Life Insurance

Split-dollar life insurance arrangements: Basics, advantages, and disadvantages

By Joon Cho, JD

Split dollar is not a type of life insurance, but rather a term associated with life insurance. A split-dollar arrangement is an agreement between two parties to share the costs and benefits of a life insurance policy when one party has a need for insurance and the other party has the funds to make the purchase.

Split dollar is commonly used in business contexts between an employer and employee or a corporation and shareholder, as a benefit to employees through cost-sharing and insurance coverage. Split dollar also can be used in personal situations between an asset owner and a trust or between parents and their children.

Split dollar basics explained

In a typical split-dollar arrangement, the employer and employee will agree to split the cost of the premiums for a permanent life insurance policy. Split dollar may be structured depending on the specific needs and goals of the employer and employee.

While various split-dollar plans have been in existence for a considerable period of time, in 2003 the IRS issued updated regulations governing the types of permissible split-dollar agreements.

According to these revised regulations, only two types are permissible:

- Economic benefit (previously known as Endorsement Split Dollar); and
- Loan regime (previously known as Collateral Assignment Split Dollar).

Economic benefit split dollar

One common structure is known as an economic benefit split dollar arrangement, whereby the employer owns the policy and pays the policy premiums directly, while the employee either pays the term cost equivalent portion of the total premium paid by the employer, or reports the term cost equivalent for the death benefit as part of his/her taxable income.

Under this method, the employee has the option to calculate the annual term cost equivalent based on either IRS Table 2001 or the insurer's annual renewable term rates – whichever is lower. By carefully following this structure, the employee ensures a tax-free death benefit.[1]

Loan regime split dollar

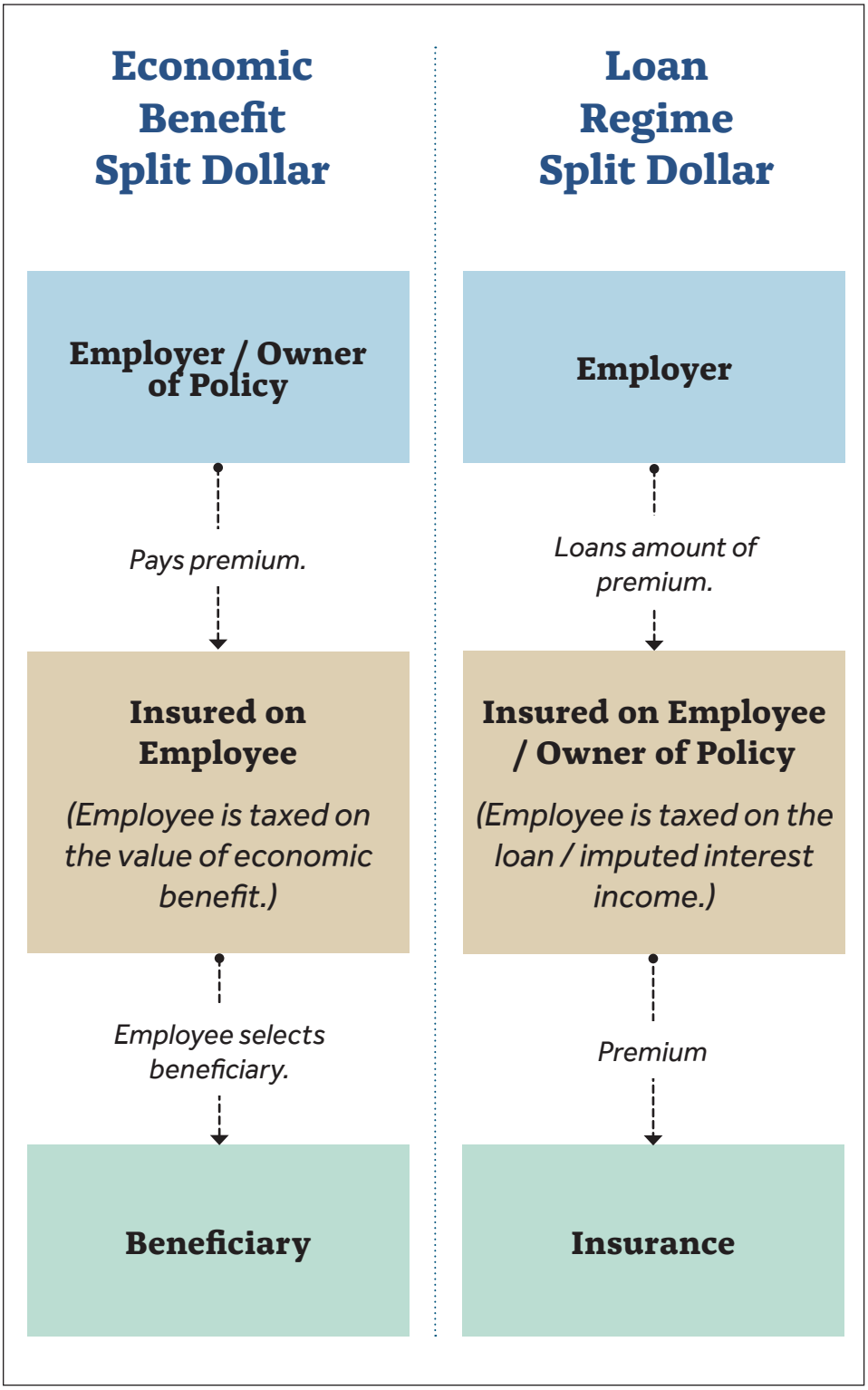
Another structure permitted for split-dollar arrangements is the loan regime split dollar method. In this scenario, the employee owns and controls the life insurance policy, while the employer provides a loan to cover the annual premium payments. The employer often demands that it has the right to recoup the loan amount from the policy's death benefit by an assignment equal to the loan amount.[2]

1 To ensure a tax-free death benefit, employers must follow IRC Section 101(j) and employees must include as income their economic benefit of the death benefit.

2 Publicly traded companies cannot use this strategy due to the Sarbanes-Oxley Act.

The loan regime split-dollar arrangement also can allow the employer to lend to the employee's irrevocable trust the annual premium required for a life insurance policy; the loan balance equals the total premiums paid. The employee agrees to repay the loan at retirement either by using policy cash values or other accumulated surplus capital, or at death using life insurance proceeds.

The employee has the option to either pay the loan interest annually or allow it to accrue over time, with the accrued interest added to the outstanding loan balance. The interest rate for the loan is determined by a fair market rate that cannot be less than the Applicable Federal Rate, per Internal Revenue Code §7872, to avoid an adverse income tax impact.



Advantages

Retaining a key employee. One of the main advantages of split dollar is that it can provide a valuable benefit to employees while also allowing employers to retain control over the policy. In the business world, retaining a key employee often can be challenging. This strategy can be particularly useful in such situations where an employee may leave the company before the policy's maturity date. It may act as an incentive to the employee to remain with the company.

Retirement benefit. Split dollar can be a useful tool for retirement planning strategy, as it allows employers to provide key employees with a retirement benefit, using potential cash value growth of the life insurance policy, that is not tied to the company's overall financial health.[3]

Permanent life insurance. Sharing the cost of life insurance gives both the employer and the employee a reduced cost option for funding a permanent life insurance solution.

Avoidance of insurability issues. Ensures continued coverage of the employee in the future in spite of issues that may arise due to declining health or injury.

3 Before entering into a split-dollar arrangement, both parties are encouraged to consult with financial, legal, and tax professionals to ensure their interests are preserved.

Disadvantages

Complexity. Split-dollar arrangement can be complex to set up and administer, involving legal agreements, calculations, and ongoing monitoring. Often, the expertise of a CPA or third-party administrator is required.

Tax implications. The tax treatment of split-dollar arrangements can be intricate and may change based on regulatory updates. Depending on the structure of the arrangement, the policy holder (employee) might face imputed income, potential gift tax issues, and other tax complexities, whereas the employers might encounter tax considerations related to loans or premium payments.

Loan interest. In the case of loan regime split dollar, the employer typically provides a loan to the employee to cover premium costs. Such a loan can accumulate interest over time, which the employee is responsible for repaying. The interest rates and potential changes can impact the overall cost of the arrangement for the employee.

Final thoughts

Split dollar is a complex life insurance arrangement that can be useful in certain business contexts. In a very competitive business world, this added benefit may make the difference in attracting the right employee. However, there are potential complexities that come with this type of benefit. Therefore it is important to carefully consider the advantages and disadvantages, while consulting with financial, legal, and tax professionals who can help guide the decision-making process.

Joon Cho, JD, joined New York Life in 2009 as an Advanced Planning Consultant. He was recruited to The Nautilus Group in 2014, where he assists Nautilus members in identifying life insurance protection opportunities for their clients. Joon has worked in the financial industry since 2000 and previously ran an advisory practice for affluent and high-net-worth clients. He also served as a commissioner for the Fairfax County, VA, Human Rights Commission for two terms. Joon earned his bachelor of arts degree from Calvin College in Grand Rapids, MI, and his JD from Suffolk University Law School in Boston. He currently holds FINRA Series 7 and Series 66 licenses.

Employers should be aware that the arrangements described herein may be subject to the Employee Retirement Income Security Action of 1974, as amended (ERISA) and Internal Revenue Code 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"). IRC Section 409A imposes certain requirements that, if not satisfied, can result in adverse tax consequences to employees. Employers should consult with their legal and tax advisors regarding the implications of ERISA and IRC Section 409A on adopting these arrangements in their particular circumstances. Loans against your policy accrue interest and decrease the death benefit and available cash surrender value by the amount of the outstanding loan and interest. Accessing cash value will reduce the available cash surrender value and death benefit. These materials are prepared by The Nautilus Group®, a service of New York Life Insurance Company, and are made available to all Nautilus Group member agents, and as a courtesy, to select agents of New York Life Insurance Company. Nautilus, New York Life Insurance Company, its employees and agents are not in the business of providing tax, legal, or accounting advice. Individuals should consult with their own tax, legal, or accounting advisors before implementing any planning strategies. SMRU 5984060 Exp. 9/30/2028