



Benefit Trends

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Split-Dollar Life Insurance Plans Clearly Divided

A split-dollar life insurance arrangement is a method of providing permanent life insurance on an individual for the benefit of his or her family or estate. The arrangement is in the form of a written agreement. Normally, the arrangement involves a corporation, a corporate employee and perhaps a third party, often a spouse or a trust.

A split-dollar plan or arrangement is not a type of life insurance product. A whole life or other permanent life insurance policy is typically used. These products provide three basic elements: a cash value build up, an investment element and a death benefit element.

Since 1964, Rev. Rul. 64-328 has provided the rules for calculating the taxable income from split-dollar arrangements. This ruling was requested by accountants and insurance professionals to determine the tax effect of a split-dollar arrangement between an employer and an employee. There are two popular plans that have been used over the years.

Endorsement Method

Under the endorsement split-dollar method, the employer is the applicant and owner of the policy with the employee's rights being spelled out in the written agreement. The agreement provides for the payment of premium by the employer so long as the employee reimburses the employer each year for any excess premium over the increase in cash value. This method normally empowers the employee to name a beneficiary for all the proceeds above the cash value or the employer's aggregate premium payments. This provision is implemented by a beneficiary endorsement method to the policy itself.

Collateral Assignment Method

The collateral assignment method is an alternative to the endorsement method. In this method, the employee initially applies for and owns the policy on his or her life. The employee names a beneficiary and then collaterally assigns the policy to the employer as security for the annual premium advances being made by the employer. As owner, the employee is technically responsible for premium payments. However, the split-dollar agreement sets forth the premium payment arrangement. Normally, the employee pays premium equal to the economic benefit cost and the employer pays the difference.

In 1996, the Internal Revenue Service (IRS) took the position that the taxability of the annual equity build up is a matter of current importance. These rules and other elements of the income taxation of split dollar continued to be discussed until a comprehensive set of new regulations was issued in proposal form in July 2002 and finalized without material change in September 2003.

In arrangements implemented prior to Sept. 17, 2003, the new rules only

apply if the split-dollar policy has become an equity split-dollar policy, meaning that the noncorporate entity has value in the policy or if there has been a material modification to the policy after Sept. 17, 2003. For those policies and for the ones issued after Sept. 17, 2003, the alternatives are as follows: terminate the agreement and return the applicable cash value to the parties, have one of the parties buy the policy from the other party, adopt the economic benefit regime or the loan regime.

Under the economic benefit regime, the employee reports the value of the current life insurance protection (the difference between the policy's face amount and the company's interest in the cash value) as income.

Demand vs. Term Loans

Under the loan regime, the parties choose from demand loans or term loans. With respect to a demand loan, the loan duration is any time the employer demands repayment. The fair market interest rate is the short-term Applicable Federal Rate (AFR) at the beginning of each calendar year. When a premium is paid during the year, this is a new loan and the current rate is charged on that portion to the end of the calendar year. At the beginning of each year, the loans are blended and the new short-term AFR rate is charged. Advantages to the employee include possible lower interest rate and the demand loan may continue indefinitely or until another terminating event.

With respect to a term loan, there is a specific repayment date that will be either short term (up to three years), mid-term (three to nine years), or long term (more than nine years). The fair market interest rate of term loans depends on the AFR rate as determined in the month the note is executed. When a premium is paid, the new loan resulting stands on its own. Thus, a series of loans is established until the end of the term. When the employment relationship ends, the loan is treated as a demand loan.

Which Option is Best For You?

It appears as if the demand loan alternative is best for employees who want a lower relative interest rate and are comfortable with the repayment risk and for employers who want repayment flexibility.

However, the term loan alternative is most appropriate for employees and employers who want certainty in the interest cost and a known date of repayment.

For more information on split-dollar life insurance plans, contact C. John Weber III at Hubbard Bert Karle Weber, Inc. at 814/453-3633 or weber.cj@hbkw.net