Client Guide

Advanced Markets

Split dollar plans

A guide for businesses and corporations

Businesses implement life-insurance strategies to:

- provide an executive benefit to attract new employees or encourage existing employees to remain with the company
- facilitate wealth-transfer goals for business owners and key executives alike
- to fund the replacement of a valuable executive.

One of the most popular techniques for using business dollars to pay life insurance premiums is through split dollar arrangements. "Split dollar" is a term used to describe an arrangement where premium payments and policy benefits are split between two parties. In a typical split dollar arrangement, one party has a life insurance need and the second party has the funds to pay for the policy.

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What are the benefits?

A split dollar plan offers benefits to both the business and participants, including:

Cost recovery — the business can recover the costs of the plan, generally using the death benefit proceeds or cash value

Enhanced control and flexibility — the business selects which participants to include and can customize benefit for each

Ability to use business dollars to fund the premium at a minimal tax impact to participant

Income tax advantages — the death benefit is received income-tax free and the cash value may be accessed tax-free to supplement income

Who is this for?

In the corporate context, split dollar plans are generally used by businesses for the following participants (i.e., the insureds):

- **Key employees** as a benefit to retain and reward
- **Business owners** to help them with life insurance protection, supplemental retirement income, and possibly buy-sell needs

What are the types of split dollar arrangements?

Corporate split dollar plans can be structured in one of four ways:

Split Dollar Type	Policy Owner	Definition	Repayment to Business	Annual cost to Participant/Insured
Endorsement	Business	Business shares some or all of the death benefit with the participant	Cost recovery optional	Participant is taxed on the "economic benefit cost" of the death benefit
Non-Equity Collateral Assignment (NECA)	Participant or Trust	Business pays the premium with expectation of repayment in the future	Greater of premium paid or cash value	Participant is taxed on the "economic benefit cost" of the death benefit
Loan Regime	Participant or Trust	Business pays the premium and treats each premium payment as a loan	Total outstanding loan balance	Loan interest can be paid yearly, accrued, or included in participant's income (i.e., imputed)
Switch Dollar	Participant or Trust	Arrangement starts as a NECA split dollar and switches to loan regime in the future	Starts as greater of premiums paid or cash value then switches to a loan	Starts as tax on economic benefit costs and then switches to loan interest cost

Endorsement split dollar

How does it work?

In an endorsement split dollar plan:

1. **The business owns** a life insurance policy on the participant

2. **The business allows** the participant to name the beneficiary on all or a portion of the policy death benefit by filing an "endorsement" with the life insurance carrier
   - An endorsement is a supplemental form recorded with John Hancock that ensures that the participant's chosen beneficiaries receive the portion of the death benefit agreed upon

3. **Each year,** the business pays the premium and the participant pays tax on the "economic benefit" associated with the endorsed death benefit (see page 4 for more information)

4. **If the participant dies during the split dollar arrangement,** the endorsed portion of death benefit is paid to the participant's beneficiaries; any remaining death benefit is paid to the business

5. **If the arrangement terminates while the insured is still alive,** the death benefit is no longer endorsed to the participant. At that time, the business can keep the policy and remove the endorsement or can transfer it to the participant as taxable income
   - Because the policy is business-owned, the employer can recover its costs using the death benefit proceeds and there is no cost to or repayment by the participant when the plan is terminated unless the policy is transferred to him/her

When is this arrangement used?

Businesses use this arrangement when they want to:

- **Provide a low-cost death benefit to an owner/ key employee** (i.e., the participant) as an additional fringe benefit
- **Own the policy** and/or obtain key person protection

What is "economic benefit" and how is this cost calculated?

To preserve the income tax free nature of the death benefit payable to the participant's family, the IRS requires that the participant be charged on the "economic benefit" provided to them under the split dollar arrangement. The economic benefit cost represents a "rental charge" for the participant's portion of the death benefit and is based primarily on the participant's age, the amount of insurance, and the risk factor provided in an IRS-sanctioned rate table (aka Table 2001) or, if available, the insurer's term rates on their one-year term product.[1]

Example

Assume that Business X is buying a $1M policy on the life of a key employee, who is currently 35 years old. As part of the split dollar arrangement, Business X agrees to endorse $500,000 of the $1M to the employee's family. The table below provides an example of the economic benefit cost to the employee at the specified ages for the $500,000 benefit:

		Annual Economic Benefit Costs	
Insured's Age	**Death Benefit Endorsed**	**Table 2001 Costs**	**JH One-Year Term Costs**
35	$500k	$495	$205
40	$500k	$550	$225
45	$500k	$765	$295
50	$500k	$1,150	$395
55	$500k	$2,075	$540
60	$500k	$3,255	$885

Economic benefit rates increase each year as the insured ages, so it is important to consider how these rising costs impact a participant's tax liability. In some cases, it may be desirable to terminate the split dollar plan or change to another type of arrangement to address these costs.

Planning note

The economic benefit rates associated with a survivorship policy can be significantly lower than the rates for a single-life policy, making a split dollar plan with a survivorship policy an extremely cost-efficient planning strategy.

Non-equity collateral assignment split dollar (NECASD)

How does it work?

In a non-equity collateral assignment (NECA) split dollar plan:

1. **The participant** (or his/her trust) purchases a life insurance policy and the business agrees to pay the annual premium each year
2. **As part of the agreement,** the participant agrees to repay the business the greater of the policy's cash value or cumulative premiums paid when the agreement terminates
3. **Each year the participant pays income tax** on the economic benefit cost associated with the death benefit he/she is entitled to receive. See page 4 for a discussion of economic benefit costs and how they are calculated
4. **To protect the business's right to be repaid,** a "collateral assignment" is filed on the policy that generally prevents the policy owner from surrendering, borrowing from, or transferring ownership of the policy without the business's consent until the business has been repaid
5. **If the participant dies while the plan is active,** the business will receive the greater of premiums paid or the policy's cash value from the death benefit and the participant/trust will receive the excess death benefit
6. **If the arrangement terminates while the participant is living,** the business will either be repaid the greater of cash value/premiums paid or the business can forgive the debt (in whole or in part). Forgiveness of the debt will be income taxable to the participant

When is this arrangement used?

This arrangement is ideal for addressing the following goals:

- **Participant** (or participant's trust) wants ownership of the policy
- **Death benefit protection is of importance,** such as to meet estate-planning needs
- **Participant looking for assistance** to pay premiums and/or minimize taxes

Planning note

The parties should consider the point in time when policy cash value becomes greater than the total premium paid. Keeping the premium cost down, using a low cash value product, or switching to a loan regime may be desirable. See switch dollar section for more information.

Loan regime split dollar

How does it work?

In a loan regime split dollar plan:

1. **The participant** (or his/her trust) purchases a life insurance policy and the business agrees to pay the annual premium each year
2. **Each premium payment** by the business is considered a loan from the business to the participant/trust
3. **Each year,** the participant will be responsible for paying the interest on the debt.
4. **Interest can be paid out-of-pocket,** accrued or imputed into income. When interest is imputed into income, the participant is responsible for paying income tax on the interest (See page 7 for an explanation of loan interest calculation)
5. **To protect the business's right to be repaid,** the participant files a "collateral assignment" on the policy that generally prevents the policy owner from surrendering, borrowing from, or transferring ownership of the policy without the business's consent until the business has been repaid
6. **Until the business is repaid,** the participant/trust can only access cash value in excess of the loan balance (i.e., the "equity")
7. **Upon termination of the agreement** (either at death or during life), the employee repays the loan using the policy's cash value or outside funds —or the business may choose to forgive all or a portion of the debt

When is this arrangement used?

This arrangement satisfies these needs:

- **Participant** (or participant's trust) wants policy ownership
- **Potential access** to cash value is important
- **Interest cost** is more economical than economic benefit cost

Although very similar in structure, the loan arrangement is different from a Non-Equity Collateral Assignment (NECA) split dollar arrangement in two important ways:

1. The premium the business pays is considered a loan to the participant. The annual cost to the participant is based on loan interest applied to the total premium the business pays to the policy (not on the economic benefit cost of the death benefit as used in the NECA).

2. The amount that will be repaid to the business is the total outstanding loan, plus interest. This means that if the policy cash value exceeds the premiums paid, any excess cash value belongs to the participant/trust. Access to cash value (i.e. "equity") is not an option under a NECA split dollar.

How is loan interest calculated?

The split dollar loan rules generally provide that interest should be calculated using the Applicable Federal Rates (AFRs). The AFRs are monthly interest rates published by the IRS for use in private loan arrangements. The rate that applies to each premium loan is determined by how long the loan will remain outstanding. For example, a loan that will be repaid within three years will have a different interest rate than a loan that will be repaid over a longer period.

The following table provides a quick guide as to which rate is appropriate based on the loan term:

AFR Rate	Loan Term
Short-term AFR	3 years or less
Mid-term AFR	Between 3 and 9 years
Long-term AFR	More than 9 years
Blended AFR	Loans payable upon demand ("Demand Loan")

As interest is earned each year on the outstanding debt, the participant will either (i) pay the interest out-of-pocket, (ii) accrue the interest, or (iii) have the interest included into his/her income by the business (commonly known as "imputed income").[2]

Planning note

Even in a low interest rate environment, economic benefit costs may be lower than interest costs, especially when the insured is younger, or the policy is a second-to-die (i.e., survivorship) policy. In such cases, it may be preferable to start the plan as a NECA split dollar and switch to a loan arrangement later on. This concept is referred to as a "switch dollar" and is discussed more on page 8.

Switch dollar

How does it work?

In a switch dollar arrangement split dollar plan:

1. **The split dollar arrangement begins** as a Non-Equity Collateral (NECA) split dollar
2. **At a future point in time,** the NECA split dollar plan switches to a loan arrangement
   - For survivorship policies, this usually occurs at the death of the first spouse when the economic benefit costs increase
   - For single-life policies, this usually occurs just before the policy's cash value exceeds the premiums paid or when the economic benefit cost exceeds loan interest costs
3. **When the switch to a loan occurs,** the loan amount will be equal to the outstanding repayment obligation on the NECA (i.e., the greater of premiums paid or cash value). Any additional premiums paid by the business after the switch will also be considered a loan and will carry an interest charge
4. **Upon termination,** the split dollar loan(s) from the business will be repaid from the death benefit (if insured dies during the plan) or, if terminated during life, using cash/other assets or policy cash value. The business may also decide to forgive the debt (in whole or in part)

When is this arrangement used?

This arrangement is used to address a variety of needs, including:

- **For survivorship policies** to offset increased costs at death of the first insured
- **On single-life policies to minimize income** and/or gift taxes as insured ages
- **To provide future access** to cash value

Additional considerations

1. Premiums are not deductible by the business in any of the split dollar arrangements.

2. When life insurance is owned by the business on the life of an employee, IRC §101(j) requires that certain conditions and requirements be met to keep the death benefit proceeds income tax free. This rule applies to both Endorsement and NECA split dollar plans.[3]

3. If the insurance is to be used for estate planning purposes, the participant should consult with legal counsel to determine if an Irrevocable Life Insurance Trust (ILIT) should own the policy and discuss the gift/estate tax ramifications of the design. For example, the economic benefit costs (Endorsement/NECA) or interest costs (loan regime) recognized by the participant may be considered a taxable gift by the participant to his or her trust for federal gift and generation-skipping transfer tax purposes.[4]

4. When a split dollar plan is between the business and a controlling shareholder/owner, special care should be taken to avoid estate tax inclusion under IRC §2042. For NECA and loan arrangements, the business's interest in the policy should be secured by a restricted collateral assignment. Endorsement split dollar arrangements may not be appropriate due to possible estate inclusion of the insurance proceeds.

5. NECA and loan regime split dollar plans may not be appropriate for directors and executive officers of publicly-traded companies under Section 402 of the Sarbanes-Oxley Act, which generally prohibits personal loans to such individuals.

6. Use of a variable life insurance policy in a loan regime arrangement where the policy is used to secure the repayment obligation could subject the business to margin loan limits (Regulation U) and registration requirements of the Federal Reserve Board.

Conclusion

Split dollar arrangements are a highly effective way to use business dollars to fund insurance for business owners and their key executives. The business determines how much control they would like to have over the plan and the arrangement can be customized for specific goals – from death benefit protection for families and to effectuate legacy plans to a focus on cash value for supplemental retirement income. For business owners looking for a flexible solution to address multiple needs, consult your financial professional about implementing a split dollar plan today.

For more information on these plans or to create a customized plan design,
please consult with your financial professional.

1. The insurer's one-year term rates may be used only if (i) they are available to all standard risks, (ii) the insurer generally makes the availability of such rates known to persons who apply for term insurance coverage from the insurer, and (ii) the insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels. While John Hancock strives to meet all these requirements, due to the nature of the product, we do not sell a lot of it. Consequently, we cannot say whether our one-year term product satisfies the regularly sold requirement. You should consult with your tax advisor to determine which rate to use in calculating economic benefit.

2. If all or a portion of the interest charged on a split dollar loan is to be paid directly or indirectly by the lender, the loan may be treated as a below market loan, which can lead to unfavorable income tax treatment on some term loans. See Treas. Reg. 1.7872-15(a)(4). Consequently, imputing interest into a participant's income may be appropriate only for demand loans and certain term loans that are payable not later than death of the individual. See Treas. Reg. 1.7872-15(e)(5).

3. The split dollar regulations treat the business as the deemed owner of the policy in a NECA split dollar arrangement, thus requiring adherence to §101(j) rules.

4. Provided that the amount of the gift is covered by the employee's annual gift tax exclusions, there will be no gift tax due. An annual exclusion gift is the annual gift amount that each individual can make to an unlimited number of people without federal gift tax. In 2020, this amount is $15,000 per individual per year (indexed annually for inflation and subject to certain rules).

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Loans and withdrawals will reduce the death benefit and the cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Withdrawals in excess of the cost basis (premiums paid) will be subject to tax and certain withdrawals within the first 15 years may be subject to recapture tax. Additionally, policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59 1/2. [Cash value available for loans and withdrawals may be more or less than originally invested.] Withdrawals are available after the first policy year.

Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are few exceptions such as when a life insurance policy has been transferred for valuable consideration.

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