StatonWalsh

Financial Clarity Through Transparency

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Split-Dollar Arrangement

The term “split-dollar arrangement” refers to a method of paying for life insurance. In a typical contract, an employer and employee agree to split the cost (premiums) and benefits (cash-value and death benefits) of a permanent life insurance policy.

The agreement between the employee and employer can take many forms. The elements commonly found in split-dollar agreements are outlined below.

Policy Ownership

There are two basic forms of policy ownership[1] for split-dollar plans.

- **Endorsement method:** The employer owns the policy but a written endorsement is added to the policy which splits the benefits between the employer and the employee.
- **Collateral assignment:** The employee owns the policy and assigns certain interests in the policy to the employer as collateral for payments made by the employer.

Splitting the Cost (premiums)

Dividing the cost of a policy can be done in any manner desired. Listed below are several typical payment arrangements:

- **Classic method.**
  - Employer pays an amount equal to the annual cash-value buildup.
  - Employee pays the balance.
- **Employer-pay-all method.**
  - Employer pays the entire premium.
  - Employee is taxed on the value of the economic benefit received.

[1] This report highlights split-dollar arrangements in the employer and employee context. Split-dollar arrangements are also possible between other parties, for example between a corporation and a shareholder, an employer and an independent contractor, a partnership and a partner, or a private individual and a trust.

Making the Payment

- **Employer pay all:** The employer pays the entire premium; the employee pays tax on the value of the economic benefits received.
- **Executive bonus plan:** The employer pays a bonus to the employee. From the bonus, the employee pays the economic benefit portion of the premium. The bonus payment is a deductible expense to the employer and taxable income to the employee. Some agreements provide an extra bonus amount to cover the additional tax due.

Splitting the Benefits

The employer and employee can decide to split the policy benefits in any way they wish.

- **Classic method.**
  - **Employer's share:** At death, the employer receives the greater of the cash value or the total premiums paid.
  - **Employee's share:** The employee's beneficiary receives the balance of the proceeds, e.g., the face amount less the amount repaid to the employer.
- **Employer-pay-all method.**
  - **Employer's share:** At death, the employer recovers the agreed-upon amount.
  - **Employee's share:** The employee's beneficiary receives the balance of the proceeds, e.g., the face amount less the sum paid to the employer.

A Few Uses of Split-Dollar

- **Fringe benefit:** Since the employer can pick and choose those employees who will benefit, split-dollar can be used to attract and retain key executives.
- **Estate planning:** When the estate is large enough to incur a federal estate tax (a taxable estate in excess of $12,060,000 in 2022),[1] an estate owner may consider removing life insurance from the estate. One way of reducing death taxes is the irrevocable life insurance trust.

[1] This is the "applicable exclusion amount", the dollar value of assets protected by from federal estate tax by an individual's applicable credit amount. In 2021, the applicable exclusion amount was $11,700,000.

- **Business continuation:** In a family-owned business there is a risk of adverse tax treatment when the corporation redeems the deceased owner's stock. See IRC Secs. 302 and 318. Under a corporate stock redemption the surviving stockholders would own stock worth more, but with an unchanged cost basis. Using a cross-purchase buy-sell agreement funded with life insurance can eliminate these problems. Differences between the owners in age and/or percentage of ownership may cause the life insurance premiums to be expensive for some stockholders. A split-dollar arrangement may assist each stockholder in purchasing enough insurance on the other stockholder(s).

- **Group term replacement:** Nondiscrimination rules can limit the amount of group term insurance available to key executives. With a split-dollar plan, executives can have increased protection now and substantial benefits at retirement.

Federal Taxation of Split-Dollar Arrangements

Split-dollar arrangements are subject to a complex web of federal income tax law[1] and regulation, including:

- **Treasury Decision 9092:** Under the final federal regulations contained in Treasury Decision 9092, issued on September 11, 2003, many of the economic benefits of a split-dollar arrangement will be treated as currently taxable. Such taxable benefits may include: (1) the value of current life insurance protection; (2) accrued cash value; (3) imputed loan interest; or (4) premium contributions from the non-owner of the policy. Depending on the relationship between the parties to a split-dollar arrangement, the economic benefits may be treated for tax purposes as compensation, dividends, a capital contribution, a gift, or "a transfer having a different tax character." Under certain circumstances, death benefits paid to a beneficiary (other than a policy owner) will be taxable income.

[1] The discussion here concerns federal income tax law; state or local law may vary.

- **IRC Sec. 409A – nonqualified deferred compensation:** IRC Sec. 409A concerns the federal income tax treatment of nonqualified deferred compensation agreements. Income deferred under an arrangement which does not meet the requirements of IRC Sec. 409A is generally subject to income taxation in the current year, including substantial penalties and interest. In some instances, a split-dollar arrangement may be deemed to come under the provisions of IRC Sec. 409A. See Treasury Decision 9321 and Notice 2007-34 for further details.

- **Employer-owned life insurance contracts:** Under federal law, amounts received under a life insurance contract paid by reason of the death of the insured are generally excluded from income. Under the provisions of the Pension Protection Act of 2006, however, death proceeds paid to an employer from a life policy owned by the employer on the life of an employee are generally includable in income, unless certain requirements are met. If these regulatory requirements are met, the death benefit can be received income tax free. This law was effective for contracts issued after August 17, 2006, except for policies acquired in an IRC Sec. 1035 exchange. See IRC Sec. 101(j).

Seek Professional Guidance

Split-dollar arrangements involve complex legal, tax and insurance questions. The guidance of a Certified Public Accountant (CPA), IRS Enrolled Agent (EA), or other financial professionals is strongly recommended.

Split-Dollar Arrangement Funding a Cross-Purchase Agreement

In order to ensure the orderly continuation of a business, co-shareholders will frequently enter into a cross-purchase agreement, in which each agrees to purchase the ownership interest of the other in case of death. A split-dollar life insurance arrangement can be used to fund such a need.

During Life

In general, the following steps would be taken:

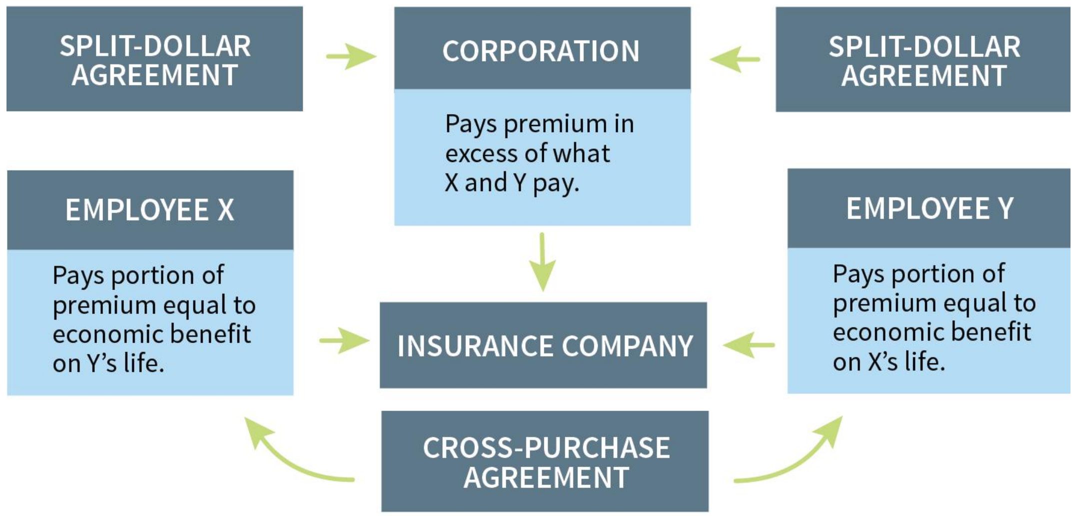
- The shareholders of a corporation, acting as individuals, enter into a cross-purchase agreement with each other, agreeing to purchase the ownership interest of a shareholder who dies.
- Each shareholder, acting as an individual, purchases a life insurance policy on the life of the other shareholder.
- Each shareholder, as an employee of the corporation, enters into a separate split-dollar agreement with the company, providing for a sharing of premiums and death benefits on the policy. Each shareholder pays that portion of the premium equal to the economic benefit[1] received. The corporation pays the remaining balance. As a part of the agreement, each shareholder assigns the policy to the corporation as security for the repayment of premiums advanced.

At Death

- The insurance company typically pays to the corporation the amounts specified in the split-dollar agreement.
- The balance of the policy proceeds is paid to the surviving shareholder. These funds are used to purchase the deceased shareholder's stock from his or her estate.

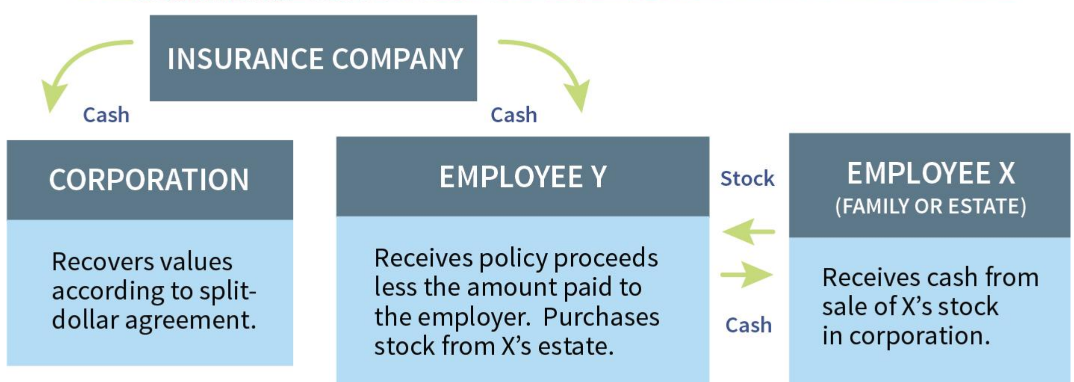
[1] Under Treasury Decision 9092, (September 11, 2003) many economic benefits of a split-dollar arrangement are currently taxable; death benefits paid to a beneficiary other than the policy owner may also be taxable. Under Treasury Decision 9321 and IRS Notice 2007-34, (April 10, 2007), some split-dollar arrangements may come under the requirements of IRC Sec. 409A concerning nonqualified deferred compensation. Those considering a split-dollar arrangement should first consult with their legal and/or tax advisors. State or local law may vary.

How Split-Dollar Funding A Cross-Purchase Agreement Works



Employees X and Y each buy life insurance policies on the other's life.

At Death of Employee X



Note: Under Treasury Decision 9092, (September 11, 2003) many economic benefits of a split-dollar arrangement are currently taxable; death benefits paid to a beneficiary other than the policy owner may also be taxable. Under Treasury Decision 9321 and IRS Notice 2007-34, (April 10, 2007), some split-dollar arrangements may come under the requirements of IRC Sec. 409A concerning nonqualified deferred compensation. Those considering a split-dollar arrangement should first consult with their legal and/or tax advisors. State or local law may vary.

Split-Dollar Arrangement Funding an Irrevocable Life Insurance Trust

Since the federal estate tax is imposed on all the assets inside an estate, many people prefer to reduce this tax by arranging to have some of their assets outside of their estate. One method of achieving this is the Irrevocable Life Insurance Trust (ILIT), a type of trust designed primarily to own life insurance policies. At death, the policy proceeds are used to provide additional dollars for estate liquidity needs. Such a trust takes maximum advantage of the gift tax laws and at the same time ensures that the proceeds of any policies inside the trust are received free of federal income and estate taxes.[1]

A split-dollar life insurance arrangement can help a key employee achieve this important estate-planning goal.

During Life

In general, the following steps would be taken:

- The employee establishes an irrevocable life insurance trust.
- The trustee of the trust obtains life insurance on the life of the employee, naming the trust as beneficiary of the policy.
- The employer and the trust enter into a split-dollar agreement, providing for a sharing of the premiums and death benefits of the policy owned by the trust. Typically the trust will pay that portion of the premium equal to the economic benefit received. The employer pays the remaining balance. As a part of the agreement, the trust assigns the policy to the employer as security for the repayment of premiums advanced.
- The employee gifts funds to the trust, to allow the trust to pay its portion of the premium. The employer may, if desired, bonus sufficient funds to the employee to cover these gifts.

[1] The discussion here concerns federal income and estate tax law. State or local law may vary.

At Death

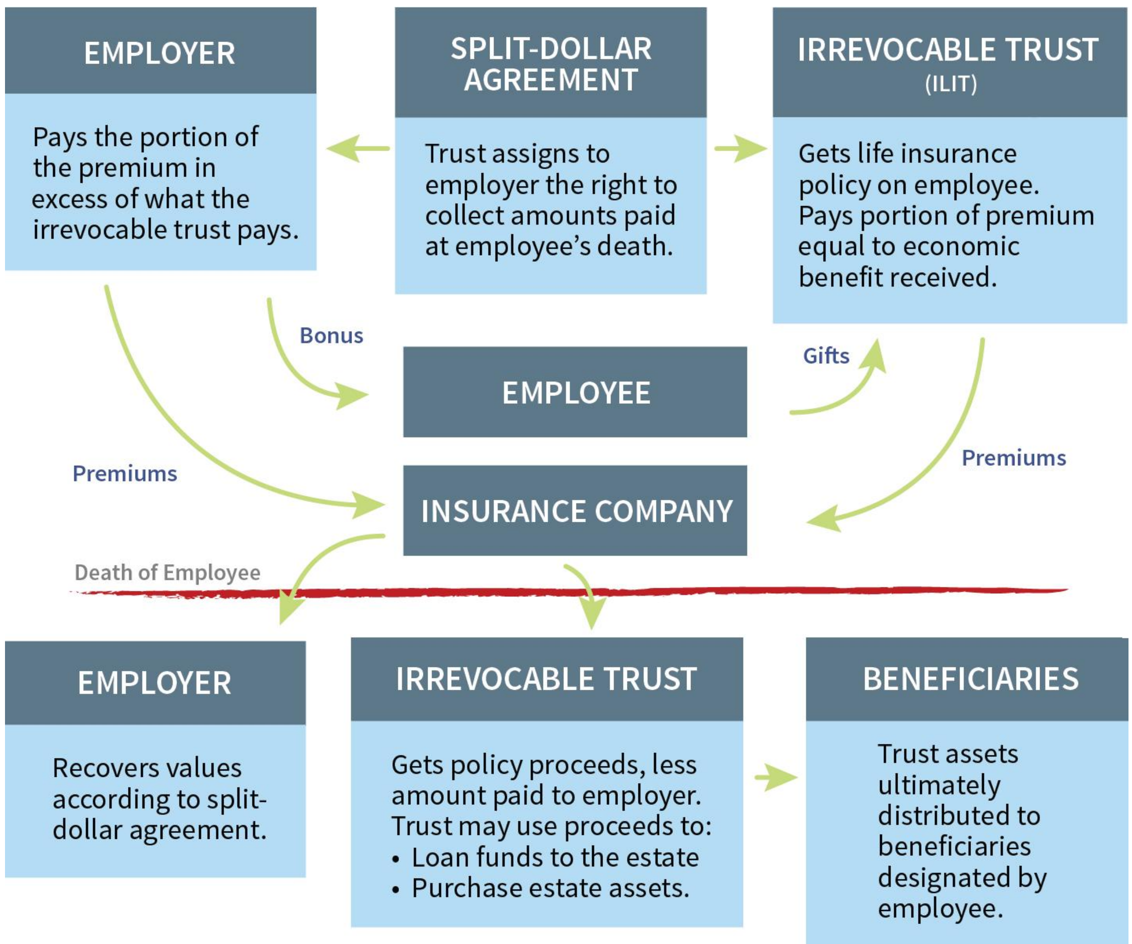
- The insurance company typically returns to the employer the amounts specified in the split-dollar agreement.
- The balance of the policy proceeds is paid directly to the trustee of the irrevocable life insurance trust. The trust (if trust provisions so provide) may then lend the funds to the employee's estate, or may use them to purchase assets from the estate. The executor would then have the cash necessary to pay the estate settlement costs without increasing the taxable estate.
- Ultimately, assets in the trust are distributed to the employee's beneficiaries.

Taxation Issues

Under Treasury Decision 9092 (September 11, 2003), many economic benefits of a split-dollar arrangement are currently taxable. Death benefits paid under a split-dollar arrangement to a beneficiary other than the policy owner may be taxable. For federal income tax purposes, split-dollar arrangements funding an irrevocable life insurance trust are generally taxed under the "loan" regime in which a non-owner (generally the business) is treated as making an interest-bearing loan to the policy owner (generally the employee). Additionally, under Treasury Decision 9321 and IRS Notice 2007-34 (April 10, 2007), some split dollar arrangements may come under the requirements of IRC Sec. 409A concerning nonqualified deferred compensation.

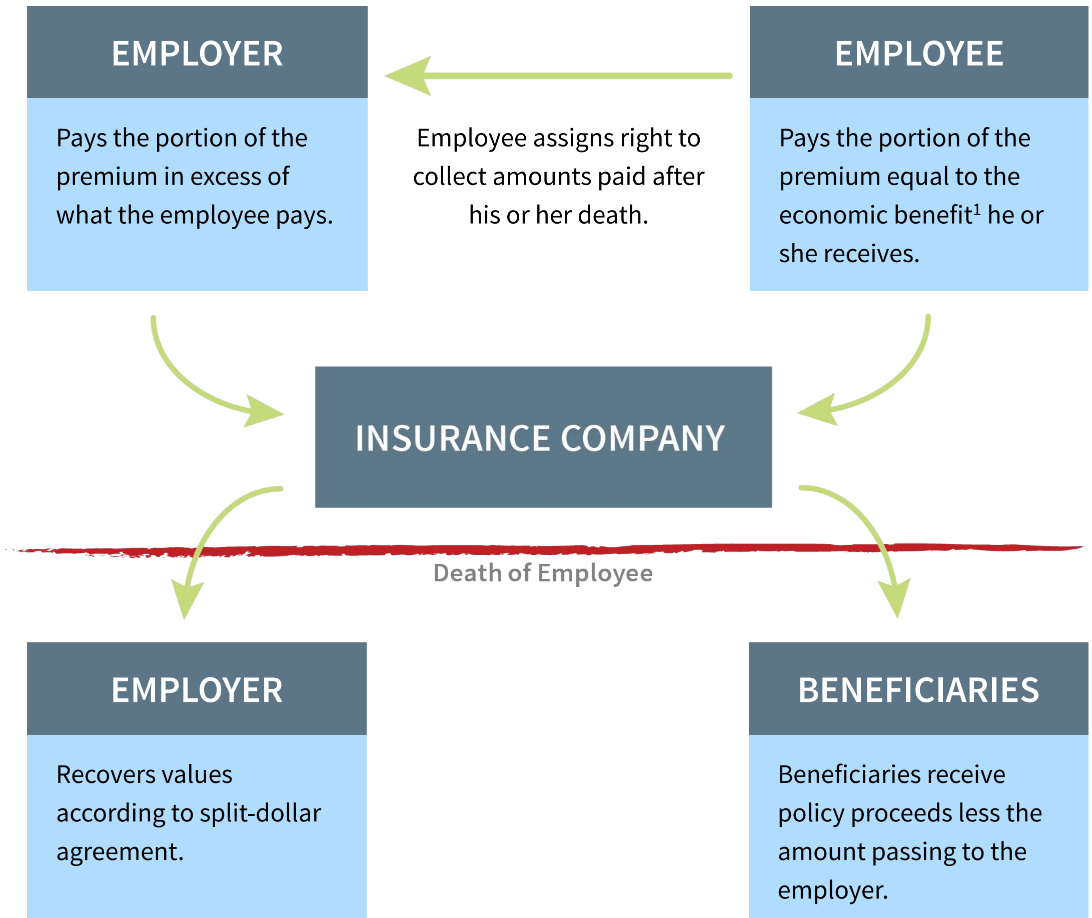
Because of the tax complexities involved, those considering a split-dollar arrangement should first consult with their legal and/or tax advisors. State or local income tax law may vary.

How Split-Dollar Funding A Life Insurance Trust Works



Note: Under Treasury Decision 9092, (September 11, 2003) many economic benefits of a split-dollar arrangement are currently taxable; death benefits paid to a beneficiary other than the policy owner may also be taxable. Under Treasury Decision 9321 and IRS Notice 2007-34, (April 10, 2007), some split-dollar arrangements may come under the requirements of IRC Sec. 409A concerning nonqualified deferred compensation. Those considering a split-dollar arrangement should first consult with their legal and/or tax advisors. State or local law may vary.

How Split-Dollar Collateral Assignment Works



Note: This diagram illustrates a very basic variety of split-dollar arrangement which can be modified to meet the needs of both employer and employee.

[1] Under Treasury Decision 9092, (September 11, 2003) many economic benefits of a split-dollar arrangement are currently taxable; death benefits paid to a beneficiary other than the policy owner may also be taxable. Under Treasury Decision 9321 and IRS Notice 2007-34, (April 10, 2007), some split-dollar arrangements may come under the requirements of IRC Sec. 409A concerning nonqualified deferred compensation. Those considering a split-dollar arrangement should first consult with their legal and/or tax advisors. State or local law may vary.

Split-Dollar Arrangement

Deferred Compensation - Collateral Assignment Method

EMPLOYER

Pays the portion of the premium in excess of what the employee pays.

Employee assigns right to collect amounts paid after his or her death.

Employer pays bonus to employee to cover costs of premiums (optional).

EMPLOYEE

Pays the portion of the premium equal to the economic benefit[1] he or she receives.

INSURANCE COMPANY

Death/Retirement of Employee

AT RETIREMENT

- Employer borrows cash value tax free[2].
- Employer pays income to employee as retirement benefit.
- Payments are tax-deductible to employer.
- Payment may be grossed up to increase payment to employee.

AFTER DEATH OCCURS

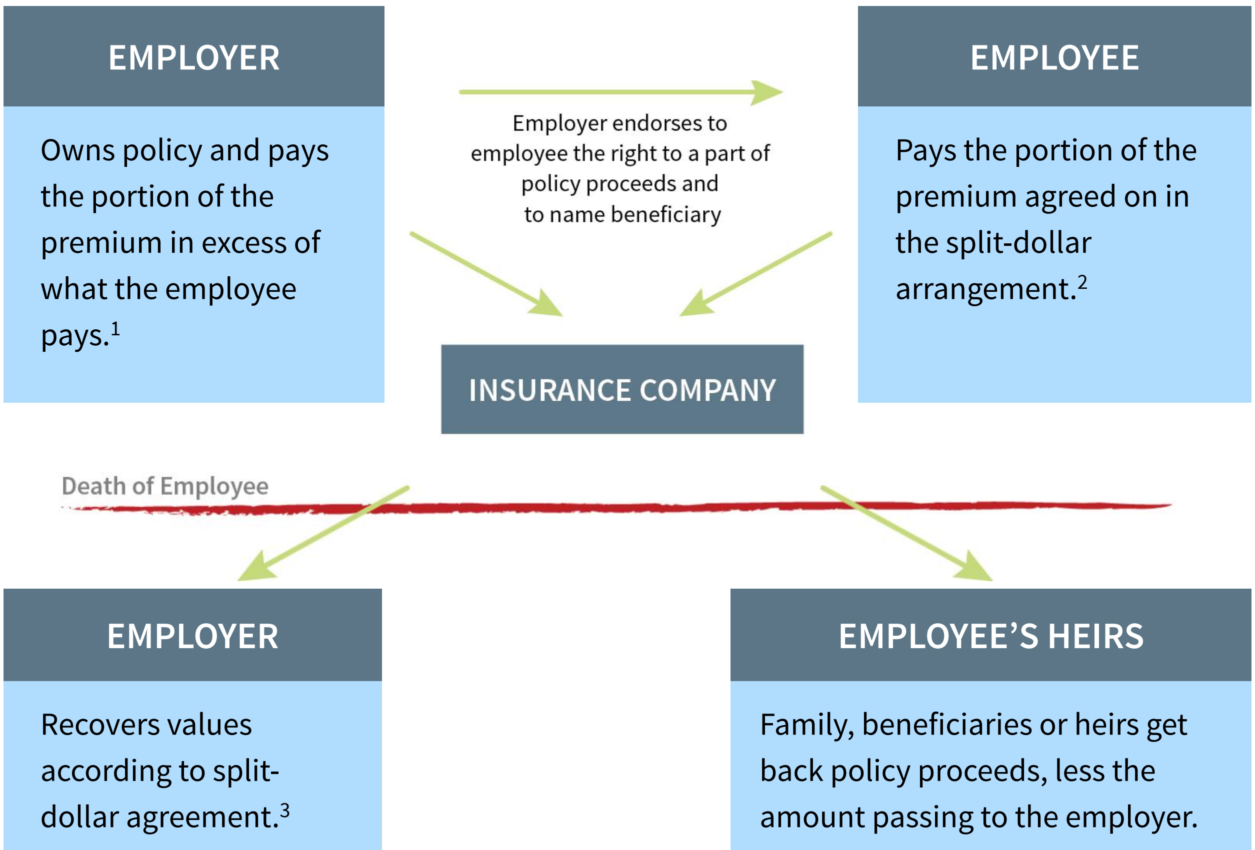
- Employer recovers values per split-dollar agreement.
- Family, beneficiaries or heirs get back policy proceeds less the amount passing to the employer.
- Employer may optionally pay out income to the employee's heirs.

Note: This diagram illustrates a very basic variety of split-dollar plan which can be modified to meet the needs of both employer and employee. A separate agreement is required to address the deferred compensation aspect of this arrangement.

[1] Under Treasury Decision 9092, (September 11, 2003) many economic benefits of a split-dollar arrangement are currently taxable; death benefits paid to a beneficiary other than the policy owner may also be taxable. Under Treasury Decision 9321 and IRS Notice 2007-34, (April 10, 2007), some split-dollar arrangements may come under the requirements of IRC Sec. 409A concerning nonqualified deferred compensation. Those considering a split-dollar arrangement should first consult with their legal and/or tax advisors. State or local law may vary.

[2] Interest charges may apply. Loans reduce death benefits. Borrowed amounts may be taxable and subject to a 10% penalty if the policy is a MEC. For details see policy information and insurance ledger.

Split-Dollar Arrangement Endorsement Method



Note: This diagram illustrates a very basic variety of split-dollar arrangement, in the employer and employee context. Split-dollar arrangements are also possible between other parties, for example, between a corporation and a shareholder, an employer and an independent contractor, a partnership and a partner, or a private individual and a trust. Split-dollar arrangements can be modified to meet the specific needs of the parties involved.

[1] Under Treasury Decision 9092, (September 11, 2003) many economic benefits of a split-dollar arrangement are currently taxable; death benefits paid to a beneficiary other than the policy owner may also be taxable. Under Treasury Decision 9321 and IRS Notice 2007-34, (April 10, 2007), some split-dollar arrangements may come under the requirements of IRC Sec. 409A concerning nonqualified deferred compensation. Those considering a split-dollar arrangement should first consult with their legal and/or tax advisors. State or local law may vary.

[2] In an employer-pay-all agreement, the employee pays nothing.

[3] Under federal law, amounts received under a life insurance contract paid by reason of the death of the insured are generally excluded from income Under the provisions of the Pension Protection Act of 2006, death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. The law was effective for contracts issued after August 17, 2006, except for contracts acquired in an IRC Sec. 1035 exchange. Professional legal and tax guidance is strongly recommended.

Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

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