIF that it intends to cancel the single life policies and repay AIF from cash surrender value.</li> <li>2. The Trustee of Trust #1 cancels the single life policies.</li> <li>3. AIF exercises its right (secured by collateral assignment) to be repaid the lesser of net cash surrender value (about \$8 million) or Premiums advanced (about \$10.5 million).</li> <li>4. The entire net cash surrender value is paid to AIF. Upon receipt of these funds by AIF, the Agreement is terminated.</li> <li>5. AIF uses the funds to repay BFP.</li> <li>6. Trust #1 now has no assets and could terminate.</li> </ol>
<b>Steps Trust #2:</b>	<ol style="list-style-type: none"> <li>1. Black Family 2006 Trust decants sufficient cash to Trust #2 to enable it to repay AIF for its premium advances.</li> <li>2. Trust #2 notifies AIF that it is terminating the Agreement and repays AIF (with funds received from the 2006 Trust) its premium advances (about \$12.5 million).</li> <li>3. Upon receipt by AIF of the repayment, the Agreement is terminated.</li> <li>4. Trust #2 (within 90-days of notice of termination) requests AIF to release its collateral assignment against the joint life policies and AIF does so.</li> <li>5. AIF distribute its remaining assets to Leon and dissolves.</li> <li>6. Trust #2 either retains the policies or surrenders them and receives the cash surrender value ("CSV"). It could also decant its assets to a different trust (e.g., a new insurance trust) and terminate.</li> </ol>
<b>Pros:</b>	<ul style="list-style-type: none"> <li>• If successful, avoids income and gift tax. Can take position that no income/gift tax is due on policy equity in excess of premium advances ("equity build-up"), relying on "no inference" language of Notice 2002-8.</li> <li>• Simple—least complex proposal. No need to file a gift tax return.</li> <li>• No valuation reports (or risk of undervaluation) or discounts, so less audit risk.</li> <li>• Can dissolve AIF now with no adverse tax consequences to Leon.</li> </ul>
<b>Cons (Possible IRS challenges on audit):</b>	<ul style="list-style-type: none"> <li>• <u>Tax on 2013 Rollout.</u> IRS asserts rollout occurred in 2013 and imposes income and gift taxes on equity build-up on rollout (at 40% each, about \$3.4 million), plus interest and penalties.</li> <li>• <u>Loan Regime Risk.</u> IRS deems Agreements were materially modified in 2007 (but not terminated) and applies loan treatment from that date (i.e., total premiums advanced treated as a loan to Leon). If income/gift tax payments Leon made (under economic benefit treatment) were less than what was required under loan treatment, IRS could seek to impose income (for last three years) and gift tax (back to 2007) on the shortfall (gift tax may be limited to last three years if "adequately disclosed").</li> </ul>

**Proposal One continued—Rollout without Using Policy Values**

**Cons (Possible  
IRS challenges  
on audit)-  
continued:**

- Tax on 2007 Rollout. IRS asserts that Agreements terminated in 2007 when AIF converted to an LP of Management IV (and thus ceased business operations) and seeks to impose income and gift tax on equity build-up on the conversion date.
- 409A Risk. IRS asserts that the Agreements are deferred compensation that do not comply with Section 409A and imposes income tax (with 20% surcharge, plus interest) on post-2004 premium payments and growth thereon not included in Leon's gross income. May be no 409A tax exposure pre-2008 as plan predates 409A and may be grandfathered. But, if IRS asserts that AIF ceased business operations in 2007 cannot impose 409A tax, as there would be no employment relationship.

<b>Proposal Two—Sale of AIF and Decanting of Rights by the Trusts (MWE 12/4/13 Proposal)</b>	
<b>Steps:</b>	<ol style="list-style-type: none"> <li>1. 2006 Trust decants assets to each of BEB 2011 Trust, JMB 2011 Trust, ASB 2011 Trust and VRB 2011 Trust (the “2011 Trusts”).</li> <li>2. For tax reasons, Debra resigns as Trustee of the 2011 Trusts.</li> <li>3. Leon sells 25% of his AIF stock to each 2011 Trust. Value of AIF is based upon the CSV of policies (including equity build-up) less loans payable to BFP with a lack of marketability/minority interest discount (assume 30%).</li> <li>4. The Trusts decant their rights under the Agreements as Owner of the policies to the 2011 Trusts.</li> <li>5. Each of the 2011 Trusts contributes its rights as Owner to AIF in exchange for additional stock.</li> <li>6. AIF is now both Owner and Employer under the Agreements, with the right to (i) repayment of premium advances and excess equity upon rollout during the life of the insured(s) and (ii) the entire death benefit upon death of the insured(s).</li> <li>7. AIF terminates the Agreement with Trust #1, surrenders the single life policies and uses the cash received to repay BFP.</li> <li>8. AIF can retain the Agreement with Trust #2 or terminate it. It can then decide to surrender the joint life policies and take the CSV or retain the policies. If the latter, it can use CSV to pay premiums or receive annual cash infusions from the 2011 Trusts.</li> </ol>
<b>Pros:</b>	<ul style="list-style-type: none"> <li>• If successful, avoids gift and income tax on the equity build-up.</li> <li>• May mitigate 409A risk outlined above.</li> </ul>
<b>Cons (Possible IRS challenges on audit):</b>	<ul style="list-style-type: none"> <li>• Proposal is complex-may trigger audit.</li> <li>• Need to report sale of AIF to get the gift tax limitations period running. Discounts may be an audit red flag.</li> <li>• <u>Tax on 2013 Rollout.</u> IRS asserts that Leon’s sale of AIF and the Trusts’ decanting of rights was a prearranged, disguised rollout in 2013 and the Trusts are entitled to the equity build-up. IRS seeks to impose income and gift tax on the equity build-up, plus interest and penalties.</li> <li>• <u>Loan Regime Risk.</u> Same as described in Proposal One.</li> <li>• <u>Tax on 2007 Rollout.</u> Same as described in Proposal One.</li> <li>• <u>409A Risk.</u> Same as described in Proposal One.</li> </ul>

<b>Proposal Three—Sale of AIF and Creation of New LLC (MWE Proposal 11/18/13)</b>	
<b>Steps:</b>	<ol style="list-style-type: none"> <li>1. 2006 Trust decants assets to each of the 2011 Trusts.</li> <li>2. For tax reasons, Debra resigns as Trustee of 2011 Trusts.</li> <li>3. Leon sells 25% of his AIF stock to each 2011 Trust. Value of AIF is based on full CSV of policies (including equity build-up) less loans payable to BFP and with a lack of marketability/minority interest discount (assume 30%).</li> <li>4. AIF takes the position that that Agreements terminated in 2007 and because the Trusts failed to repay premium advances within 90 days, AIF has the right to take ownership of the policies.</li> <li>5. AIF exercises that right and the Trusts transfer ownership of the policies.</li> <li>6. AIF then surrenders the single life policies and uses CSV to repay BFP for loans.</li> <li>7. AIF create an LLC ("Newco") and transfers its assets to Newco.</li> <li>8. AIF then transfers its interests in Newco to the 2011 Trusts and liquidates.</li> <li>9. Newco can surrender the joint life policies or retain them. If the latter, can use CSV to pay premiums or must rely on annual cash infusions from the 2011 Trusts.</li> </ol>
<b>Pros:</b>	If successful, avoids income and gift tax on equity build-up.
<b>Cons (Possible IRS challenges on audit):</b>	<ul style="list-style-type: none"> <li>• Proposal is complex-may trigger audit. Need to report sale of AIF to get the gift tax limitations period running.</li> <li>• Gift tax risk if contract rights are undervalued. Discounts may be an audit red flag.</li> <li>• AIF's right to keep any equity build-up upon taking ownership of the policies is less than certain under the Agreements.</li> <li>• <u>Tax on 2013 Rollout</u>. IRS asserts that Leon's sale of AIF followed by transfer of policy ownership to AIF and dissolution of AIF was a prearranged, disguised rollout in 2013 and that the Trusts are entitled to the equity build. Imposes income and gift tax on equity build-up, plus interest and penalties.</li> <li>• <u>Loan Regime Risk</u>. Same as described in Proposal One but risk is increased because we are asserting the Agreements terminated in 2007.</li> <li>• <u>Tax on 2007 Rollout</u>. Same as described in Proposal One but risk is increased because we are asserting the Agreements terminated in 2007.</li> <li>• <u>409A Risk</u>. Same as described as in Proposal One.</li> <li>• Debra must resign as Trustee of the 2011 Trusts.</li> </ul>

<b>Proposal Four—Discounted Sale of Rights Under Agreements (MWE Proposal 12/5/11)</b>	
<b>Steps:</b>	<ol style="list-style-type: none"> <li>1. The 2006 Trust buys AIF's rights as Employer under the Agreements for cash. Value is based on an appraisal that would apply a significant discount to current CSV.</li> <li>2. AIF uses the cash to repay BFP, distributes excess cash to Leon and dissolves.</li> <li>3. The 1999 Trusts terminate the Agreements and fail to repay premium advances (now owed to the 2006 Trust).</li> <li>4. The 2006 Trust exercises its right to take ownership of the policies. Can decide to surrender them or retain them. It would likely surrender the single life policies.</li> </ol>
<b>Pros:</b>	If successful, avoids income and gift tax on equity build-up.
<b>Cons (Possible IRS challenges on audit):</b>	<ul style="list-style-type: none"> <li>• Proposal is complex-may trigger audit. Need to report sale of AIF to get the gift tax limitations period running.</li> <li>• Gift tax risk if contract rights are undervalued. Discounts may be an audit red flag.</li> <li>• AIF's right to keep any equity build-up upon taking ownership of the policies is less than certain under the Agreements.</li> <li>• Sale of rights under the Agreements for a value sharply discounted from CSV may trigger audit in light of a 2012 Tax Court Case (<i>Neff v. Comm 'r</i>).</li> <li>• <u>Tax on 2013 Rollout</u>. IRS asserts that AIF's sale of its rights under the Agreements followed by transfer of policy ownership to AIF and dissolution of AIF was a prearranged, disguised rollout in 2013 and that the 1999 Trusts were entitled to the equity build-up. Imposes income and gift tax on equity build-up, plus interest and penalties.</li> <li>• <u>Loan Regime Risk</u>. Same as described in Proposal One but risk is increased because we are asserting that Agreements terminated in 2007.</li> <li>• <u>Tax on 2007 Rollout</u>. Same as described in Proposal One but risk is increased because we are asserting that Agreements terminated in 2007.</li> <li>• <u>409A Risk</u>. Same as described in Proposal One.</li> </ul>



## Summary of Coverage

### Individual Life Insurance Coverage on Leon Black

- \* Split-Dollar Entity: AIF IV Management, Inc.
- \* Policy owner: Norman Brownstein, Trustee under the Leon D. Black Insurance Trust #1 dated September 13, 1999.
- \* These policies' register dates are September 1999.

Carrier	Policy Number	Amount of Coverage	Normal Annual Premium	Account Value 09-30-13	Net Cash Surrender Value 09-30-13	Split-Dollar Advance 09-30-13
Prudential	V1 016 844	\$30,000,000	\$502,335	\$5,050,052.38	\$5,050,052.38	\$6,108,212
AXA Equitable	49 232 126	\$15,000,000	\$264,894	\$2,374,633.02	\$2,355,976.73	\$3,172,980
Security Life of Denver	610014742	\$5,000,000	\$96,380	\$615,839.41	\$615,839.41	\$1,180,138
<b>Total - Individual Life Insurance Coverage</b>		<b>\$50,000,000</b>	<b>\$863,609</b>	<b>\$8,040,524.81</b>	<b>\$8,021,868.52</b>	<b>\$10,461,330</b>

### Second-to-Die, Wealth Transfer Life Insurance Coverage on Leon & Debra Black

- \* Split-Dollar Entity: AIF IV Management, Inc.
- \* Policy owner: Norman Brownstein, Trustee under the Leon D. Black Insurance Trust #2 dated September 13, 1999.
- \* These policies, other than the Prudential policy, have a register date of April 28, 1999 in order to save Debra's insurance age. (Prudential utilizes "current age" vs. "closest age", therefore backdating was not necessary and the register date for the Prudential policy is 9/13/99.)

Carrier	Policy Number	Amount of Coverage	Normal Annual Premium	Account Value 09-30-13	Net Cash Surrender Value 09-30-13	Split-Dollar Advance 09-30-13
Prudential	V0 001 958	\$20,000,000	\$179,595	\$3,219,723.25	\$3,219,723.25	\$2,304,955
New York Life	75 500 858	\$20,000,000	\$196,080	\$3,631,861.88	\$3,627,940.28	\$2,514,929
Pacific Life	VP 6089 7390	\$5,010,000	\$33,218	\$541,960.63	\$541,960.63	\$424,480
John Hancock	20 039 301	\$30,000,000	\$359,022	\$6,130,484.67	\$6,130,484.67	\$4,622,974
AXA Equitable	49 232 123	\$25,000,000	\$205,246	\$3,221,055.07	\$3,210,496.16	\$2,627,947
<b>Total Second-to-Die Life Insurance Coverage</b>		<b>\$100,010,000</b>	<b>\$973,161</b>	<b>\$16,745,085.50</b>	<b>\$16,730,604.99</b>	<b>\$12,495,285</b>

*This information has been taken from sources which we believe to be reliable, but there is no guarantee as to its accuracy. It is not a replacement for any account statement or transaction confirmation issued by the provider. Please compare this document to your custodial statement for accuracy, as applicable.*

Please refer to the prospectus and most recent annual report for further information.

Transcription errors do not affect actual policy values.

Black & Debra Black, Last Revised 09/13/99, CFAW Insurance 09-30-13.doc