A Business Split-Dollar Life Insurance Plan

Presented by: **Sabrina Hanson**
Hanson Financial Group

Prepared for:

What Is a Business Split-Dollar Life Insurance Plan?

A business split-dollar life insurance plan is not a type of insurance policy but rather, when used by a business, is an arrangement that allocates life insurance policy benefits and, in some cases, premium costs between an **employer** and a valued **employee**.

In a typical business split-dollar life insurance plan, an **employer** assists one or more selected **employees** to purchase needed life insurance protection by paying all or a portion of the premiums, the total of which the **employer** will ultimately recover from the policy benefits.

As a result of this premium and benefit sharing arrangement, the **employee** receives valuable life insurance protection at a reduced out-of-pocket cost, while the **employer** eventually recovers its share of the premium costs from the policy's cash value or death benefit.

Business Split-Dollar Life Insurance Plan in Action

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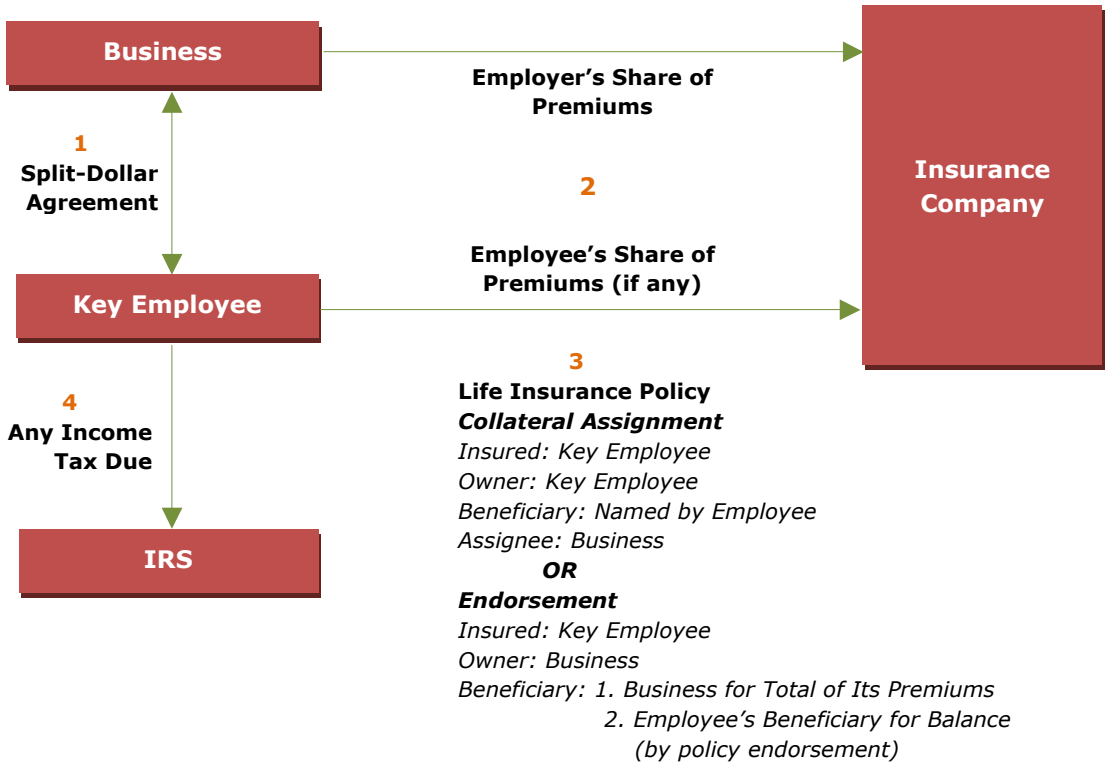
Here's how a split-dollar life insurance plan could work today...



1. The business enters into a split-dollar agreement with each selected employee. The agreement spells out the rights and responsibilities of each party.

2. Based on the premium sharing arrangement, the business and employee each contribute a portion of the premium payments.

3. The ownership and beneficiary arrangements of the life insurance policy are determined by selection of the collateral assignment or endorsement method.

4. The employee may have to pay income tax on the economic benefit received (economic benefit tax regime) or on imputed interest on the employer's premium "loans" (loan tax regime).

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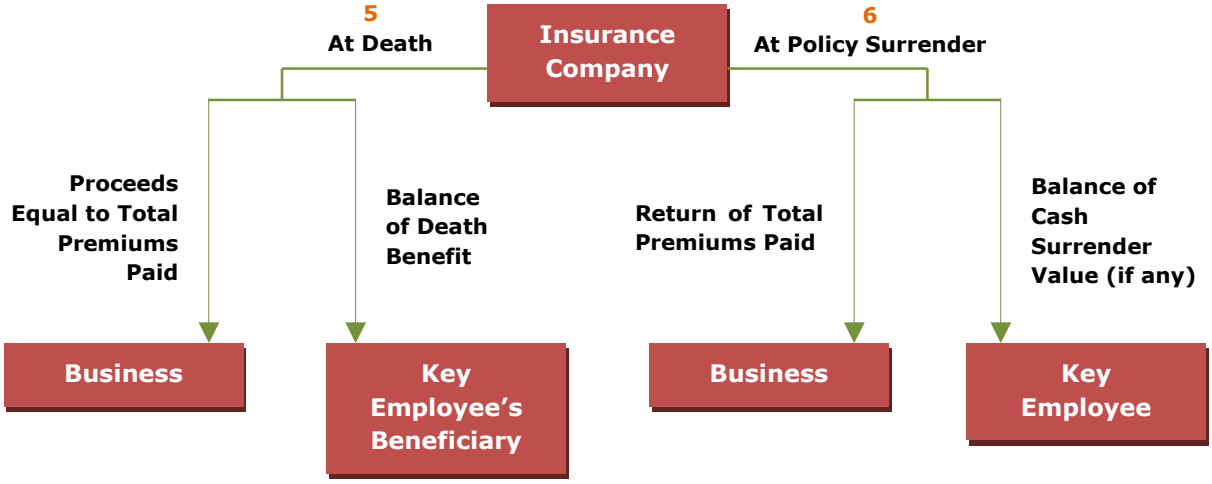
Here's how a split-dollar life insurance plan could work at the employee's death or policy surrender...



5. At the employee's death, the business is usually entitled to receive from the death benefit the total of the premiums it has paid, with the employee's beneficiary receiving the balance of the death benefit, generally on an income-tax-free basis. In an endorsement split-dollar plan, the employee must have either paid for the cost of the current life insurance protection or taken the value of the current life insurance protection into account as an economic benefit in order for his/her beneficiary to receive death proceeds free of income tax. Otherwise, the death proceeds are considered payable from the business to the employee's beneficiary and are taxable as income to the beneficiary.

6. If the policy is surrendered prior to the employee's death, the business is usually entitled to receive from the cash surrender value the total of the premiums it has paid, and the employee receives the balance, if any.

Types of Split-Dollar Life Insurance Plans

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A business split-dollar life insurance plan is an arrangement under which an **employer** and a valued **employee** agree to share, or split, the premiums and benefits of a life insurance policy. How the policy benefits are allocated determines the type of split-dollar arrangement in effect:

Equity Split-Dollar Plan

In an equity split-dollar arrangement, the **employee** receives an interest in the policy's cash value (equity) that is disproportionate to the **employee's** share of the premium payments, while the **employer** pays more of the premium cost. Typically, the party paying less (the **employee**) also receives the benefit of current life insurance protection.

Non-Equity Split-Dollar Plan

In a non-equity split-dollar arrangement, the **employer** typically provides the **employee** with current life insurance protection, but the **employee** has no interest in the policy's cash value.

Since the objective of a business split-dollar life insurance plan is to provide a valued **employee** with life insurance policy benefits at a reduced out-of-pocket cost, the tax treatment of the split-dollar arrangement should also be taken into account.

Tax Treatment of Split-Dollar Life Insurance Plans

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There are two mutually exclusive regimes which determine how a split-dollar life insurance plan will be taxed. The **ownership of the life insurance policy on the employee's life** is the primary determinate as to which of these tax regimes will apply to the split-dollar plan:

Economic Benefit Regime (Endorsement Split-Dollar Plan)

The **employer** owns the life insurance contract, advances money to pay the premiums and provides economic benefits to the **employee** by allowing the **employee** to name a beneficiary for the policy's death benefit by means of an endorsement to the life insurance contract.

The **employee** is then taxed on the value of the economic benefits received in each taxable year.

The endorsement method allows the policy's cash value to be carried as a business asset and borrowed for business purposes (withdrawals and loans will reduce the policy's death benefit and cash value available for use).

Loan Regime (Collateral Assignment Split-Dollar Plan)

The **employee** owns the life insurance contract, names a personal beneficiary and assigns the policy as collateral to the **employer**, in return for the **employer's** premium payments. At the **employee's** death, the **employer** receives a portion of the death benefit (usually equal to the total premiums it has paid) and the **employee's** beneficiary receives the balance. If the policy is surrendered, the **employer** receives back the total premiums it has paid, up to the policy's cash surrender value, and the **employee** receives any remaining cash surrender value.

The payment of premiums by the **employer** for a life insurance contract owned by the **employee** is treated as a series of loans to the **employee**. Unless the **employee** pays the **employer** market-rate interest on the loans, the **employee** is taxed each year on the difference between market-rate interest and the actual interest paid, if any.

Since the **employer's** premium contributions are considered loans to the **employee**, federal and state law should be checked to determine if there are any restrictions on corporate loans to employees, shareholders, officers, etc., before implementing a collateral assignment split-dollar plan. In addition, publicly-held corporations are strongly encouraged to consult their securities counsel on the potential impact of the Sarbanes-Oxley Act of 2002 on collateral assignment split-dollar plans.

A professional tax advisor should be consulted in the design and administration of a split-dollar life insurance plan in order to avoid unintended tax consequences.

Split-Dollar Life Insurance Plan Premium Variations

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In order to overcome the problem of the employee generally having to pay a large portion of the premiums in the early years, a number of premium sharing variations have been developed, including:

Employer Pay All Split-Dollar

The **employer** pays the entire premium. Depending on policy ownership, the **employee** either reports as income the value of the economic benefits received (economic benefit tax regime), or the difference between market-rate interest and the actual interest paid by the **employee**, if any (loan tax regime).

Level Outlay Split-Dollar *

The **employee's** premium contribution is a level amount for a specified period of time, with the **employer** paying the balance of the premium.

Economic Benefit Split-Dollar (Endorsement Plan Only) *

The **employee** pays the portion of the premium equal to that year's reportable economic benefit and the **employer** pays the balance. This approach eliminates the **employee's** out-of-pocket cost for the tax on the economic benefit.

Bonus Split-Dollar (Endorsement Plan Only) *

The **employer** bonuses the annual economic benefit to the **employee**. The **employee** then uses the bonus to pay the portion of the premium equal to that year's reportable economic benefit and the **employer** pays the balance of the premium. Assuming overall compensation is reasonable, the **employer** can deduct the bonused amount, which the **employee** must include in income. Another alternative is for the **employer** to bonus both the economic benefit and the tax on the bonus, resulting in no out-of-pocket cost to the **employee**.

Bonus Split-Dollar (Collateral Assignment Plan Only)

The **employer** bonuses to the **employee** an amount equal to the **employee's** tax liability on the market-rate interest imputed to the outstanding premium "loans." The **employee** then uses the bonus to pay his/her tax liability. Assuming overall compensation is reasonable, the **employer** can deduct the bonused amount, which the **employee** must include in income. Another alternative is for the **employer** to bonus both the tax liability on the imputed interest and the tax on the bonus, resulting in no out-of-pocket cost to the **employee**, assuming the employer is paying the full premium.

** **Important Note:** Any premiums contributed to an **endorsement** split-dollar plan (economic benefit tax regime) by the **employee** are considered income to the **employer**.*

Uses of a Split-Dollar Life Insurance Plan

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As a method of splitting life insurance premiums, benefits and ownership between a business and selected owners and/or valued employees, the split-dollar approach is a flexible, cost-effective funding mechanism that can be used to satisfy a variety of needs.

For example, a split-dollar life insurance plan can be used:

As a Selective Executive Fringe Benefit:

- A split-dollar plan can be helpful in retaining selected employees by helping them to purchase needed personal life insurance.
- A split-dollar plan can be linked with a deferred compensation plan in order to provide an additional executive fringe benefit at an owner's or valued employee's death and/or retirement.

In Business Continuation Planning:

- A sole proprietor can use a split-dollar plan to assist an employee in purchasing the life insurance needed to fund a sole proprietorship buyout.
- A split-dollar plan can be utilized to assist shareholders of a closely-held corporation to purchase the insurance needed to fund a cross purchase buy-sell plan.
- When family retention of a business interest is the objective, a split-dollar arrangement between the corporation and the shareholder-employee's spouse may be an effective way to provide the funds for a Section 303 partial stock redemption at the shareholder's death.

To Provide Needed Estate Liquidity:

- If a shareholder-employee is in a higher tax bracket than the corporation, a split-dollar plan may be a cost-effective way for the owner to purchase additional life insurance for estate liquidity purposes.

To Replace or Supplement Group Term Insurance:

- A split-dollar plan can be used to supplement the limited coverage provided to valued employees by a group term insurance plan, or to replace a portion of selected employees' group term insurance with more cost-effective coverage.