Split dollar life insurance

Advisor guide

Get the whole story about split dollar life insurance.

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Key information to look for inside:

1. Under what circumstances should you consider split dollar to meet the needs of your clients? ***Page 4***

2. There are two types of split dollar arrangements that you can implement for your clients with life insurance — loan regime and economic benefit. ***Page 5***

3. Split dollar arrangements can help employers reward and retain key employees or help families transfer wealth to the next generation in a tax-efficient manner. ***Page 9 to 17***

Put the flexibility of split dollar to work in your practice.

Split dollar life insurance offers you the potential to help your clients in a variety of ways. Because of that, it's important for you to have a good grasp of this premium paying arrangement. To make that easier for you, we've developed this guide. We hope you'll find it to be a valuable resource and will refer back to it often.

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Definition of split dollar

Split dollar life insurance is a premium paying arrangement where two parties, an owner and a nonowner of a life insurance policy, share the premium payments. It can be used whenever one party needs life insurance and the other party is willing to help pay for it. The party helping to pay premiums may be entitled to a total or partial refund of its premium contributions from the policy's cash values or death proceeds.

Keep in mind that as life changes (e.g., marriage, birth of a child, job change, retirement), so will the life insurance needs. Make sure these strategies and products are suitable for long-term life insurance needs. It's also important to understand that, for a variable or indexed universal life policy, continued premium payments may be necessary to keep the policy from lapsing if the stock market goes down or if loans or withdrawals are made from the policy.

Uses of split dollar

Part of the attraction for split dollar is that it is extremely flexible and can be used to help your clients in a variety of ways.

Employee benefits

Business owners can provide split dollar life insurance as a benefit to **help attract, reward and retain key employees**. It may be for a large number of employees or a single employee. Because of its flexible design, split dollar can reflect variations in both business and individual planning needs. It can also be designed to help a company recover the cost of its premium outlays.

Buy-sell agreement funding

Although this application isn't as common, business owners who establish a cross-purchase buy-sell agreement can also use a split dollar arrangement to assist them in purchasing the life insurance that funds it. **Where significant differences in age or percentages of ownership exist**, or where some owners are required to pay higher premiums due to health or smoking status, split dollar may also help minimize the impact of these disparities.

Private split dollar

A private split dollar arrangement is something to consider where a senior family member is willing to help a less affluent junior family member acquire needed permanent life insurance. Also, it can be a useful way to purchase life insurance for estate liquidity needs without causing the death proceeds to be included in the insured's gross estate. The especially good news is that the family member providing the premium dollars **retains access to the funds** he or she advances. These types of split dollar arrangements let the senior family member make the necessary funds available with **minimal or no gift tax consequences**.

2003–Present

Split dollar final regulations

The final regulations apply to split dollar life insurance arrangements entered into after September 17, 2003, and to arrangements entered into on or before that date which are materially modified after it.

Tax treatment under the final regulations

The final regulations provide two choices for the income taxation of split dollar: loan regime and economic benefit.

1. **Loan regime**

   Loan regime premium payments are treated as a loan from the nonowner of the policy (lender) to the owner of the policy (borrower). Generally, taxation will depend on whether the policyowner has access to policy values in excess of premiums paid. Typically the policy is pledged as collateral for the loans.

   Loan regime (equity)

   If the policyowner does have access to policy values in excess of premiums paid, the arrangement is said to be an equity arrangement. In that case, if the lender charges less than a market rate of interest, as measured by the Applicable Federal Rate (AFR), the borrower is taxed on the below-market-rate element of the transaction, called imputed interest income. The imputed interest income is taxed as ordinary income. The amount of the imputed interest income will depend on several factors:

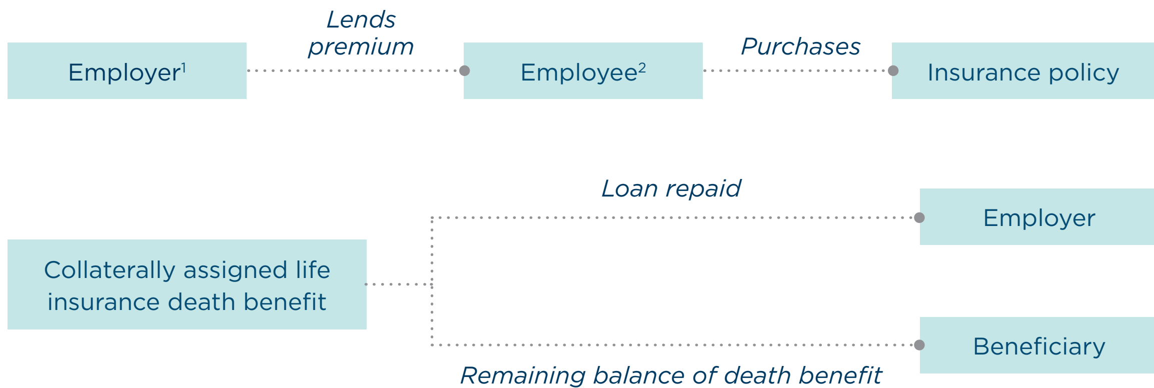
   - Whether the loan is repayable on demand (demand loan) or has a stated term of years (term loan),
   - If it is a term loan, whether there are any contingencies that might shorten the term of the loan
   - Whether the borrower is an employee or a shareholder, or whether it is a gift loan

   Loan regime (nonequity)

   If the policyowner does not have access to policy values in excess of premiums paid, the arrangement is said to be a nonequity arrangement. In that case, the borrower is taxed on the value of the life insurance coverage, in excess of the lender's interest, net of any reimbursement from the borrower. The value of the coverage is measured by one-year term insurance rates, either those supplied by the Internal Revenue Service or the rates of the insurer's one-year term insurance policies, if they comply with IRS guidance.

See how the loan regime works:

During working years or split dollar arrangement (death of insured)

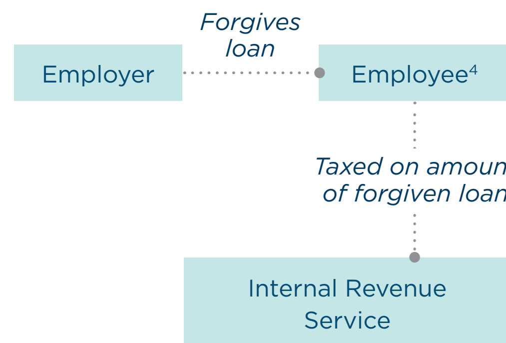


Upon separation from service or end of agreement

Loan is paid back by employee

OR

Loan amount is forgiven[3]



[1] The majority of split dollar cases are employee/employer; in private split dollar scenarios substitute grantor/grantee.

[2] Employee is taxed on the imputed interest of the loan.

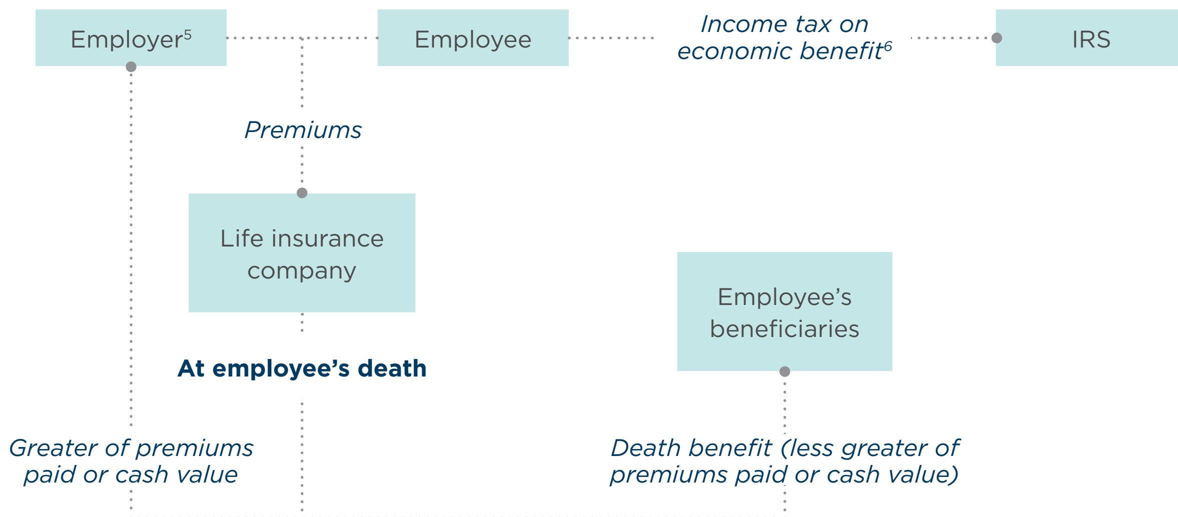
[3] The forgiven loan is additional compensation for the employee.

[4] Agreement is terminated and the employee owns the life insurance policy free and clear of pledge.

2. Economic benefit regime (nonequity)

One party owns the policy and pays all or part of the premiums, and is entitled to the greater of premiums paid or policy cash values. The other party is taxed on the value of current life insurance protection for which he or she has named a beneficiary, less any premium contribution.

See how the economic benefit regime works:



Economic benefit regime (equity)

One party owns the policy, and pays all or part of the premiums and the other party has access to cash values greater than premiums paid. In addition to the economic benefit of the life insurance protection, the nonpaying or partial paying party is taxed on these available amounts, beyond their own contribution, whether he or she accesses them or not. Because of this potential additional tax, equity economic benefit split dollar isn't used very often.

[5] The majority of split dollar cases are employee/employer; in private split dollar scenarios substitute grantor/grantee.

[6] See the reference section page 37-38 for Table 2001 rates and an example of alternative term rates.

Valuing the nonowner’s life insurance protection (their “economic benefit”)

The final split dollar regulations state that the value of the life insurance protection will be measured based on guidance published by the IRS in the Internal Revenue Bulletin.[7] In this case, IRS Notice 2002-8[8] is the most recent guidance and states:

Interim guidelines

- **PS 58 rates** may not be used after 2001, except for split dollar arrangements in effect before January 28, 2002, under a contractual agreement that provides for the use of PS 58 rates.
- **An insurer’s alternative term rates** may only be used for arrangements entered into after December 31, 2003, if they’re available to all standard risks for initial-issue one-year term insurance. For this purpose, the IRS won’t consider an insurer’s published premium rates to be available to all standard risks unless:
  - the insurer generally makes the availability of such rates known to those who apply for term insurance
  - the insurer regularly sells term insurance at such rates to those who apply for term insurance through the insurer’s normal distribution channels
- **Table 2001 rates** (published in Notice 2001-10) may be used for new arrangements until further guidance is published. It’s important to note that Table 2001 approximates the group term life insurance rates under IRC § 79 that don’t reflect the insured’s health. This means that a split dollar life insurance plan can be a bargain for the medically impaired since the value of their insurance protection is understated.

[7] Treasury Regulations Section 61-22(d)(3)(iii).

[8] Notice 2002-8, IRB 2002-4, 1/28/2002.

Split dollar case studies

In spite of the complexity of the 2003 split dollar regulations, split dollar life insurance arrangements still provide a valuable tool to match an employer's cash flow with a key employee's need for life insurance or a senior generation's desire to transfer wealth to the next generation in a tax-efficient manner.

Consider the following case studies that illustrate the concept, but note that they do not relate to any existing business or person and are hypothetical in nature.

Case study #1

Key employee split dollar arrangement

Consider a manufacturing company with a top design engineer that it wants to reward and retain. He is 55 and currently earning $250,000 per year, plus bonus. The company wants to make sure he stays until retirement at 65. The long-term goal is to fund an insurance-based retirement plan for this key employee, and the short-term goal is to provide him with low-cost life insurance coverage.

If the employee will provide substantial services for each of the next 10 years, the company is willing to commit to $100,000 for each year. The employee may choose one of three nonqualified compensation plans:

Plan A — Loan regime split dollar

- The key employee will own the policy, and the company will pay the $100,000 annual premium directly to the insurer, but treat it as a loan to the key employee in the books and records
- The key employee will pledge the policy as collateral for the loan
- The loan will be interest free, so split dollar regulations require that the interest-free element be taxed to the key employee each year as additional compensation, which is called imputed interest income
- The key employee will name a personal beneficiary for the death benefit in excess of premiums paid
- At the key employee's age 65, the company will forgive the loan as a retirement bonus
- Promising to forgive the loan or transfer the policy makes the arrangement a nonqualified deferred compensation plan, which means it must comply with Section 409A IRC

Plan B — Economic benefit split dollar

- The company will own the policy and let the key employee name a personal beneficiary for the death benefit in excess of the greater of the premiums paid, $100,000 each year, or the cash value of the policy
- The split dollar regulations specify that the value of the life insurance coverage will be taxed to the key employee each year, as additional compensation, based on Table 2001 rates or an insurer's annual renewable term rates
- The policy will be an asset on the company's balance sheet
- At retirement, the company will transfer the policy to the key employee, who will then be taxed on the fair market value of the policy, approximately its cash value
- Promising to forgive the loan or transfer the policy makes the arrangement a nonqualified deferred compensation plan, which means it must comply with Section 409A IRC

Plan C — Executive bonus arrangement

- The company will pay the key employee an additional $100,000 as a bonus each year
- Assuming the executive is in a 40% tax bracket, $60,000 will be paid into the policy each year

Illustration parameters for the comparison

The comparisons are based on the same base case policy illustration parameters:

- Nationwide YourLife® Indexed UL Accumulator
- 55-year-old male
- Nontobacco preferred
- 40% income tax rate
- Annual employer commitment of $100,000; $60,000 net of taxes on executive bonus
- $1,500,000 initial death benefit (rounded up to the nearest $100,000 from minimum non MEC death benefit)
- Reduce death benefit to $500,000 in year 11
- Option: Increasing for 10 years, switching to level in year 11
- Arrangement lasting 10 years
- Guideline Premium Test
- Multi Index Crediting Rate 6.0%
- Annual Pt to Pt Crediting Rate 6.0%
- $500,000 Long Term Care Rider
- Monthly payments in retirement
- Withdrawals and loans for years 11 to 25
- Target cash value at maturity $1.00, with Overloan Protection Rider

The only difference is the tax treatment of the funding arrangement:

- For the loan regime, the average Applicable Federal [Interest] Rate for a long term loan for the 10 years ending July 2015 of 3.85% was used
- For the economic benefit regime, IRS Table 2001 rates were used
- The loan forgiveness and the policy transfer will be considered a wage, subject to income tax withholding; the employer will lend the employee enough to cover the withholding and the employee will then borrow enough from the policy to reimburse the employer

We measured the efficiency of the three plans with an internal rate of return calculation. The key employee's "investment" is the income tax he has to pay, and his "return" is the cash flow in retirement. The key employee will have to withdraw money from the policy to reimburse the company for the income tax withholding on his retirement bonus. Since the "investment" of that income tax cost will be immediately offset by the "return" coming out of the policy, they wash out and do not have to be considered to calculate the internal rate of return.

Internal rate of return comparison				
Year	**End of year age**	**Plan A** Loan Regime Investment (tax paid)	**Plan B** Economic Benefit Investment (tax paid)	**Plan C** Executive Bonus Investment (tax paid)
1	56	1,540	2,463	40,000
2	57	3,080	2,761	40,000
3	58	4,620	3,060	40,000
4	59	6,160	3,338	40,000
5	60	7,700	3,597	40,000
6	61	9,240	3,907	40,000
7	62	10,780	4,335	40,000
8	63	12,320	4,843	40,000
9	64	13,860	5,499	40,000
10	65	15,400	6,275	40,000
Annual distribution for 15 years		82,750	77,141	67,668
Internal rate of return		28.07%	38.11%	8.00%
Tax adjusted IRR		46.79%	63.51%	13.33%
Retirement bonus		1,000,000	1,139,505	N/A
Tax on retirement bonus		400,000	455,802	N/A

It's obvious that the split dollar arrangements are more efficient than the executive bonus, primarily because the entire $100,000 is going into the policy instead of the $60,000 of after-tax dollars.

The internal rate of return is best for economic benefit split dollar. Loan regime split dollar has better cash flow and less tax at rollout, but economic benefit requires less income tax during the premium paying years. Because the key employee's investment is so small, the internal rates of return for the split dollar plans are very impressive.

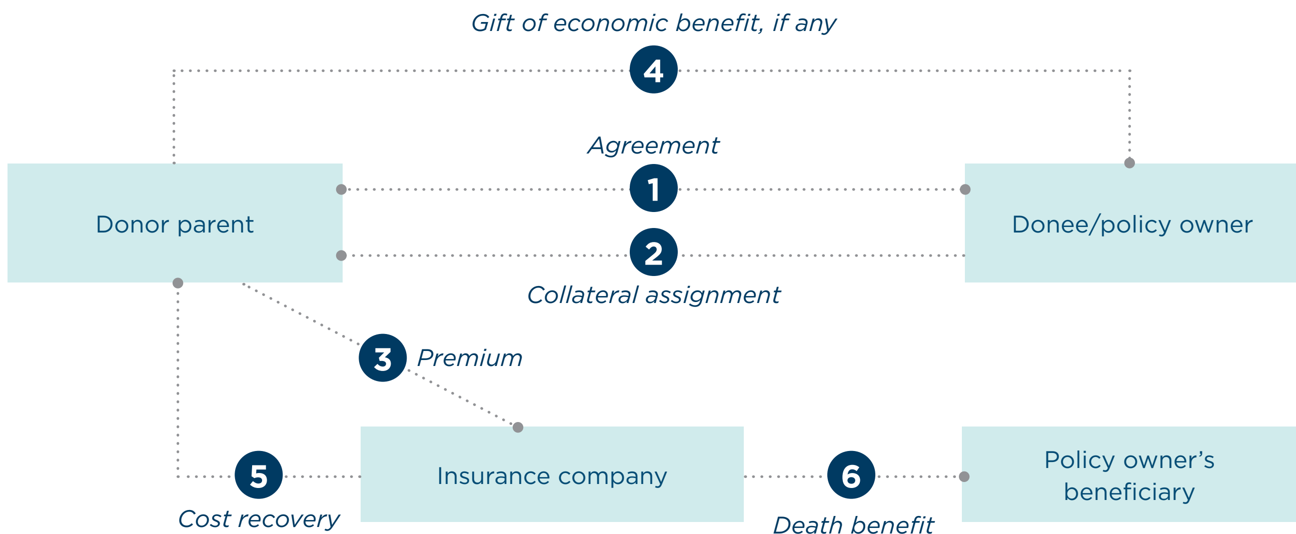
All three approaches are tax adjusted for a 40% income tax rate. The tax adjustment is necessary because most retirement income is taxable (e.g. pensions, 401(k) and IRA distributions). To make the income tax-free cash flow from an insurance-based retirement plan (IBRP) comparable to taxable retirement income, the income tax-free cash flow has to be grossed up.

The income tax-free nature of IBRP distributions is more important today than ever because of the 39.6% top income tax bracket and the 3.8% supplemental Medicare tax on net investment income. In the IBRP, the cash flow is never included in gross income, so it avoids both the potentially higher income tax and the potential Medicare tax.

Case study #2

Nonequity loan regime family split dollar arrangement

1. The donor/parent and the donee/policyowner enter into a nonequity loan regime split dollar agreement
2. The donee/policy owner collaterally assigns an interest equal to the greater of premiums paid or policy cash values and the death benefit to the donor/parent
3. Life insurance policy premiums are paid in accordance with the split dollar agreement
4. If the donor/parent pays the entire premium, the "economic benefit" amount is an imputed gift from the donor/parent to the donee/policy owner
5. At the death of the insured or termination of the split dollar agreement, the donor/parent is reimbursed his or her costs
6. The donee/policy owner's beneficiary receives the death benefit income tax free



It's important to note that **these premium advances are loans, not gifts**. Also, under the terms of the split dollar agreement and collateral assignment, **the donor/parent controls the access to the policy cash values**. Finally, at the donee/policy owner's death, the insurance company pays the death proceeds to the donee/policy owner's beneficiary and the donor/parent according to the terms of the split dollar agreement and the collateral assignment.

In terms of tax consequences, each year the donor/parent is deemed to make a gift to the donee/policy owner equal to the economic benefit less any premium contribution by the donee/policy owner. This means that if the donee/policy owner is contributing an amount equal to the economic benefit (the value of the net life insurance coverage based on term insurance rates), there is deemed to be no gift by the donor/parent. Typically, however, the donor/parent will pay the entire premium, and the amount of the economic benefit will be deemed a gift by the donor/parent to the donee/policy owner. If the donee/policy owner pays a portion of the premium, that amount will be considered income to the donor/parent.

From a practical perspective, there's a possibility that the donor/parent will predecease the insured donee/policy owner. If that happens, the donee/policy owner will need to continue premium payments or a substitute payer may be needed. As an alternative, the donor/parent may prefund the arrangement with a transfer of funds sufficient to cover future anticipated premiums. Since that transfer would be subject to a collateral assignment to the donor/parent and his or her estate, this wouldn't result in a gift by the donor/parent. Note that if the donor/parent dies while the split dollar arrangement is in effect, the donor/parent's gross estate will include the policy cash values.

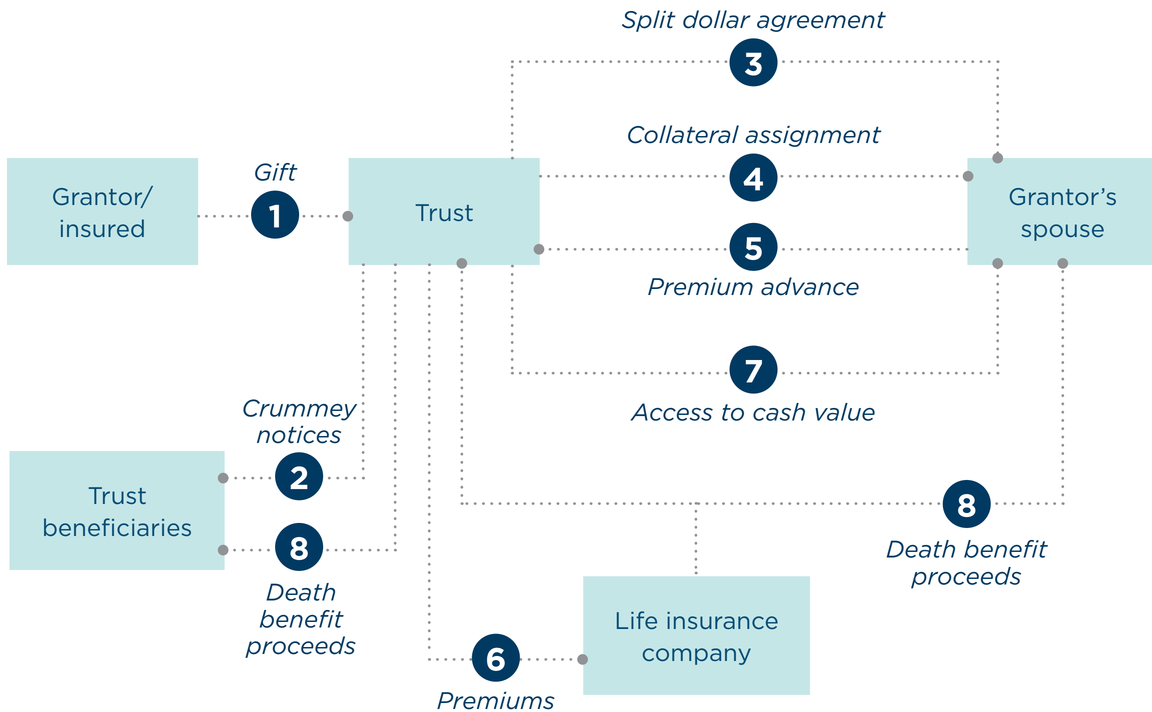
Remember that as the insured ages, the economic benefit amount increases, and thereby, increases the donee/policy owner's portion of the premium payment and the donor's gift. This means that the parties should consider and plan for a rollout or termination strategy when the split dollar arrangement is set up. Some alternatives to consider are:

- The donor/parent could make gifts to the donee/policy owner using the annual gift tax exclusion and gift tax applicable exclusion so that such amounts accumulate for purposes of the future rollout
- The donor/parent could forgive the repayment, which would result in a gift to the donee/policy owner that could be offset against the donor/parent's annual gift tax exclusion and gift tax applicable exclusion
- The donor/parent could establish a grantor retained annuity trust (GRAT) with the donee/policy owner the remainder beneficiary; the term of the GRAT should be structured to match the planned duration of the split dollar arrangement so the payment of the remainder interest from the GRAT matches the rollout of the split dollar arrangement

Case study #3

Nonequity loan regime spousal/estate liquidity split dollar arrangement

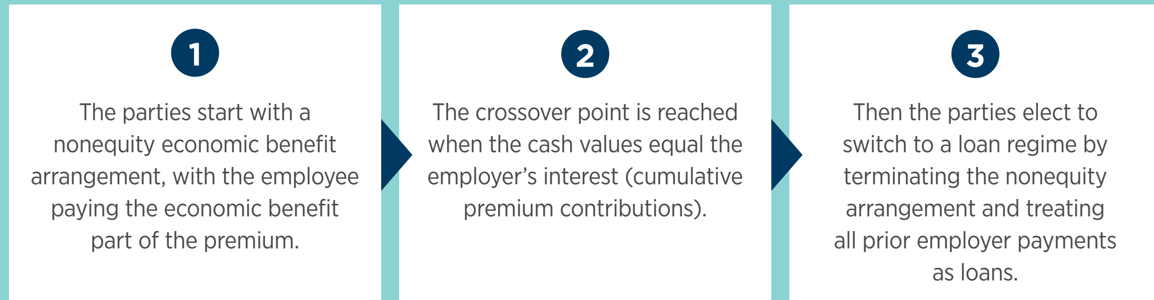
1. The grantor/insured establishes an irrevocable life insurance trust (ILIT) and makes a gift from his or her separate assets
2. The trustee makes the gift available to the trust beneficiaries pursuant to the Crummey provisions of the trust agreement
3. The trustee applies for a policy on the grantor's life and enters into a loan regime nonequity split dollar agreement with the grantor insured's spouse and uses the grantor's gift to pay a premium equal to the economic benefit of the death benefit that is payable to the ILIT; the insured's spouse pays the balance (i.e., lends the balance of the premiums to the ILIT)
4. The trustee executes a collateral assignment in favor of the spouse for an amount equal to the premiums borrowed from the insured's spouse or the total cash surrender value of the policy, whichever is greater
5. The insured's spouse lends premium amounts in excess of the economic benefit to the trust from separate assets (this is not a gift; it is a loan)
6. After the expiration of the Crummey withdrawal period, the trustee pays the life insurance policy premiums to the life insurance company
7. Under the terms of the split dollar agreement and collateral assignment, the insured's spouse controls the access to the policy cash values and can use them for the family's benefit
8. At the insured's death, the life company pays the death benefit to the trust and the spouse according to the terms of the split dollar agreement and the collateral assignment



Due to the escalating cost of the economic benefit, the parties should consider establishing an exit strategy or rollout at the appropriate time. As discussed previously with regard to family split dollar arrangements, this might include the grantor insured's spouse making gifts to the trust that are large enough to fund the future rollout of the arrangement by having the trustee use those funds to pay off the grantor insured's spouse. Alternatively, as explained previously, the grantor insured's spouse could establish a GRAT and time its termination with the rollout of the split dollar arrangement.

Switch dollar life insurance

The switch dollar concept represents an attempt to let the parties to a split dollar arrangement take advantage of low economic benefit costs during the early years of the arrangement, while still avoiding a tax on any equity at rollout.



The result is that any equity developed after the switch accrues for the employee's benefit without being taxed to the employee at a subsequent rollout. While attractive, this technique leaves some questions to be answered:

- Should there be an exit strategy for repaying the employer during the employee's life as well as at death?
- Will the policy cash value that is used to determine the employer's interest at the time of the switch be measured before or after surrender charges?

The history and development of split dollar

The evolution of split dollar has covered several periods. It began in 1955 with the IRS's view that split dollar was an interest-free loan that entailed no tax consequences. In 1964-1966, the IRS revisited the issue and decided split dollar resulted in a transfer of economic benefit to employees in the form of current life insurance protection, and that this benefit could be measured using government PS 58 rates or the insurance company's term rates if lower and available to all standard risks.[9]

However, the IRS didn't clearly address the tax treatment of "equity" arrangements in which the employer's premium contributions accrued for the employee's benefit. The first attempt to raise this issue appeared in an IRS Technical Advice Memorandum. It was controversial because the IRS ruled that employees should not only be taxed on the value of current life insurance protection, but also on cash values as they accrued for the employees' benefit.[10]

The public reaction over taxation of equity arrangements and disagreement about the proper use of insurers' term rates to measure the value of employees' current life insurance protection led to the issuance of two IRS notices and temporary regulations, which provided interim guidance on the tax treatment of split dollar until final regulations were issued on September 18, 2003.[11]

1955

IRS considered split dollar an interest-free loan with no tax consequences.

1964-66

IRS decided split dollar was a transfer of economic benefit to employees.

2003

IRS issued final regulations on the tax treatment of split dollar.

[9] Rev. rulings 64-328 and 66-110.

[10] TAM 9604001.

[11] IRS Notices 2001-10, 2002-8, Reg. 164754-01, Reg. 1.61-22(j)(1)(i), Reg. 1.83-6(a)(ii)(A), Reg. 1.301-1(q)(4)(i), and Reg. 1.7872-15(n)(1).

1964

Split dollar methods

When the IRS started taxing split dollar in 1964 with the release of Rev. Rul. 64-328, it recognized two contractual forms of split dollar arrangements:

Collateral-assignment method	
Insured	Employee
Owner	Employee
Premium payment	Employee has primary responsibility for paying premiums. Employer contributes an amount each year equal to the annual increase in the policy's cash surrender value.
Premium reimbursement	Employee collaterally assigns the policy to the employer to ensure the return of the employer's premium advances: • Before death, reimbursement, in full or part, comes from the policy's cash value • After death, reimbursement comes from the death proceeds and the employee's beneficiary receives the balance

Endorsement method	
Insured	Employee
Owner	Employer
Premium payment	Employer has primary responsibility for paying premiums. Employee reimburses employer for premiums in excess of the increase in the policy's cash surrender value.
Premium reimbursement	Employer designates itself beneficiary for an amount equal to the policy's surrender value to ensure the return of premium advances, and the employee selects a beneficiary for the remainder: • Before death, reimbursement comes from the policy's cash value • After death, reimbursement comes from the death proceeds and the employee's beneficiary receives the balance

1996-2003

Tax treatment of cash values

To understand the controversy over the taxation of cash values that accrue for the employee's benefit, it's helpful to compare the nonequity and equity approaches to split dollar.

Nonequity approach	Equity approach
Employer's interest in the policy's cash value is equal to the greater of the cash value or its total premium advances, so the employer owns any cash values in excess of its premium contributions.	Employer's interest in the policy's cash value is limited to the amount of its total premium contributions, with any excess belonging to the employee.

Providing ownership of this excess to the employee raises the issue of how it should be taxed to the employee. This led to the release of TAM 9604001, which caused much controversy and led the IRS to issue interim guidance pending the effective date of final regulations.

Replacing policies under pre-January 28, 2002 split dollar agreements

Along with providing interim guidance on how to value life insurance protection, Notice 2002-8 gave taxpayers a set of rules they could follow to avoid adverse income tax consequences on the termination of pre-January 28, 2002 equity split dollar plans, whether endorsement or collateral assignment:

- They could either terminate the plan or convert it to a loan arrangement before January 1, 2004
- As an alternative, they could avoid taxation of the employee's share of the cash value as long as the arrangement was kept in effect and the employee annually reported the value of current life insurance protection as taxable income

A substantial number of those with existing equity split dollar arrangements didn't take advantage of the grandfathering opportunities under Notice 2002-8. Those who didn't bail out of pre-January 28, 2002 equity split dollar life insurance arrangements by January 1, 2004, are facing the consequences of that decision, and **the tax cost of either continuing or terminating these arrangements increases with the passage of time**.

- **The higher cost of continuing these plans** is tied to the annually increasing term life insurance rates used to measure the value of the coverage that is taxed to the employee each year
- **The escalating cost of termination** stems from the increasing share of the policy's cash value that will be taxed to the employee at potential rollout

What to do when you uncover a pre-January 28, 2002 split dollar arrangement where they didn't take advantage of the grandfathering opportunities and the taxpayer may be better off with a new replacement policy.

- **Replacement considerations for equity plans**
  When considering replacement, you must understand that the transaction **will probably be treated as a termination of the split dollar arrangement and take the policy outside of the protection of the grandfather rules** of Notice 2002-8. For an equity plan, this means the employee's share of the cash value may be taxed to the employee at termination of the plan. It's important to compare the potential premium savings for the employer and any other advantages of the replacement to the potential taxes incurred by the employee on the equity cash value of the existing policy at termination of the plan.

  Note that even where replacement isn't an issue, if the policy has accumulated little or no equity, it may be advisable to terminate the plan unless the employee is in bad health and needs the coverage. This is because the tax on the reportable economic benefit will increase with the employee's age until it may force a termination of the plan, at which point the employee may be taxed on an even larger amount of cash value.

- **Replacement considerations for nonequity plans**
  In the case of nonequity plans, beyond the usual replacement issues, the split dollar related question is what effect taking the plan outside of the grandfather rules of Notice 2002-8 has on the reporting of the annual economic benefit from the coverage. That means **going from using the life company's lower term rates on the existing policy to Table 2001 for the replacement policy unless the new carrier has a qualifying term contract**. To put that into perspective, you should understand that at age 55 the Table 2001 rate is only around a third of the PS 58 rate, but may be several times higher than a company's grandfathered alternative term rate.

  As a result, the decision rests on whether the possible premium savings and other advantages of the replacement policy override any higher reportable income to the employee on the new coverage if the policy is to be maintained under a new nonequity split dollar arrangement.

  If replacement isn't an issue, it comes down to determining at which point the plan will have to be terminated because the reportable economic benefit to the employee is too high to justify the coverage. But the coverage may still be worth keeping if the employee needs it and is in poor health.

Reference

Tax basis in the policy under the economic benefit method

According to the final regulations, the nonowner of the policy isn't entitled to receive a tax basis in the policy for premiums he or she paid or for the value of current life insurance protection included in income. Previously, the IRS had given mixed signals on the subject of using premium contributions to offset imputed income and adding basis in the contract.[12]

Tax basis in the policy under loan regime method

The basis of an employee's policy in a loan regime situation (after the employer either forgives the loan as a retirement bonus or is repaid out of policy values) would be premiums paid minus any withdrawal to repay the employer.

Contributory arrangements under the economic benefit method

It's interesting to note that the final regulations provide that any amount paid by the employee for current life insurance protection or any other benefit is income to the employer.

Tax treatment of premiums

IRC § 264(a)(1) provides that no deduction is allowed for premiums on any life insurance policy if the taxpayer is directly or indirectly a beneficiary under the policy. This means that the sponsor (employer/corporation/grantor/lender) won't be entitled to an income tax deduction for the payment of premiums.

[12] PLRs 7916029 and 8310027.

Tax treatment of death benefits under the economic benefit method

The amount of death benefit paid to the employee's beneficiary that is attributable to the amount of income recognized by the employee or paid for by the employee is income tax free to the employee's beneficiary under IRC § 101.

Due to abuses commonly referred to as "janitor insurance," new § 101(j) was created by the Pension Protection Act of 2006. It states that unless certain requirements are met, the death proceeds of employer-owned life insurance paid to the employer will be taxable to the extent they exceed the premiums and other costs paid by the employer. The IRS has released Notice 2009-48, which provides guidance on the application of § 101(j) to split dollar life insurance.[13]

According to IRC § 101(j) with employer-owned life insurance policies that are issued or modified after August 17, 2006, the death benefit is taxable where it exceeds the employer's cost basis in the contract. However, if one of the following exceptions applies, and the notice and consent requirements are met, the death benefit will not be subject to tax.

Exception one — For employees who fall into one of the following categories:

- Working for the employer within 12 months of the date of death
- A director
- A highly compensated individual; "highly compensated" is defined as one of the following:
  - One of the five highest-paid officers
  - Among the highest-paid 35% of all employees

Exception two — For life insurance proceeds that fall into one of the following categories:

- Payable directly to heirs or beneficiaries
- Payable to a trust that benefits the heirs or beneficiaries
- Payable to the estate of the insured
- Used to buy the deceased individual's equity interest in the employer

[13] Notice 2009-48, 2009-24 IRB 1085, 05/22/209.

Notice and written consent requirements:

- The employer must notify insured individuals in writing regarding the maximum amount of insurance that may be obtained, as well as the fact that the coverage may be maintained after the insured person no longer works for the employer
- The employer must also receive a written acknowledgment from each employee indicating that he or she accepts the provisions listed above.

In addition to the requirements listed above, IRC § 6039I requires employers to attach a Form 8925 to the employer's annual income tax return stating:

- The number of employees at the end of the year
- The number of employees insured at the end of the year
- The total amount of insurance in force at the end of the year
- The employer's name, address, taxpayer identification number and the type of business
- The employer has valid consent for each insured employee, or the number of employees from whom consent was not obtained

Rollout

When establishing a split dollar life insurance arrangement, it's important to understand that they're normally terminated upon the following occasions:

- The employee's death
- The termination of the employee's employment
- Surrender of the policy
- The employee's imputed income from the value of current life insurance protection reaches a crossover point and begins to exceed the premium

The termination of an arrangement for a reason other than the employee's death is referred to as "rollout" and is generally planned for when the split dollar arrangement is created. The most likely events to cause rollout are the employee's retirement or reaching the crossover point where imputed income starts to exceed the policy's actual premium.

The rollout of economic benefit split dollar depends on whether the arrangement was non-equity or equity split dollar.

For non-equity, there are three alternatives:

1. The employer will surrender the policy for its cash value, and the arrangement will terminate; the employer will be taxed on any excess of policy value over premiums paid
2. The employer will recover its premiums, then transfer the policy to the insured; the insured will be taxed on the remaining fair market value
3. The employer will transfer the entire policy to the insured employee; the employee will be taxed on the fair market value of the policy, and the employer will get an income tax deduction for premiums paid, possibly adjusted for expired cost of insurance

For the seldom-used equity arrangements, the employer may:

1. Recover its premiums and transfer the remainder to the insured, in which case there will be no taxation because the insured was taxed on the equity as it accrued
2. Transfer the entire policy to the insured, in which case the insured will be taxed on the premiums, and the employer will get a corresponding income tax deduction

The rollout for loan regime split dollar also depends on whether the arrangement was non-equity or equity.

For non-equity loan regime:

1. The employee surrenders the policy, the employer keeps any gain in the policy as taxable income and the employee repays the loan from policy basis
2. The employee keeps the policy and will repay the loan from either policy values or outside funds; the employer transfers the rights to any gain to the employee as tax-deductible income distribution for the employer and taxable income for employee
3. The employee keeps the policy and employer forgives the loan and all forgiven loan amounts and transferred gain are tax-deductible income distribution for the employer and taxable income to the employee

For equity loan regime:

1. The employee surrenders the policy and is taxed on any gain in the policy and repays the loan from policy basis
2. The employee keeps the policy and will repay the loan from either policy values or outside funds; there is no tax deduction for employer or taxable income for employee
3. The employee keeps the policy and employer forgives the loan and all forgiven loan amounts are tax-deductible income distribution for the employer and taxable income to employee

Subchapter S corporations

With Subchapter S corporations, **noncontributory split dollar plans (where the employee isn't personally paying any portion of the premiums) subject employee/shareholders to a form of double taxation**. The reason is that the employee/shareholder must recognize taxable income on both the passed through non-deductible premium contribution and the economic benefit (imputed income) for the value of the personal life insurance protection. Fortunately, contributory plans (economic benefit regime plans under the final regulations) avoid this double trap since the employee/shareholder may offset the imputed income with premium contributions.

It's also important to **make sure the creation of the split dollar arrangements for a Subchapter S shareholder doesn't create a second class of stock**. Subchapter S corporations are only permitted one class of stock, so if the economic benefits stemming from the split dollar plan are deemed to create another class of stock, the Subchapter S election is automatically revoked. In any case, the IRS has held that there is no second class of stock if the corporation is reimbursed for the value of the insurance protection received by the covered shareholder. See PLRs 9331009, 9309046, 9413023, 9651017 and 9735006.

Split dollar death proceeds under the estate tax

According to IRC § 2042, if an insured has any incidents of ownership in life insurance on his or her life at the time of death, either alone or with any other person, the death proceeds are includible in the insured's estate. The tax court held in the case of Eleanor M. Schwager, 64 T.C. 781 (1975) that **the incidents of ownership rules apply to split dollar life insurance arrangements**.

The preamble to the final regulations states that for estate tax purposes:

> *"... regardless of who is treated as the owner of a life insurance contract the inclusion of the policy proceeds in a decedent's gross estate will continue to be determined under section 2042. Thus, the policy proceeds will be included in the decedent's gross estate under 2042(1) if receivable by the decedent's executor, or under 2042(2) if the policy proceeds are receivable by a beneficiary other than the decedent's estate and the decedent possessed any incidents of ownership with respect to the policy."*

This seems to mean that **the estate tax treatment of split dollar will continue to be governed by the rules that existed prior to the adoption of the final regulations**. Also, this view is supported by the fact that the release of the final regulations was accompanied by Rev. Rul. 2003-105, which announced that in connection with the release of the final regulations certain rulings were obsolete. None of the rulings listed governed the estate tax treatment of split dollar. This means that Rev. Ruls. 76-274 and 82-145 (addressing specific situations of estate inclusion/exclusion of split dollar arrangements) still apply. Tax counsel should be made aware of this issue so it can be addressed in the split dollar document.

Avoiding the estate tax with triangular split dollar

A way to avoid including split dollar death proceeds in the insured's gross estate is to establish a "triangular" split dollar plan. With these, **a third party (most likely the employee's ILIT) enters into the split dollar arrangement with the employer instead of the employee**. As a result, the insured possesses no incidents of ownership that could cause the proceeds to be included in his or her estate.

Triangular split dollar for controlling shareholders

Controlling shareholders have an additional problem with avoiding the inclusion of death proceeds in their gross estate through the use of triangular split dollar arrangements. While incidents of ownership can't be attributed to them through the third party, they will be attributed to them through the corporation because of their control of the corporation.

This seems to preclude using a triangular economic benefit method arrangement since under such an approach the corporation is the owner of the contract and its incidents of ownership will be attributed to the controlling shareholder. Reg. 20.2042-1 (6).

A possible solution is to use a triangular loan regime split dollar arrangement between an irrevocable life insurance trust and the corporation. The collateral assignment from the trust to the corporation in a loan regime arrangement severely limits the corporation's rights in the policy. Essentially, all policy rights are vested in the trustee, and the corporation is only entitled to reimbursement at the termination of the agreement, so no incidents of ownership should be attributed to the controlling shareholder.

The application of Employee Retirement Income Security Act (ERISA) to split dollar

ERISA coverage

Employee welfare benefit plans like split dollar life insurance plans, that are established for employees or their beneficiaries, are subject to ERISA's provisions on fiduciary responsibility, reporting and disclosure, and claims procedures. However, split dollar plans are entirely exempt from ERISA's participation, funding and vesting requirements.[14]

Fiduciary responsibility

Section 401(a) of ERISA requires that a plan be established and maintained pursuant to a written instrument, with one or more named fiduciaries that have authority to control or maintain the operation and administration of the plan.

Reporting and disclosure

ERISA's reporting and disclosure requirements are covered under Section 104 of ERISA and provide that, in the case of plans that are for a select group of employees or are small, there are certain exemptions from those requirements:

- **Exemption for select employees**
  The exemption for select employees applies where the participants are chosen from a group of management or highly compensated employees.[15] The benefits from such a plan must be paid from the employer's general assets or provided exclusively through insurance contracts or policies where the premiums are paid directly by the employer from its general assets. An employer-pay-all split dollar plan that meets these requirements will be exempt. On the other hand, if the employee or employee's beneficiary pays any portion of the premium under the plan, this exemption isn't available.

- **Exemption for small plans**
  This exemption[13] only applies to split dollar plans that (1) have fewer than 100 participants, (2) for which benefits are paid from the general assets of the employer or through insurance contracts or policies paid for by the employer or the employer and employees, and (3) for which any premium rebates on the employee contributions are returned to them within three months of the receipt by the employer. A plan that meets these requirements will be exempt from the reporting and disclosure requirements, except that the administrator must furnish copies of the summary plan description to participants and beneficiaries and provide certain documents to the secretary of labor upon request.

[14] PLRs 7916029 and 8310027.

[15] Labor Regulations § 2520.104-24.

ERISA claims procedure

According to § 503 of ERISA, a split dollar plan must have a claims procedure. Basically, this means the agreement with the employee must (1) include a provision for written notification of a denial of benefits (with an explanation for the denial), and (2) provide a "reasonable opportunity" for a "full and fair" review of the denial by the named fiduciary.

SEC disclosure rules and the Sarbanes-Oxley Act 2002

According to SEC rules governing the disclosure of executive compensation for purposes of proxy, registration and other federal securities law filings:

- The Table 2001 or similar amounts for coverage generated by employer premium contributions must be reported.
- If the employee has an interest in the policy's cash value, either the balance of the annual premium or any incremented increase in cash value, payable to the employee upon termination of the plan, must be reported. These reporting requirements apply to the CEOs of publicly traded companies and the four most highly paid executives (where compensation exceeds $100,000) employed at year end.

In addition, the Sarbanes-Oxley Act of 2002 **prevents public companies that are registered under the 1934 Securities Exchange Act from lending to directors and executive officers or their equivalents**. This limitation may apply to split dollar because of the characterization of loan regime arrangements as loans by the final regulations. (It may be less likely that the limitation would apply to economic benefit method arrangements.) The problem is made worse by the lack of clarity in the act's provision that was designed to leave out existing loan arrangements but which might capture future premium payments under such arrangements.

In any case, to avoid this risk, directors and executive officers or their equivalents should consider paying the entire premium from their own funds under existing arrangements until the law is clarified. That is because the penalties for violation of the law are criminal as well as civil. To the extent that this approach would present a financial burden to the participants, the company might pay a bonus, with or without a gross up for taxes, to the participants to cover the cost. It's important to note, however, that the act's provisions only apply to public companies and not non-public companies. Also, the final regulations don't address the application of Sarbanes-Oxley to split dollar since, in the view of the IRS, the interpretation and administration of that act fall within the jurisdiction of the Securities and Exchange Commission. In any event, most public companies chose to eliminate or freeze their split dollar plans in light of the Sarbanes-Oxley Act.

IRC § 409A and employer/employee split dollar

Internal Revenue Code § 409A was enacted to provide rules governing the taxation of non-qualified deferred compensation arrangements. In that regard, if an arrangement is subject to § 409A but is not in compliance with those rules, all deferred compensation under the arrangement is subject to immediate taxation to the employee plus a 20% penalty tax and an interest charge. Fortunately, split dollar life insurance arrangements aren't subject to § 409A if:

- The plan only provides death benefits for an employee[16]
- The plan is a loan regime arrangement and there is no agreement for the employer to forgive the loan[17]

On the other hand, a split dollar arrangement may be subject to § 409A where:

- Under an economic benefit arrangement the employer agrees to a future transfer of an interest in the policy to the employee
- The employer commits to pay premiums beyond the normal retirement age of the employee
- Under an equity loan regime arrangement that is expected to terminate at the employee's normal retirement date the employee has a vested right to compensation that is payable in a later year
- Under a loan regime split dollar arrangement the employer agrees to forgive the loan at retirement

[16] IRS Notice 2007-34.

[17] IRS Notices 2001-10, 2002-8, Reg. 164754-01, Reg. 1.61-22(j)(1)(i), Reg. 1.83-6(a)(ii)(A), Reg. 1.301-1(q)(4)(i), and Reg. 1.7872-15(n)(1).

Reverse split dollar

Reverse split dollar represents an attempt to move wealth from a corporation to an employee or owner employee under favorable tax consequences by theoretically reversing the roles of the employer and employee.

- The employer corporation pays a portion of each premium equal to the economic benefit of the death benefit that is payable to the corporation
- The employee pays the balance of the premium

The purported benefit of reverse split dollar is that the employer's share of the premium is determined using PS 58 rates rather than the insurer's lower term rates, which means:

- The employer is potentially overpaying for its death benefit protection that inures to the employee's benefit through the generation of cash values that belong to the employee and on which the employee is purportedly not taxed at termination of the arrangement during the employee's life
- The amount of benefit accruing to the employee through cash values may be enhanced by having the employer prepay premiums
- To the extent the prepaid premiums aren't applied before termination of the arrangement, the employer would be reimbursed for the unused amounts without regard to the time value of its money that helped generate cash values for the employee

In reaction to the development of the reverse split dollar concept, the IRS stated in Notice 2001-10 that using PS 58 rates to measure the cost of the employer's death benefit "overstates" the employer's investment and there is no published authority that authorizes the use of those rates.

Further, in Notice 2002-59 the IRS states that no authority authorizes the use of Table 2001 rates or an insurer's alternative term rates to measure the value of the employer's share of the death benefit.

Finally, Notice 2002-59 doesn't provide any guidance on how to measure the value of life insurance purchased by an employer under a reverse split dollar arrangement. This means any reverse spit dollar arrangement using PS 58, Table 2001 or an insurer's alternative term rates is likely to be the subject of IRS challenge and possible increased taxes, interest and penalties to the parties involved.

Table 2001 rates

Interim table of one-year term premiums for $1,000 of life insurance protection					
Attained age	Section 79 extended and interpolated annual rates	Attained age	Section 79 extended and interpolated annual rates	Attained age	Section 79 extended and interpolated annual rates
0	$0.70	34	$0.98	68	$16.92
1	$0.41	35	$0.99	69	$18.70
2	$0.27	36	$1.01	70	$20.62
3	$0.19	37	$1.04	71	$22.72
4	$0.13	38	$1.06	72	$25.07
5	$0.13	39	$1.07	73	$27.57
6	$0.14	40	$1.10	74	$30.18
7	$0.15	41	$1.13	75	$33.05
8	$0.16	42	$1.20	76	$36.33
9	$0.16	43	$1.29	77	$40.17
10	$0.16	44	$1.40	78	$44.33
11	$0.19	45	$1.53	79	$49.23
12	$0.24	46	$1.67	80	$54.56
13	$0.28	47	$1.83	81	$60.51
14	$0.33	48	$1.98	82	$66.74
15	$0.38	49	$2.13	83	$73.07
16	$0.52	50	$2.30	84	$80.35
17	$0.57	51	$2.52	85	$88.76
18	$0.59	52	$2.81	86	$99.16
19	$0.61	53	$3.20	87	$110.40
20	$0.62	54	$3.65	88	$121.85
21	$0.62	55	$4.15	89	$133.40
22	$0.64	56	$4.68	90	$144.30
23	$0.66	57	$5.20	91	$155.80
24	$0.68	58	$5.66	92	$168.75
25	$0.71	59	$6.06	93	$186.44
26	$0.73	60	$6.51	94	$206.70
27	$0.76	61	$7.11	95	$228.35
28	$0.80	62	$7.96	96	$250.01
29	$0.83	63	$9.08	97	$265.09
30	$0.87	64	$10.41	98	$270.11
31	$0.90	65	$11.90	99	$281.05
32	$0.93	66	$13.51		
33	$0.96	67	$15.20		

Nationwide YourLife® Annual Renewable Term rates

Annual rates per $1,000 of life insurance coverage for all available standard risks							
Attained age	Premium rate	Attained age	Premium rate	Attained age	Premium rate	Attained age	Premium rate
20	0.48	40	0.48	60	1.63	80	11.16
21	0.47	41	0.49	61	1.79	81	12.30
22	0.47	42	0.51	62	1.95	82	13.60
23	0.46	43	0.52	63	2.12	83	15.04
24	0.46	44	0.54	64	2.28	84	16.66
25	0.45	45	0.55	65	2.44	85	18.77
26	0.44	46	0.59	66	2.76	86	21.65
27	0.43	47	0.63	67	3.08	87	25.13
28	0.41	48	0.68	68	3.40	88	28.64
29	0.40	49	0.72	69	3.72	89	32.22
30	0.39	50	0.76	70	4.04	90	35.85
31	0.39	51	0.82	71	4.50	91	41.09
32	0.39	52	0.89	72	5.00	92	46.21
33	0.39	53	0.95	73	5.56	93	51.09
34	0.39	54	1.02	74	6.17	94	55.42
35	0.39	55	1.08	75	6.83	95	60.32
36	0.41	56	1.19	76	7.48	96	78.00
37	0.43	57	1.30	77	8.22	97	92.66
38	0.44	58	1.41	78	9.06		
39	0.46	59	1.52	79	10.07		

Note: taxpayers considering the use of the alternative rates for any purpose should consult with their qualified tax and legal advisors.

Remember these key points about split dollar:

1. The two types of split dollar arrangements that you can implement for your clients with life insurance are economic benefit and loan regime
2. The split dollar final regulations apply to arrangements entered into after September 17, 2003, and to those entered into on or before that date but materially modified after it
3. When implementing any split dollar plan, it's important to begin with the end in mind so the plan can be properly set up for potential future tax ramifications

Remember also that not all life insurance products and services are suitable for all clients or situations. Be sure to consider your clients' objectives, their need for cash flow and liquidity, and their overall risk tolerance when using any strategy.

Distributions from a life insurance policy will immediately reduce both the cash value and the death benefit, and may cause the need for additional premiums in the future to keep the policy in force. Care should be taken to ensure that your clients' life insurance needs continue to be met. Also note that investing involves market risk, including the possible loss of principal.

Let us know when we can help you.

We're happy to offer you this detailed guide on split dollar life insurance, but we can provide even more value by consulting with you on your split dollar cases. When you uncover an opportunity with a business client, contact your Nationwide wholesaler or our Advanced Consulting Group.

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