Split Dollar Life Insurance Retirement Plan Basics

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Split dollar life insurance is an arrangement between an employer and an employee to share the cost and benefits of a life insurance policy. Split dollar is an important part of the compensation package for many key employees. Split dollar arrangements are used to provide a non-qualified fringe benefit to a select group of key employees where the company's primary concerns are flexibility in selecting participants, current benefit to the executive, overall value and cost recovery.

Split dollar life insurance is also used in gift and estate planning.[1]

In a split dollar arrangement, the employer and the employee purchase an insurance policy on the life of the employee and agree, in writing, to split the cost of the insurance premiums, the policy's death proceeds, and cash value. The agreement usually takes one of two forms:

Endorsement Form: The employer owns the life insurance contract and an employer-employee contract specifies the death proceeds payable to the employee's beneficiary.

Collateral Assignment Form: the employee owns the contract. The employer advances premiums to the employee to pay the premiums. A collateral assignment of the policy and benefits secures the advances.[2]

Split dollar insurance arrangements are, almost without exception, funded using permanent (cash value) insurance policies – e.g. whole life, universal life, second-to-die (survivorship). If the employer retains ownership of the policy, the employer's interest in the policy's cash value is reported in the employer's balance sheet.

Split dollar plans can be used to:

- Attract, motivate, and retain employees
- Provide low-cost life insurance protection to employees
- Fund severance benefits
- Fund stock purchase agreements
- Fund nonqualified deferred compensation plans

Split dollar life insurance offers advantages to both the employer and the employee:

- Split dollar arrangements are generally not subject to Employee Retirement Income Security Act (ERISA) nondiscrimination rules. The arrangement need not cover all employees--the coverage, amounts, and terms of the split dollar arrangement are negotiable on a case by case basis.
- Split dollar plans allow employees to obtain life insurance coverage using employer funds.
- The employer's investment is secured. If the insured employee dies or his or her employment is terminated, the employer is reimbursed for its premium payments from the policy proceeds.
- Split dollar plans can be customized to meet the objectives of both employer and employees.

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[1] Non-business plans are most often set up between individuals (private split-dollar plans) or through an irrevocable life insurance trust (ILIT).

[2] Sarbanes-Oxley limits the use of collateral assignment split dollar insurance by public companies.

- The death benefit from a split dollar plan (both the employer's share and the share going to the beneficiary of the employee) is generally free from income tax.
- As benefit plans go, Split Dollar plan administration is simple. Most companies administer the plan themselves with the help of their accountant.

Split dollar plans have some disadvantages as well:

- The Employer generally receive no tax deduction for its share of premium payments under the split dollar plan.
- Depending on how the agreement is structured,
    - employees may have to pay income tax on the value of the economic benefits provided to them each year.
    - if the employer's premium payments are considered a series of loans to the employee, the employee must pay a reasonable rate of interest to the employer. Otherwise, the employee is considered to have received taxable interest under the deemed interest rule.

Two sets of tax rules govern split dollar arrangements.

- Endorsement arrangements: The employer is treated as transferring "economic benefits" to the employee. The employee includes in taxable income, the value of the life insurance premium provided by the employer, plus the employee’s portion of the increase in cash value (if any) of the policy during the employee’s taxable year.

- Collateral Assignment arrangements: The employer is treated as lending premium payments to the employee. The loan agreement determines taxation unless the imputed interest rules apply.

	Employer	Employee
Premium Paid (Income Tax)	Non-deductible Note: a pre-arranged promise to transfer the employer’s interest to the employee is a deferred compensation arrangement subject to the rules of IRC409A	Reports all or portion of employer paid premiums and contract-gain income computed using IRS Table 2001. Collateral Arrangement: May include imputed interest in income if stated interest rate insufficient. Neither premium paid nor interest (actual or imputed) is deductible.
Benefit Received (Income Tax)	Not included in ordinary income. (But see IRC §101(j))	Not included in income
Estate Tax	Not Applicable	Includable in gross estate if incidents of ownership[3] are retained.

[3] Incidents include: Ownership of the life insurance policy, the right to change the beneficiary of the policy, to borrow against the policy, or to use it as collateral for a loan. Treas. Reg. § 20.2042-1(c)(2) As a practical matter, almost all proceeds are includible.

	Employer	Employee
Post Death or Conversion (Income Tax)	Benefit received as lump sum – Not Applicable Benefit received in installments – interest on installments is included in gross taxable income	Benefit received as lump sum – Not Applicable Benefit received in installments – interest on installments included in gross taxable income

Death, retirement, and succession options for split dollar plans include:

- Do nothing, continue the plan: The employee continues to be taxed on either the economic benefit or loan interest, if not required to be paid.

- Terminate the plan:
    - Endorsement Plan: the employer can either continue the policy and name itself as beneficiary or surrender the policy for its cash value.
    - Collateral Assignment: the employee loan must be paid back to the employer.

- Policy Roll Out (transfer to the employee):
    - Endorsement Plan; usually structured as a bonus to the employee.
    - Collateral Assignment: the employer releases the collateral assignment. In either scenario, the employee is taxed on the value of the contract and the employer receives a tax deduction.[4]

This document is general in nature and may not apply to your circumstances. The document is not intended as financial, investment, business planning, or tax advice and may not be relied upon for those purposes. For detailed information about split dollar life insurance plans please consult you financial and tax advisors.

To speak with a Steven Roy Management representative about split dollar plans, call us at [818] 489-4228 or contact us at Steven@StevenRoyManagement.Com

[4] A pre-arranged promise to transfer the employer's interest to the employee is a deferred compensation arrangement subject to the rules of IRC409A. Section 409A requires a written plan document and limits the circumstances for triggering the receipt of benefits as well as certain alterations of benefits (for example, a provision allowing the participant to accelerate retirement benefits is generally not allowed). If the requirements of Section 409A are not met, the employee may be subject to less favorable tax treatment.