Counselor's Corner: The Basics of Split Dollar

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Situation: All too often when I get a call from a financial advisor contemplating an executive benefit arrangement using life insurance s/he is often contemplating either a Deferred Compensation/SERP arrangement with a delayed business tax-deduction and maximum golden handcuff, or some form of a Section 162 Executive Bonus/REBA Arrangement with an immediate business income tax-deduction and no or minimal golden handcuff. Financial advisors rarely mention Split Dollar. This is unfortunate because for business owners contemplating establishing an executive benefit arrangement to retain, reward, or recruit key employees, consideration of Split Dollar may have relevance today due to an increased desire to keep money in the business or connected to the business because of the uncertain tax and economic environment.

When I describe some of the ways Split Dollar can be structured, I'm finding more financial advisors and their business clients interested in establishing one of its many forms. Part of the reason Split Dollar has been somewhat off to the side in this arena is because of its perceived complexity. Some of the complexity is attributable to the many ways it can be designed and used. Another reason for its lack of use is a general unfamiliar understanding of Split Dollar since the enactment of regulations. This Counselor's Corner will review the basic forms of Split Dollar arrangements.

Situation: Split Dollar is a term used to describe a life insurance arrangement where premium payments and policy benefits are split between two parties. In a typical Split Dollar arrangement, one party has a need for life insurance and the second party has the funds to pay for the policy.

A Split Dollar plan offers benefits to both the business and participants, including:

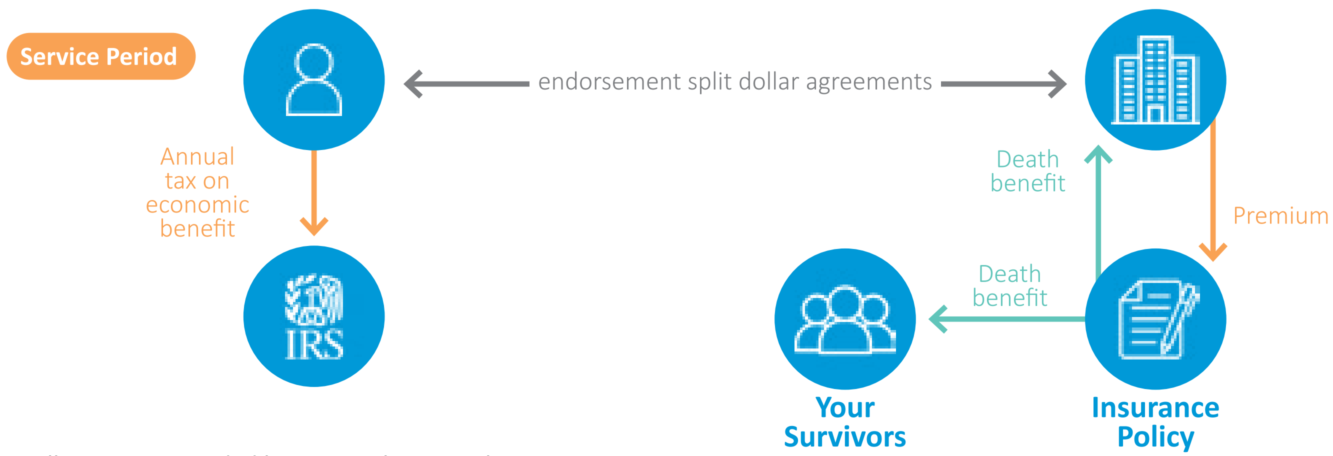
- Cost recovery — the business can recover the costs of the plan, generally using the death benefit proceeds or cash value.
- Enhanced control and flexibility — the business selects which participants to include and can customize benefit for each.
- Ability to use business dollars to fund the premium at a minimal tax impact to participant.
- Income tax advantages — Where the business is in a lower income tax bracket than the participant your acquiring insurance at a reduce cost since life insurance is generally acquired with after-tax dollars. Furthermore, the death benefit is received income-tax free and the cash value may be accessed tax-free to supplement income.

What are the types of split dollar arrangements?

In general, since the enactment of regulations in 2003 treatment of Split Dollar arrangements fall into the following three broad categories: Endorsement, Non-Equity Collateral Assignment and Loan Regime.

Endorsement Split Dollar.

In this approach, the employer owns the life insurance policy and endorses a portion of the death benefit to the employee who pays annual income tax on the "economic benefit value" of the death benefit amount. The employer decides up-front how much death benefit will be apportioned between the employee and the business.



Source: Illustration provided by Principal Financial

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This approach is often used when the employer wants to either control the life insurance policy, provide a keyperson death benefit for the business, or add a pre-retirement death benefit to a non-qualified deferred compensation plan for the employee. The employer maintains control of the policy and, when the split dollar agreement terminates, has the flexibility to surrender it, keep it, or transfer ownership of the policy to the employee. Alternatively, the employer and employee could agree at plan implementation that the policy (cash value and death benefit) will be transferred to the employee in the future, providing further incentive to the employee to remain working for the employer.

What is "economic benefit value"?
To preserve the income tax-free nature of the death benefit payable to the participant's beneficiary, the IRS requires that the participant be charged on the "economic benefit" provided to them under the split dollar arrangement. The economic benefit charge is based on the participant's age, the amount of participant's insurance, and the factor provided in an IRS rate table (Table 2001) or, if available, the insurer's term rates on their one-year term product. The economic benefit rates associated with a survivorship policy can be significantly lower than the rates for a single-life policy, making a split dollar plan with a survivorship policy an extremely cost-efficient planning strategy especially for business owners. Economic benefit rates increase each year as the insured ages, so it is important to consider how these rising costs impact a participant's tax liability. In some cases, it may be desirable to terminate the split dollar plan or change to another type of arrangement to address these costs.

Non-Equity Collateral Assignment Split Dollar.

In this approach, the employee (or his/her trust) owns the life insurance policy and, as with Endorsement Split Dollar, pays income tax on the annual economic benefit value of the death benefit to be received. The employer pays the premium and has a collateral assignment on the policy cash value and death benefit for the greater of the premium paid or the policy cash surrender value.

If the participant dies while the plan is active, the business will receive the greater of premiums paid or the policy's cash value from the death benefit and the participant/trust will receive the excess death benefit. If the arrangement terminates while the participant is living, the business will either be repaid the greater of cash value/premiums paid or the business can forgive the debt (in whole or in part). Forgiveness of the debt will be income taxable to the participant.

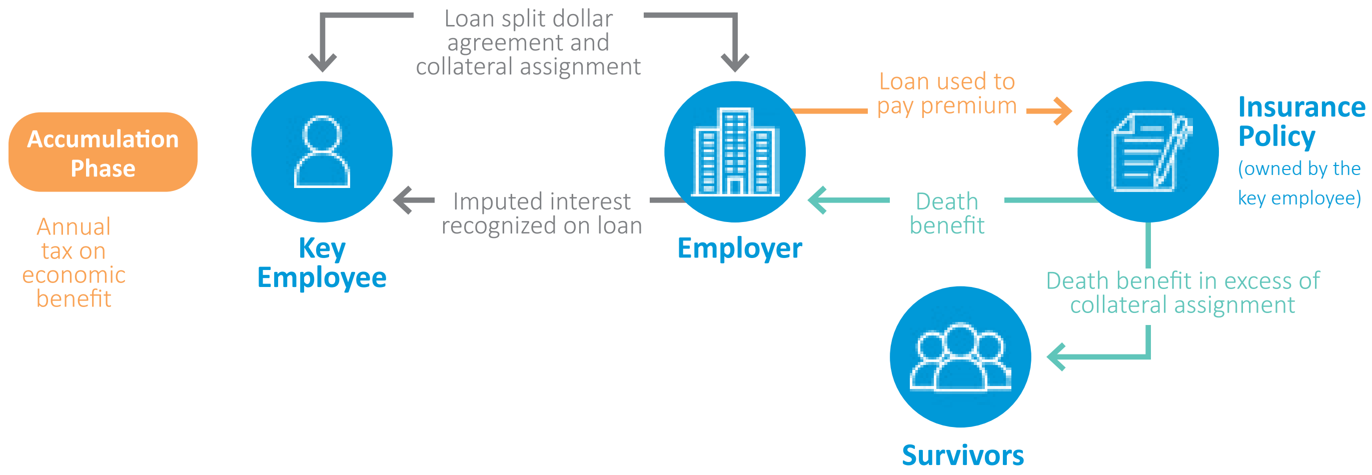
This approach is used most often when:

- The intention is (1) to not to terminate the split dollar arrangement during lifetime, unless other sources will be used to repay the employer because a full surrender will terminate the policy or (2) to release the collateral assignment and treat it as a bonus;
- The insured is the business owner who is focusing on using corporate dollars for an estate planning strategy; and/or
- The policy is survivorship because the economic benefit cost for two lives is very low.

Loan Regime Split Dollar.

Loan Regime Split Dollar is similar to Non-Equity Collateral Assignment Split Dollar with two key differences:

- The annual amount owed by the employee is determined by an interest rate, usually the applicable federal rate (AFR), applied to the outstanding loan balance; and
- The employer is repaid the outstanding loan balance, which is the premiums paid (or premiums plus interest, if accrued); any excess policy cash value ("equity"/policy gain) belongs to the employee.



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Unlike the other two forms of Spit Dollar each premium payment by the business is considered a loan from the business to the participant/trust. Each year, the participant will be responsible for paying the interest on the debt. Interest can be paid out-of-pocket, accrued or imputed into income. When interest is imputed into income, the participant is responsible for paying income tax on the interest.

The Loan Regime approach is used when the focus is building cash value for the employee. The employee owns the policy, the employer will get back the premiums paid for the plan, and the employee can use any potential excess cash value for income needs. Typically, the annual premium is overfunded because the focus is on building cash value in the policy to repay the employer and to meet the target supplemental retirement income goals of the employee.

In Summary

Split dollar arrangements are an effective way to use business dollars to fund insurance for business owners and their key executives. The arrangement can be customized for specific goals – from death benefit protection for families, to effectuate legacy plans, to a focus on cash value for supplemental retirement income. For those who decide to allocate more cash toward benefits for key employees, split dollar as a concept offers a range of options allowing the employer to provide a valuable benefit to the employee, keep the premium paid in or connected to the business, and recover the premium outlay.

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