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Split-Dollar Life Insurance—Collateral Assignment Method

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SPLIT-DOLLAR LIFE INSURANCE—COLLATERAL ASSIGNMENT METHOD

The Concept

- ◆ A split-dollar arrangement is a method of purchasing life insurance that splits premium payments, policy benefits, or both between a business and an employee (or sometimes between two individuals or between an individual and a trust).
- ◆ Premium payments and policy benefits are split between the parties in a manner that is specified in the split-dollar agreement.
- ◆ Split-dollar arrangements are designed to terminate at a specified future date, such as the employee's retirement or the death of an insured.

The Purpose

- ◆ Split-dollar is a method for buying—rather than a reason for buying—life insurance. A need for life insurance should always exist before a split-dollar arrangement is implemented.
- ◆ In a business setting, split-dollar is often used when the employer needs to provide a valuable fringe benefit to recruit or retain a key employee.
- ◆ A split-dollar arrangement can also provide needed life insurance protection for an employee at a lower current out-of-pocket cost than a personally purchased policy.

The Details

- ◆ Ownership of a life insurance policy in a split-dollar arrangement has important tax consequences under Treasury Department regulations.
- ◆ Split-dollar arrangements usually structure policy ownership in one of two ways: the endorsement method or the collateral assignment method.
- ◆ Under the collateral assignment method, the employee owns the policy and names the beneficiary, but assigns policy benefits to the employer as collateral for the employer's premium advances under the arrangement.



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- ◆ A third party—for example, the employee's irrevocable trust or adult child—may be the policyowner rather than the employee. The employee may choose this ownership method for estate planning purposes.
- ◆ At the employee's death, life insurance proceeds are split between the employer and the employee's beneficiaries. The employer receives the amount dictated in the agreement (typically, a return of premiums only, a return of cash value only, or a return of the greater of the premiums paid or the cash value) and the employee's beneficiaries receive the remaining proceeds.

Equity Arrangements

- ◆ "Equity split-dollar" is an arrangement in which the employer's share of the cash value and death benefit is limited to the aggregate net premiums paid. Any cash value in excess of the employer's premium payments inures to the benefit of the owner-employee, giving the employee an "equity" interest in the cash value along with current life insurance protection.
- ◆ In a "non-equity" arrangement, the employer provides the employee with current life insurance protection but no interest in the policy's cash value.
- ◆ In an equity arrangement, the employee enjoys additional benefits that are reflected in the taxation of the split-dollar arrangement. Typically, equity arrangements will be treated as loans. If the loan does not provide sufficient interest, the loan is a split-dollar loan. As such, the employee is taxed on the imputed interest at the applicable federal rate (AFR).

Tax Aspects

- ◆ Final Treasury regulations issued in September 2003 clarified and altered the federal taxation of split-dollar arrangements.
- ◆ The regulations provide two alternative tax regimes: the economic benefit regime and the loan regime.
- ◆ The two-regime approach applies to split-dollar arrangements entered into on or after September 18, 2003, and to pre-existing arrangements that are "materially modified" on or after that date.



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- ◆ The regime that applies to a particular case hinges, with some exceptions, on who owns the life insurance policy, which depends on whether the arrangement was set up under the endorsement or the collateral assignment method.

Loan Regime/Collateral Assignment

- ◆ The loan regime generally applies to a collateral assignment arrangement when: (a) the payment is made directly or indirectly by the non-owner to the owner; (b) the payment is either a loan under federal tax rules, or a reasonable person would expect repayment in full to the non-owner; and (c) the repayment is to be made from, or is secured by, the policy's cash value, death benefit or both.
- ◆ Under the loan regime, the non-owner of the life insurance policy (the lender) is treated as making a series of loans, with interest charges, of all or part of the premiums to the owner of the policy (the borrower).
- ◆ Each loan will bear interest at the AFR or higher. If the loan interest is "forgiven" each year by the lender, the borrower includes the forgiven interest amount in gross income. The borrower is not taxed annually if the loan interest is paid or accrued.
- ◆ The loan regime applies to an equity collateral assignment arrangement in which the employee owns the policy and uses it as collateral for the employer's advance of premium payments.
- ◆ The loan regime does not apply to a non-equity collateral assignment split-dollar arrangement involving employment or a gift, where the employer or donor is treated as the owner and the economic benefit regime applies.
- ◆ For example, a non-equity, private split-dollar arrangement between two individuals would not be subject to the loan regime since it involves gifts.

More on Loans and Taxes

- ◆ The loan regime seeks to account for the benefits the lender provides to the borrower when the loans are "below market." If a split-dollar loan does not require sufficient interest, the loan is below market and interest is charged under applicable federal rates.



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- ◆ If the split-dollar loan requires sufficient interest, then the loan—with some exceptions—is subject to the general tax rules for debt instruments.
- ◆ When a split-dollar loan is subject to a below-market interest rate, it is generally recharacterized as a loan with interest at the AFR, coupled with a transfer from the lender to the borrower.
- ◆ The timing, amount and characterization of transfers between lender and borrower will depend on both the relationship between the lender and the borrower and whether the loan is a demand loan or a term loan. For example, the transfer is generally characterized as compensation if the lender is the borrower's employer.
- ◆ If a split-dollar loan is repayable on demand, the short-term AFR applies in calculating the interest.
- ◆ Since this rate changes monthly, the calculation normally would have to be made monthly. But tax law permits taxpayers to use a blended annual rate when a demand loan has a fixed principal that is outstanding for an entire calendar year.
- ◆ The IRS releases the blended annual rate each year.
- ◆ The borrower cannot deduct interest on a split-dollar loan.
- ◆ Split-dollar arrangements taxed under the loan regime generally will not be subject to the IRC §409A tax rules (which apply to deferred compensation arrangements) as long as the employer is under no obligation to forgive the loan debt or to continue future premium payments without charging a market rate of interest.

The Outcome

- ◆ Unless the employee or other insured dies while the split-dollar arrangement is in effect, the arrangement will eventually terminate as specified in the agreement between the parties—at the employee's retirement, for example.
- ◆ Such a lifetime exit strategy from a split-dollar arrangement is known as a "rollout."
- ◆ At rollout, the policy is transferred to the employee, and the employer is repaid out of policy values or other employee assets.



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The Bottom Line

Along with other potential uses, a split-dollar arrangement can be an effective way for employers and key employees to cement a solid working relationship by providing life insurance coverage that gives additional financial security to employees and their families.



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SUMMARY

WHAT IS SPLIT-DOLLAR LIFE INSURANCE?

A split-dollar arrangement is a method of purchasing life insurance in which the premium payments, policy benefits, or both are split between a business and an employee (or sometimes between two individuals or between an individual and a trust).

Split-dollar is a method of buying life insurance, not a reason for buying it. A need for life insurance should always be present before a split-dollar arrangement is implemented.

WHAT IS THE COLLATERAL ASSIGNMENT METHOD?

The ownership of a life insurance policy used to fund a split-dollar arrangement has important tax consequences under regulations issued by the Treasury Department.

In the collateral assignment method, the employee owns the policy and names a beneficiary, but assigns policy benefits to the employer as collateral for the employer's premium advances under the arrangement. A third party (for example, the employee's irrevocable trust or adult child) may be the policyowner. This ownership method is often used to meet estate planning objectives.

At the employee's death, life insurance proceeds are split between the parties. The employer typically receives a return of premiums only, a return of cash value only, or a return of the greater of the premiums paid or the cash value. The employee's beneficiaries receive the remaining proceeds.

A lifetime exit strategy from a split-dollar arrangement is known as a "rollout." The policy is transferred to the employee, who repays the employer out of policy values or other assets.

WHAT IS EQUITY SPLIT-DOLLAR?

"Equity split-dollar" is an arrangement in which the employer's share of the cash value and death benefit is limited to its aggregate net premiums paid. Cash value that exceeds the employer's aggregate net premiums



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is credited to the employee. Thus, the employee builds an equity interest in the cash value while enjoying current life insurance protection.

In a “non-equity” arrangement, the employer provides the employee with current life insurance protection but no interest in the policy’s cash value.

HOW ARE SPLIT-DOLLAR ARRANGEMENTS TAXED?

Final regulations issued in September 2003 provide for two alternative tax regimes: the economic benefit regime and the loan regime.

Under the “loan regime,” which applies to the collateral assignment method, the life insurance policy’s non-owner (the lender) is generally considered to have made a series of loans, with interest charges, of all or part of the premiums to the policyowner (the borrower).

Each loan bears interest at the applicable federal rate (AFR) or higher. If the loan interest is “forgiven” each year by the employer, the employee includes the forgiven interest amount in gross income. The employee is not taxed annually when the loan interest is paid or accrued.

The loan regime seeks to account for the benefits the lender provides to the borrower when the loans are “below market.” If a split-dollar loan doesn’t require sufficient interest, the loan is below market and interest is applied under tax code rules.

A split-dollar loan that requires sufficient interest is, with some exceptions, subject to the general tax rules for debt instruments.

A non-equity collateral assignment arrangement is taxed under the economic benefit regime—that is, the employee is taxed on the annual value of the death benefit payable to the employee’s beneficiaries, usually as measured by IRS Table 2001.



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Split-dollar arrangements taxed under the loan regime generally will not be subject to the IRC §409A tax rules (which apply to deferred compensation arrangements) as long as the employer is under no obligation to forgive the loan debt or to continue future premium payments without charging a market rate of interest.

WHAT ARE THE ADVANTAGES TO THE EMPLOYER?

- ◆ Split-dollar life insurance can be an effective method of attracting and retaining valuable key employees, and the employer can be highly selective regarding which employees are covered.
- ◆ The employer may have access to the policy's cash value.
- ◆ The arrangement does not need IRS pre-approval.

WHAT ARE THE ADVANTAGES TO THE EMPLOYEE?

- ◆ Split-dollar life insurance is an effective way to provide needed insurance protection at a reduced current out-of-pocket cost to the employee.
- ◆ A split-dollar arrangement can be combined with a cross-purchase buy-sell agreement to reduce the current out-of-pocket premium cost to younger owners when there is a wide difference in the owners' ages.



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