



FERRIS FINANCIAL, LLC

HELPING YOU PLAN, PROTECT & PROSPER



## Overview

Split dollar life insurance is not a type of insurance, but rather a method for dividing the premiums, ownership interests, and benefits of a permanent life insurance policy between two parties. There are two basic forms of split dollar taxation: economic benefit regime and loan regime. Split dollar plans may be sponsored by an employer in a work setting, or an individual or trust in a private setting. This Guidepost discusses employer sponsored split dollar plans. A separate Guidepost is available that describes private split dollar plans.

## Details & Operations

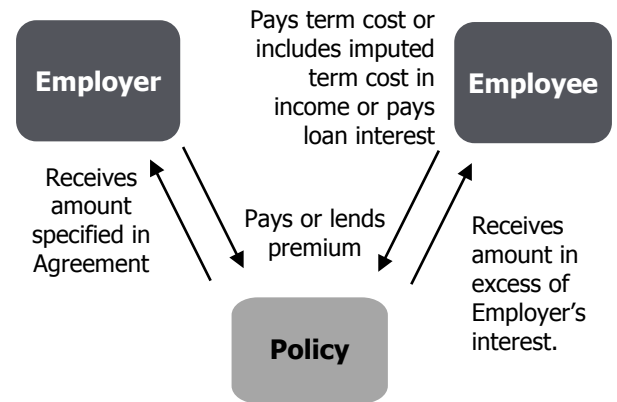
After it's determined to enter a split dollar arrangement that will help meet the client's life insurance and planning objectives, the client's legal counsel drafts, and the parties execute, an agreement that spells out each party's rights and responsibilities. Common items found in a split dollar agreement include: identities of the parties, premium payment responsibilities, death benefit distribution terms, right to policy cash value, and termination events. The terms of the agreement should be coordinated with the design of the underlying policy.

**Economic Benefit Regime (EB):** The employer is the actual or deemed owner of the policy in an economic benefit regime split dollar arrangement. Generally, the employer pays the premium, and the employee includes the term cost equivalent for the death benefit in his or her taxable income, or depending on the terms of the arrangement, the employee may alternatively be required to pay the term cost equivalent portion of the premiums. Under an economic benefit arrangement, the employer's interest in the policy is the greater of its cumulative premiums paid or the policy's cash value. The employee's beneficiary is entitled to the death benefit in excess of the employer's interests.

**Loan Regime (L):** The employee, or a trust established by the employee, is generally the owner of the policy in a loan regime split dollar arrangement. The employer makes loans to the employee or trust at a stated interest rate. All equity in the policy in excess of the loan amount accrues to the benefit of the owner employee or trust. At death, the loan is repaid to the employer, and the employee's beneficiary receives the death benefit in excess of the employer's interests in the policy.

## ***Employer Sponsored Split Dollar Arrangement***

1. Employer and Employee execute a split dollar agreement.
2. If Economic Benefit Regime (EB) split dollar, Employer owns the policy (or Employer is deemed owner for federal tax purposes); if Loan Regime (L) split dollar, Employee owns the policy.
3. Employee is either imputed the term cost as taxable income or pays the term cost or loan interest as applicable, and Employer pays or loans the premiums.
4. Lifetime policy surrender:
  - If EB, Employer is entitled to the policy's entire cash value;
  - If L, Employer is entitled to loan principal and unpaid interest, and Employee receives any remaining cash values.
5. Death proceeds:
  - If EB, Employee's beneficiary is entitled to any death benefit in excess of Employer's interest; Employer will receive the greater of premiums paid or cash value.
  - If L, Employer is entitled to loan principal and unpaid interest, and Employee's beneficiary receives any remaining values.



## **Tax Implications**

### ***Income Tax Considerations***

Income taxation of a split dollar arrangement is governed by regulations contained in Reg. §1.61-22 (economic benefit regime) and Reg. §1.7872-15 (loan regime). The applicable regime is largely determined by who the owner is of the contract for split dollar purposes. If the employer or donor owns the contract, the arrangement is generally subject to the economic benefit regime. If the employee or donee (or a trust for either) is the owner, loan regime split dollar rules generally apply.

There is an exception to the general ownership rule in certain economic benefit split dollar arrangements. Even if the employee or a trust is the nominal owner of the policy, the employer will be treated as the owner of the policy for split dollar taxation purposes if the employer is entitled to all policy lifetime values, and the employee has no current or future interest in the policy's cash values.

**Economic Benefit Regime:** The owner or deemed owner (employer) pays the premium, which is considered investment in the contract (or basis). The non-owner (employee) either pays the term cost of the death benefit; or if the employer pays, the employee includes the term cost in income. The employee accrues no basis in the policy. Term costs paid by the employee to the employer are income to the employer, and the employer gets a deduction for amounts the employee includes in income. Death proceeds are typically received income tax free by both parties or their designated beneficiaries, provided that all economic benefits payable to the non-owner's beneficiary have been properly accounted and paid for.

**Loan Regime:** The non-owner (employee) pays the premium, which is considered a loan to the employee (or trust). The owner (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 is taxable to the employer, whether paid during the insured's lifetime or at death.

## ***Gift and Estate Tax Considerations***

- ◆ **Gift Tax:** Employer sponsored split dollar arrangements generally do not have gift tax implications. Gift taxes are of greater concern in private split dollar arrangements. However, when an employee'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.
- ◆ **Estate Tax:** The final split dollar regulations do not address estate tax issues relating to split dollar arrangements. However, 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 under the terms of the split dollar agreement or any other related document.

## **Insights and Caveats**

Split dollar plans in effect prior to September 18, 2003, that have not been modified are not subject to the final regulations and may be subject to different tax rules. The exchange of a policy subject to a grandfathered split dollar agreement will likely be considered a modification that will cause loss of grandfathering.

- ◆ The term insurance cost under economic benefit split dollar is determined by using IRS Table 2001 or a term charge from the issuing company's regularly sold, initial issue, standard one-year term policy, if less.
- ◆ In a loan regime split dollar, 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.



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