

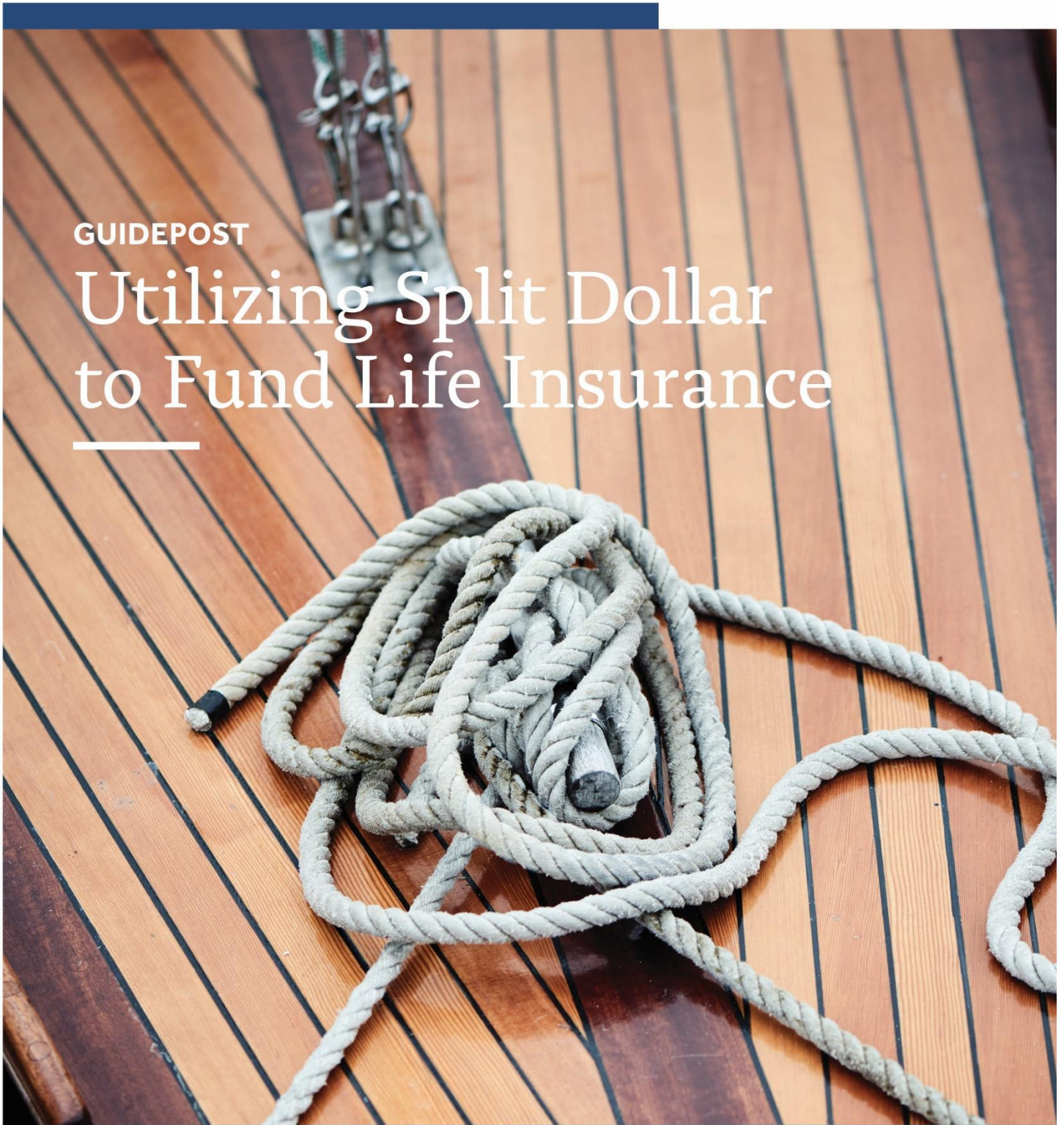


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GUIDEPOST

# Utilizing Split Dollar to Fund Life Insurance

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# Utilizing Split Dollar to Fund Life Insurance

A split dollar insurance arrangement is a strategy that divides the premiums, ownership interests, and benefits of a permanent life insurance policy between two parties. It is generally utilized to fund a life insurance policy on a gift and/or income tax efficient basis, as well as to provide a financing party the opportunity for reimbursement of premiums or access to policy cash values. Two contexts are generally conducive to split dollar planning:

- Funding premiums in an irrevocable trust for the benefit of an insured's family on a gift tax efficient basis (**Private Split Dollar**); and
- Using permanent life insurance as a tax-efficient retention and reward tool for employees who are key to the success of a business (**Employer Sponsored Split Dollar**).

## Split Dollar Arrangements - In General

To enter into a split dollar arrangement, an attorney generally establishes an agreement that defines each party's rights and responsibilities with respect to an insurance policy. Common items found in a split dollar agreement include: identities of the parties, premium payment responsibilities, death benefit distribution terms, rights to policy cash values, and termination events. Under a split dollar arrangement, one party typically pays all or a portion of the premium on a life insurance policy, while another party is entitled to a share of policy values (usually a portion of the death proceeds).

Treasury Regulations govern taxation of all split dollar arrangements entered into after September 17, 2003. As a result, there are two basic structures: economic benefit regime and loan regime. Under an economic benefit arrangement, one party funds premiums on a policy and endorses a portion of death proceeds to another party (also known as Endorsement Split Dollar). The deemed cost of the insurance benefit received by such party is referred to as the "economic benefit," and is determined based on IRS actuarial guidelines. Income and gift taxation of economic benefit arrangements is governed by regulations contained in Treas. Reg. §1.61-22. Under loan regime split dollar, premium payments are treated as loans by one party to the other party, and subject to general tax rules governing debt instruments, including adequate interest accrued or paid on such loan. Loan regime taxation is governed by Treas. Reg. §1.7872-15.

The applicable tax regime is largely determined by the owner of the insurance contract. If the premium payor owns the insurance policy and endorses a portion of the death benefit to another party, the arrangement is generally subject to the economic benefit regime. If the premium payor funds premiums of a contract owned by another individual or entity, loan regime rules generally apply. There is one notable exception to the ownership rule as well: economic benefit regime will apply to split dollar arrangements if the premium payor is entitled to all policy lifetime values, and the nominal policy owner (usually the donee or employee) has no current or future interest in the policy's cash values and is only entitled to death benefit protection.

## Private Split Dollar

Private split dollar is commonly employed in the estate planning context between family members (traditionally between an individual and a trust for the benefit of such individual's heirs). Under such arrangement, an individual donor generally funds insurance premiums on the life of the donor, or perhaps on the life of another individual. The policy can be owned by the donee, or a trust for the benefit of family and other specified beneficiaries. The purpose of such arrangement is generally twofold:

- Insurance death proceeds are generally removed from the taxable estate of the donor for federal (and possibly state) estate tax purposes; and
- The gift tax value of any premium payment is reduced significantly—this strategy can be especially helpful in situations involving large premiums.

Funding of a private split dollar plan can be affected under either of the above-mentioned tax regimes, with corresponding advantages and disadvantages.

## Economic Benefit Regime

Under an economic benefit split dollar arrangement, the donor pays the premium, while the donee/trust receives the cost of the term insurance as a gift (or the donee may pay the term cost equivalent portion of the premiums). The donor's interest in the policy is stipulated as the greater of his/her cumulative premiums paid or the policy's cash value. The donee/trust is entitled to the death benefit proceeds in excess of the donor's interests. For split dollar purposes, the donor is considered the owner of such policy; however, for estate tax purposes, title to such policy is held by the donee/trust (primarily to keep insurance proceeds outside of the donor's taxable estate).

### *Tax Considerations*

The deemed term insurance cost of an economic benefit split dollar arrangement is generally considered a gift to the donee/trust. Under IRS guidance, the value of such benefit is calculated under either Table 2001 (per IRS Notice 2001-10), or, if lower, using the issuing carrier's published initial issue one-year term rates for standard risks (assuming such policies are regularly sold by such carrier).

Because of the gift tax efficiency of establishing insurance coverage under the economic benefit regime, such arrangements are commonly employed with single life universal and survivorship universal life insurance products. Such policies are also commonly employed in the estate planning context given their optimization of death benefit relative to premiums, which in turn provides liquidity for estate tax purposes.

## Loan Regime

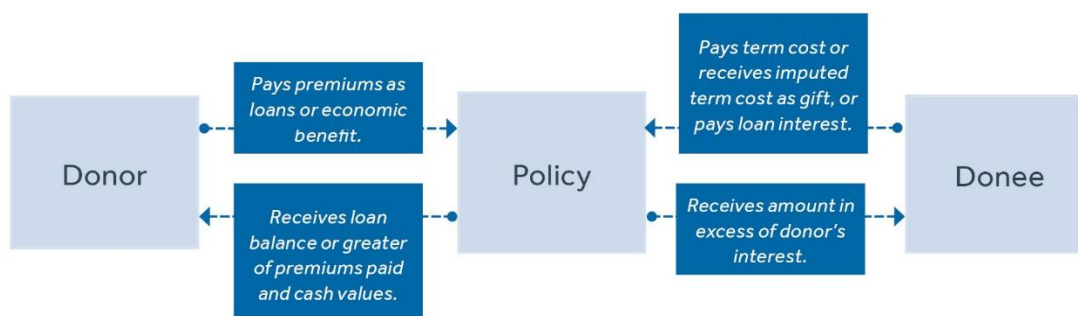
Under a loan regime split dollar arrangement, the donor makes loans to the donee (or trust) on specified terms at a stated interest rate. The loan should generally provide for adequate interest at the applicable federal rate (which varies depending on the term of the loan), typically accrued if the donee/trust does not have assets beyond the life insurance policy.

### *Tax Considerations*

Because premiums are advanced in the form of a loan, there is generally no gift, deemed or otherwise, when premiums are paid. Of course, loan forgiveness in the future may be considered a gift at such point. Care must be exercised if loans are subsequently forgiven as well, lest the validity of a loan arrangement be called into question. Any loan principal paid to the donor is a tax-free return of investment; however, unless the donee is a grantor trust of the donor, loan interest paid to the donor is generally taxable as income to the donor, whether paid during the insured's lifetime or at death.

Under a split dollar loan arrangement, the cumulative premiums (and accrued interest if any) remains payable to the premium payor (donor). As a result, an increasing share of policy proceeds may be required to be repaid at death, resulting in a smaller portion of death proceeds for the benefit of heirs. For this reason, an increasing death benefit whole life policy (with increasing cash values) may be more suitable for such arrangements. An additional advantage of a high cash value product in this context is the potential to use policy values to repay some or all of the loan during the insured's lifetime.

## Private Split Dollar - Flowchart



## Employer Sponsored Split Dollar

If a split dollar arrangement is utilized in an employment context, the employer generally funds an insurance policy on the life of an employee as part of the employer's retention and compensation strategy for that employee.

### Economic Benefit Regime

Under an economic benefit regime split dollar arrangement, the employer is the actual or deemed owner of the life insurance policy on the employee's life. Generally, the employer pays the premium, and the employee includes the policy's term cost in his/her taxable income, or depending on the terms of the arrangement, the employee may alternatively be required to pay the term cost. The employer's interest in the policy is the greater of its cumulative premiums paid or the policy's cash value. The employee's beneficiaries are entitled to the death benefit in excess of the employer's interests.

#### *Tax Considerations*

The employer pays the premium, which is considered its investment in the contract (or basis). The employee either pays directly the term cost of the death benefit, or if the employer pays the term cost, the employee includes the term cost in his/her taxable income, and the employer receives a deduction for the term cost paid (assuming the employee's overall compensation is considered reasonable). The employee accrues no basis in the policy. Death proceeds are typically received income tax free by both parties or their designated beneficiaries, provided that all economic benefits payable to the employee's beneficiaries have been properly accounted for and paid.

Employer sponsored split dollar arrangements generally do not have gift tax implications. However, when a nonemployee's trust is involved, payment of the term cost by the employer is deemed to be income to the employee and a gift from the employee to the trust. Likewise, direct payment by the employee of the term cost is a gift to the trust.

### Loan Regime

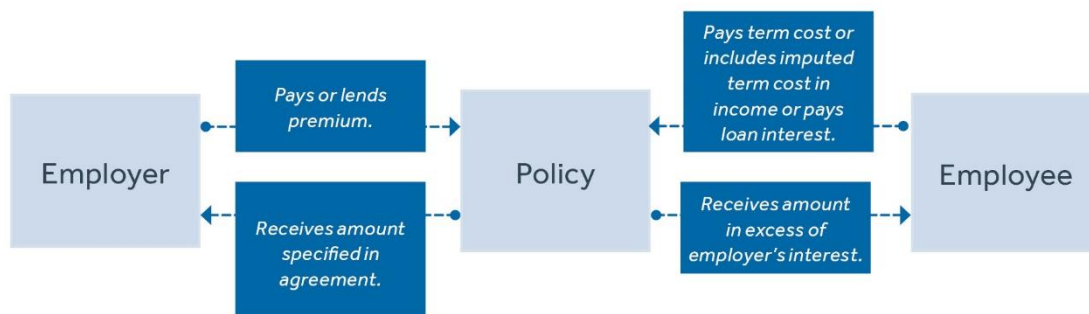
In a loan regime split dollar arrangement, the employee (or a trust established by the employee) is generally the owner of the life insurance policy. The employer makes loans to the employee (or trust) at a stated interest rate. All equity in the policy in excess of the outstanding loan obligation accrues to the benefit of the employee (or trust). Upon the death of the insured, the loan is repaid to the employer, and the employee's beneficiaries receive the death benefit in excess of the outstanding loan.

#### *Tax Considerations*

The employer pays the premium, which is considered a loan to the employee (or trust). The employee (or trust) pays interest on the loan, either annually or cumulatively. The loan principal paid to the employer is a tax-free return of investment; however, loan interest paid to the employer is taxable income to the employer, whether paid during the insured's life or at death.

To the extent the insured possesses incidents of ownership in the policy, death proceeds will be included in the insured's estate, with a deduction for the part that goes to the employer. If the split dollar arrangement is between a trust established by a majority shareholder/insured and the corporation, the death proceeds will be included in the majority shareholder's estate if the corporation is given any incidents of ownership in the policy.

### Employee Split Dollar - Flowchart



## Insights and Caveats

- Split dollar arrangements in effect prior to September 18, 2003, that have not been modified are not subject to the final Treasury Regulations as described above. Generally, the tax treatment of split dollar arrangements entered into prior to the final regulations are considered grandfathered and will be governed by IRS Notice 2002-8. The exchange of a policy subject to a grandfathered split dollar agreement likely will be considered a modification that will cause loss of grandfathering. In a loan regime split dollar arrangement, it is important for the stated interest rate to be at or above the applicable federal rate (AFR) that is in effect during any month in which a premium loan is made, as published by the IRS each month. Otherwise, the difference between the amount of interest charged under the arrangement and the minimum interest required by reference to the applicable AFR will be imputed as taxable income to the employee and, in the case of certain term loans, the undercharging of interest payable over the life of the loan may be taxable in the first year on a present value basis.
- Certain split dollar arrangements may be considered employer owned life insurance under the rules of Internal Revenue Code (IRC) §101(j). As such, it may be necessary to comply with "Notice and Consent" requirements of IRC §101(j).
- Lastly, note that an employer split dollar plan may be considered a welfare benefit plan for purposes of the Employee Retirement Income Security Act of 1974 (ERISA) with corresponding documentation, fiduciary, and claims procedure requirements, as well as potential reporting obligations.

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Employers should be aware that the arrangements described herein may be subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and Internal Revenue Code Section 409A ("Section 409A"), the tax rule applicable to non-qualified deferred compensation. ERISA imposes certain requirements on employee benefit plans and their sponsors, including but not limited to, fiduciary, disclosure and reporting requirements. These requirements depend on the type of plan ("retirement or welfare plan;" or "top hat retirement" or "top hat welfare plan"). Section 409A imposes certain requirements that, if not satisfied, can result in adverse tax consequences to employees. New York Life Insurance Company and its employees, agents and affiliates do not provide tax or legal advice. Employers should consult with their legal and tax advisors regarding the implications of ERISA and Section 409A on adopting these arrangements in their particular circumstances.

The cash value in a life insurance policy is accessed through withdrawals and policy loans, which accrue interest at the current rate. Loans and withdrawals will decrease the cash surrender value and death benefit.

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