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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.



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**TOPIC: Split Dollar Opportunities for Closely-Held Businesses.**

**MARKET TREND:** With higher income tax rates but lower interest rates, split-dollar arrangements remain prevalent in closely-held business planning. A split-dollar arrangement is a flexible and cost-effective tool for leveraging the purchase of life insurance to serve multiple business objectives, including compensation, retirement and buy-out planning.

**SYNOPSIS:** Split-dollar arrangements allow closely-held businesses to share the costs of life insurance coverage with an insured employee or owner on an efficient basis, which can achieve multiple business objectives, including: (1) attracting and compensating key employees, (2) supplementing retirement benefits, and/or (3) funding buy-outs upon a business owner's death or retirement. Developing the most cost-efficient arrangement requires advisers to identify who wants (and should) own the policy, which is the most cost-effective structure for policy acquisition, and who will ultimately benefit from any excess growth in the policy's cash value.

**TAKE AWAYS:** Illustrating how a split-dollar arrangement can share the costs of premium funding may facilitate the business' acquisition of needed coverage. The arrangement's overall success, however, will require monitoring and management of the associated economics for both parties, from formation through termination. Even with an adviser's support, navigating the tax, compliance and administrative requirements of a successful split-dollar plan requires technical knowledge and precision. Thus, advisers should work with a strong team of legal and accounting professionals to achieve optimum planning results for business split-dollar plans.

***PRIOR REPORTS: 14-15; 12-39.***

Split-dollar arrangements ("**SDAs**") are a common yet powerful planning tool for leveraging the acquisition of life insurance to serve multiple business objectives, including compensation, retirement and buy-out planning for the acquisition and retention of key executives and owners. Selection of the appropriate and most cost-efficient arrangement requires advisers to match the available options with the goals and needs of the business.

***BUSINESS SDAs – THE BASICS***

Purpose. SDAs share the costs of buying a life insurance policy between a business and its insured employee, executive and/or owner (or, in many cases, the insured's irrevocable life insurance trust, "**ILIT**"). Typically, the business funds most or all the premiums, retaining a right to repayment (secured by or paid from the policy proceeds) upon the insured's death or earlier termination of the SDA. In a "non-equity" arrangement, the only benefit provided to the insured is current life insurance protection, and the business retains the right to any growth in policy cash value in excess of the premiums it advances (the policy "**equity**"). In an "equity" arrangement, the insured or the insured's ILIT generally retains the right to any policy equity upon termination of the SDA.

Policy Ownership. Typical ownership structures for SDAs include (1) the endorsement method, where the business is the policy owner and beneficiary and "endorses" the insured's interest in the policy death benefit (*i.e.*, the amount in excess of the business' premium advances) to the insured or his/her ILIT and (2) the collateral assignment method, where the insured (or his/her ILIT) owns the policy, designates the beneficiary, and collaterally assigns an interest in the policy to the business to secure its right to repayment of its premium advances.

Taxation. For income, gift and employment tax purposes***, SDAs entered into or materially modified after September 17, 2003***[1] are taxed under either the (1) economic benefit regime or (2) loan regime. As discussed below, regime application depends on policy ownership.

*Economic Benefit SDA.*[2] Typically, the business is the policy owner or deemed owner and funds the policy premiums in exchange for an interest in the policy equal to the ***greater of its cash value or the total premiums paid***. The insured/insured's ILIT receives an annual "economic benefit" equal to the term cost of the current insurance protection provided by the policy. The term cost is determined by using premium rates published by the IRS (see Table 2001) or, if lower, qualifying one-year term rates published by the issuing insurance carrier, both of which will increase each year with the age of the insured. The annual economic benefit is taxable to the insured (*e.g.*, as compensation to an employee or as a distribution to an owner), and will be taxed as an imputed gift from the insured to the ILIT, if an ILIT owns the policy or death benefit interest.

If the SDA is structured as an equity arrangement, the economic benefit regime taxes the insured currently on the insured's/ILIT's right to the policy equity. Also, if the SDAs involves a compensatory component (as with an insured employee), the tax provisions under Internal Revenue Code ("**Code**") §409A for non-qualified deferred compensation arrangements ("**NQDCs**") likely apply, generally ***making an economic benefit equity SDA undesirable***.

Note that, for purposes of SDA taxation, a business generally will be considered the deemed owner of a policy subject to a non-equity SDA documented using the collateral assignment method (*i.e.*, where the insured/insured's ILIT is the named policy owner), and the economic benefit tax regime will still apply.

*Split-Dollar Loans.*[3] The insured, or more commonly, the insured's ILIT, owns the policy, and the business makes interest-bearing loans to the insured/ILIT to pay the policy premiums. The ILIT must repay the loans at the specified maturity dates, typically secured by a limited collateral assignment of the policy to the business. The business has no other powers over the policy or any interest in its cash value apart from a security interest; rather, the ILIT retains all rights to the policy's cash value and death benefit, subject to the obligation to repay the loan(s) (with interest). If the loan provides for sufficient interest (generally, the federally-set AFR), it is governed by the general tax rules for debt instruments. The sufficiency of the interest rate depends on the type and term of the loan -- whether it is a term loan, demand loan, or hybrid loan (*i.e.*, a loan payable on the death of an individual or conditioned on the future performance of services) and the month of issuance.[4] The insured is taxed on any forgone interest that is not paid or accrued.[5]

***SELECTING THE RIGHT REGIME - ECONOMIC BENEFIT VS. LOAN***

For business purposes, choosing between an economic benefit SDA and a split-dollar loan often depends on three main questions:

- Who wants to own/control the policy?
- Which arrangement is more cost-efficient for the insured?
- Who will receive the policy equity upon termination?

The chart below indicates which regime to consider based on answers to the above.

| | **Economic Benefit** | **Split-Dollar Loan** |
|---|---|---|
| **Policy Ownership** | Business<br>• Business ownership generally requires application of the economic benefit regime | Insured/Insured's ILIT<br>• Loan regime applies, <u>unless</u> SDA is non-equity (then the business is the deemed policy owner and the economic benefit rules apply) |
| **Income Tax Costs to Insured** | Taxed on annual term insurance cost. Consider:<br>• If there is a young insured or a survivorship arrangement. Initial term rates should be low (*e.g.*, Table 2001 rate per $1,000 of coverage for a 40-year old is $1.10)<br>• If the insured wants predictability<br>    o Terms rates are fixed by a schedule, so taxable amounts and costs can be determined several years in advance<br>    o With loans, the business often makes a new loan with each premium (subject to a new rate) and total interest on all outstanding loans determines the annual taxable benefit<br>• If the policy will not initially develop equity. The parties can take advantage of the low term rates and later switch to a loan before policy equity appears | Taxed on any foregone interest on loans. Consider:<br>• If the insured is older or after the first death in a survivorship arrangement<br>    o Practically, term rates may be too high for older insureds<br>    o Rates also will jump upon the first insured's death under a survivorship policy |
| **Policy Equity** | To Business<br>• If the business is entitled to policy equity, the economic benefit regime generally applies, even if the insured or the insured's ILIT owns the policy | To Insured/Insured's ILIT<br>• Only loans can generally provide the insured/insured's ILIT with access to policy equity without imposition of tax<br>• Loan arrangements also should avoid possible application of Code §409A for NQDCs (unless the business forgives the loan) |

## *SDA APPLICATION – TYPICAL EXAMPLES*

SDAs can facilitate insurance planning for several business purposes. The goals of the business and the insured, based on the above, will guide the selection of the appropriate structure.

Employee Compensation/Benefits. A business may enter into a SDA to recruit, retain, and reward key employees, executive, and officers.[6] The insured receives death benefit protection and, depending on the structure selected, may also have ownership of the policy and rights to the policy equity. In this regard, SDAs offer unique flexibility -- the business does not have to cover or offer the benefit to all employees, as the ***coverage, amounts, and terms of SDAs generally are not subject to ERISA nondiscrimination rules.***

- *Example:* John is a talented, young employee at X Co., a fast-growing private company. X Co. wants to provide additional benefits to John, both in recognition of past performance and as motivation for future efforts, but does not want to deal with either the permanence or complexities of stock options, NQDCs or similar compensatory arrangements until John is further established with the company. John does not yet have a large estate but has just started a family, which relies primarily on his sizable salary for support.

  X Co. and John enter into an economic benefit SDA. X Co. owns and pays premiums on the a life insurance policy insuring John, endorsing death benefits in excess of the premiums paid to John's designated beneficiaries (after providing notice to and obtaining John's consent to the policy acquisition).[7] John receives added protection for his family and is taxed each year using the lower of the Table 2001 rates or the carrier's qualifying one year term costs, which are fairly low, given John's young age. X Co. retains control of the policy, in the event John decides to terminate his employment.

Retirement Benefits/Deferred Compensation. A business may use SDAs in combination with NQDCs, like supplemental executive retirement plans ("**SERPs**"), to either informally fund the plan or provide additional retirement benefits.

- *Example:* Jane, a top executive at C Co., a privately held company, has concerns about the company funding additional retirement benefits into its unfunded SERP. Jane wants an alternative that provides her with more control over and security for her retirement benefits.

  Jane acquires a life insurance policy on her life with an investment component. To emphasize cash value growth, the policy death benefits could be set to the minimum amount required so that, in relation to the premium, the policy will avoid classification as a modified endowment contract ("**MEC**").[8] C Co. and Jane will enter into a series of split-dollar demand loans (a separate loan for each premium payment), which will accrue interest. Jane owns the policy and the equity, giving her additional control and security over the policy and benefits. Jane generally can later access the equity through withdrawals (up to tax basis) or policy loans without imposition of taxation. To re-pay the loans, Jane can use her other assets, independent compensation from the business,[9] or withdrawals from the policy equity. If Jane ultimately receives her SERP benefits, the cash flows from the SERP could help offset the loan repayments, or if the loans have otherwise been paid, Jane could offset the tax due on her SERP benefits with withdrawals (up to tax basis) of policy equity, which generally are not subject to taxation.

Buy-Out Funding. A business and its owners may enter into SDAs to buy life insurance that supports the buy-out of a business owner at death.

- *Example:* The two equal owner/employees of Y Co., Joe and Jay, decide to enter into a "cross-purchase" arrangement, with each owner buying life insurance on the other. If one dies, the survivor must use the death benefits as part of the funding to purchase the deceased owner's business interests. Due to their cash flow and liquidity issues, however, neither can easily afford to pay the full policy premiums.

  Y Co. enters into non-equity collateral assignment SDAs with each owner to pay premiums due on the policies. Rather than paying the full amount of premiums as they come due, Jay and Joe will pay only tax on the annual economic benefit provided by the term insurance coverage under the policy they own.

### *OTHER CONSIDERATIONS*

The above provides a few basic examples of the wide variety of business cases and circumstances that could benefit from SDA planning. Split-dollar planning, however, can be technical and nuanced, which requires close attention to details (see *WRMarketplace* No. 14-15 for a discussion of seemingly minor split-dollar oversights with potentially significant adverse results).

Business SDA planning also should be coordinated with the insured's overall tax plan. For example, general estate tax principles apply to determine the estate taxation of proceeds received under a policy subject to a SDA. An insured facing estate tax exposure may prefer an ILIT own the policy subject to the SDA, so the insured does not possess any "incidents of ownership" in the policy that could result in estate tax exposure.[10] Achieving successful implementation of a SDA that meets the insured's and business' needs in such a case, including crafting the insured's ILIT and managing associated gift and GST tax issues raised by imputed gifts of the annual economic benefit or any forgone interest to the ILIT, will be best served by involving legal and accounting advisers early in the planning process.

In addition, all SDAs require an "exit" strategy for ending the arrangement and repaying the business, which should be contemplated from inception of the arrangement. Exit options may involve a transfer or surrender of the policy, a repayment of the business from the policy equity or the insured's/ILIT's other assets, etc. The strategy must be tailored depending on the SDA structure and the circumstances of the business and insured and should be periodically reviewed to ensure the strategy remains effective, as proposed, over the duration of the arrangement.

### *TAKE AWAYS*

- Illustrating how a SDA can share the costs of premium funding may facilitate the business' acquisition of needed coverage.

- The SDA's overall success, however, will require monitoring and management of the associated economics for both parties, from formation through termination.

- Even with an adviser's support, navigating the tax, compliance and administrative requirements of a successful SDA requires technical knowledge and precision.

- Advisers should work with a strong team of legal and accounting professionals to achieve optimum planning results for business SDAs.

## NOTES

[1] Effective date of the final split-dollar Treasury Regulations.
[2] Reg. §1.61-22(d)-(g).
[3] Reg. §1.7872-15.
[4] The sufficiency of interest for term and hybrid loans is based on the monthly AFRs issued by the IRS for the term of the loan (*i.e.*, short-term (3 years or less), mid-term (4 to 9 years), or long-term (more than 9 years)). Demand loans are separate, with AFRs based on the blended average of the January and July short-term AFRs for the applicable year.
[5] Again, such forgone interest will be taxed as an imputed gift from the insured to the ILIT, if an ILIT owns the policy.
[6] For public companies, federal and state securities laws may limit the use of SDAs and should be reviewed carefully. For example, the Sarbanes Oxley Act of 2002 prohibits personal loans to directors and covered executives. Thus, split-dollar loans involving public companies and directors and covered executives should be avoided, and even economic benefit arrangements should be considered very cautiously given the lack of guidance in this area.
[7] Generally, unless notice is provided and consent obtained from an insured employee as required by Code §101(j)(4), Code §101(j) taxes an employer-policy owner on death benefits received under an "employer-owned life insurance" ("**EOLI**") contract in excess of the total premiums and other amounts paid by that policyholder for the contract. Generally, any policy underlying a SDA where the business owns the policy, and the business (or a related person) will receive the death benefits, constitutes an EOLI contract (*e.g.*, most employer-employee economic benefits SDAs). Thus the business should satisfy the notice and consent requirements before obtaining any policy under such an arrangement.
[8] If the policy is a MEC, withdrawals, surrenders and policy loans (including pledges of the MEC as loan collateral) are taxed as ordinary income until they exceed any gain in the contract (essentially cash value over premiums paid).
[9] The compensation must be received entirely independent of the loan repayment, since any deemed forgiveness or indirect payment of the loan by the business can have adverse income tax consequences under the split-dollar rules.
[10] This would include, for example, a corporation's ownership of a policy subject to a SDA, which insures a majority shareholder. The corporation's incidents of ownership in the policy will be attributed to the insured majority shareholder, likely pulling policy death benefits payable for the benefit of the shareholder into his estate. The corporation and shareholder may prefer to structure the SDA with an ILIT owning the policy and providing a restricted collateral assignment to the business. If a loan is used, the parties also likely will want to avoid demand loans, as the corporation's ability to demand repayment of the loan at any time may be considered an "incident of ownership," potentially attributable to the majority shareholder for estate tax purposes.

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