Article 1: Split Dollar Regulatory Compliance and Plan Objectives

Split Dollar Background [1]

Split dollar life insurance (split dollar) arrangements involve the sharing of the costs and benefits of a life insurance policy or policies between two parties, commonly an employer and key employee. Since the 1950's, split dollar has been a popular way for companies to provide key employees a significant benefit. Split dollar confounded the Internal Revenue Service (IRS) for decades as it searched for the proper way to regulate these arrangements and integrate them into the Internal Revenue Code (Code). Originally, the IRS treated split dollar as an interest-free loan from the employer to an employee which did not cause the employee to realize any taxable income.

In September of 2003, after many years of trying, the IRS issued its final split dollar regulations providing much-needed clarity on proper plan structuring. Among other things, the rules divided split dollar plans into two distinct types: Economic Benefit regime and Loan regime with rules for each. Not only did this provide the guidance required to design these arrangements correctly, but it also allowed split dollar to better fit within the tax code in general.

Below, we discuss some (but not all) of the more important issues and aspects of split dollar arrangements.

Regime Differences

The purpose of each split dollar version is different, and these differences extend not only to the key employee but the employer as well. The economic benefit regime design is used to efficiently provide death benefit coverage for a key employee during their employment years. The death benefit coverage has value and results in income inclusion for the key employee. This value is determined either by using IRS tables or the life insurance carrier's annually renewable term rates.

Loan regime plans, on the other hand, are intended to accumulate assets that the executive can access in the future along with death benefit coverage during retirement. For the economics to be favorable for both parties, these plans require the achievement of two distinct goals.

- Repay the employer's premiums (at a minimum).
- Accumulate cash values accessible to the executive.

Conflicting Objectives

While the economic benefit regime form of split dollar is straight forward, with the key employee recognizing the value of the coverage received as income, the loan design is more nuanced. With loan regime split dollar, there are two concurrent objectives that the employer and key employee are working to achieve. Most importantly, the premiums paid by the employer must be returned at some point in the future (frequently with interest) depending on the terms of the agreement. All, or a portion, of the death benefit, is allocated to the employer to make good on this obligation. Secondly, the key employee is anticipating access to policy value during retirement.

Those not familiar with the operation of life insurance policies may not recognize this conflict and the influence it could have on plan compliance. Key employee access to policy value (presumably at retirement), reduces both the surrender value[2] and the death benefit. Unfettered access to policy value by the key employee, impaired policy performance or both could cause the death benefit to reach a level that is not sufficient to repay the premiums to the employer.

[1] Triscend[NP] does not provide tax or legal advice. Consult your independent advisers on these matters.

[2] The value at which the policy could be surrendered to the insurance company for cash.

Compliance Considerations

Regardless of the intent of the arrangement, the IRS has created a straight forward way to distinguish between the two regimes, and it relates to the order in which the owners are named on the life insurance policy. That is, if the employer is named first as an owner of the life insurance policy, the plan will be deemed economic benefit split dollar. Conversely, naming the key executive as the first owner of the life insurance policy will cause the arrangement to be treated consistently with loan regime rules. While simple, it is critical that plan participants confirm the ownership of the life insurance policy or policies is correct and reflects the intent of the parties.

Once policy ownership is confirmed to be correct, participants in the economic benefit form of split dollar should ensure that the value of the death benefit coverage received by the key employee is calculated correctly. This value drives the amount of income recognized by the key employee. According to the IRS, this death benefit is valued on a per 1,000 dollars of insurance basis with those rates being provided by IRS Table 2001 or the insurance company's rates for term coverage. Using the life insurance company's (annually renewable term) rates generally, result in lower income recognition and are favored by most participants if available.

Determining income inclusion for Loan regime plans is entirely different. Consistent with its name, the Loan form of split dollar treats the premiums paid by the employer to the insurance policy as loans (for tax purposes only) to the key employee. These "loans" bear interest the key employee must pay or have forgiven by the employer. The loan and sufficient interest but be paid back to avoid income inclusion. These interest rates are published monthly by the Department of the Treasury and are referred to as short, mid and long-term Applicable Federal Rates (AFR). Selection of the proper rate should reflect the anticipated term of the plan and other factors from the plan agreement.

Questions to ask

- What is the principal purpose of the plan and is policy ownership consistent with split dollar regulations?
- Is the proper interest rate being used and is it paid or forgiven?
- Is the obligation to the employer secured?
- Are there controls on the amount of value the employee can access during retirement?

Understanding the most important factors that influence the success of an arrangement equips the parties to make wise decisions and structure the plan to achieve its goals with increased probability. Our purpose is to educate both nonprofit employers and executives participating in or considering participation in a split dollar plan.

Next week, we will examine the legal agreement that governs a split dollar plan. Specifically, we will review some of the most common contractual clauses included in split dollar agreements, how these terms are negotiated and some unintended consequences.

Contact us for a plan review and assessment.

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