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Split-Dollar Life Insurance—Collateral Assignment Method

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SPLIT-DOLLAR LIFE INSURANCE—COLLATERAL ASSIGNMENT METHOD

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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