Split Dollar Loan Arrangement with a Rollout

Split Dollar Loan / § 409A Combo Arrangement

A split dollar loan is an arrangement where an employer helps to provide an executive with supplemental retirement and death benefits by providing the funding for the ownership of a life insurance policy. The employer pays premiums on a life insurance policy owned by the executive, but retains a collateral assignment interest in the policy equal to the sum of the premiums it has advanced. The premium advances are treated by the IRS as loans and the executive pays taxes on the interest that is "imputed" on the loans.

Additionally, the employer can promise a benefit at retirement that would extinguish the executive's obligation to reimburse the employer for premiums paid. This additional benefit should be considered a separate arrangement and would be subject to the requirements of IRC § 409A. The executive would treat the forgiveness of the premium loans as taxable income.

Steps for Implementing a Split Dollar Loan Arrangement

1. The employer identifies a need to retain and reward a key executive. The employer and the executive agree that personal life insurance protection and the related cash value accumulations are important components of the executive's overall compensation package. The parties execute a split dollar agreement setting forth their rights and obligations.
2. In a separate agreement, the employer agrees to provide an additional benefit at retirement that will provide the executive with funds necessary to repay the obligation under the split dollar loan arrangement. If desired, the company can promise an additional "gross-up" benefit to cover the executive's tax costs from the arrangement. This second agreement must comply with the provisions for § 409A.
3. The executive acquires a cash value life insurance policy on his or her life and executes a collateral assignment indicating the policy rights reserved to the employer.
4. The employer makes premium payments on the policy.
   - The premium payments are treated as advances or below-market loans from the employer to the executive;
   - Each year, the executive is taxed under IRC § 7872 on the amount of interest imputed by the IRS on the sum of premiums that have been advanced;
   - The employer retains a collateral assignment interest in the policy equal to the sum of premiums advanced.

Split Dollar Loan Arrangement with a Rollout, continued

5. At retirement, the split-dollar arrangement is terminated. The second agreement under § 409A provides the executive with the funds needed to reimburse the company and release the collateral assignment on the life insurance policy. Of course, should the executive terminate employment prior to retirement, the promised compensation under the second agreement would be forfeited. The executive would then be obligated to repay the loan with other amounts.

6. After termination of the split dollar loan arrangement, the policy's available cash values can be accessed through loans and withdrawals to potentially supplement the executive's retirement income.* The policy death benefit will be paid income tax-free** to the executive's beneficiaries.

Potential Advantages

- Source of supplemental retirement income*
- Only collateral assignment amount is subject to claims of employer's creditors
- Tax-preferred retirement benefits*
- Flexibility on timing of retirement income
- Death benefit not taxable as income**
- Permits "Golden Handcuffing"
- Executive receives policy with full cash value intact at retirement

Some Disadvantages

- Executive taxed annually on "imputed interest"
- Reimbursement benefit is subject to § 409A rules
- Reimbursement benefit is fully taxable to executive at retirement
- No cost recovery for employer

* The policy's cash values are available to the executive as a source of supplemental retirement income through loans and withdrawals. Policy loans and partial withdrawals may vary by state, reduce available surrender value and death benefit or cause the policy to lapse. Generally, policy loans and partial withdrawals will not be income taxable if there is a withdrawal to the cost basis (usually premiums paid), followed by policy loans (but only if the policy qualifies as life insurance, is not a modified endowment contract and is not lapsed or surrendered).

** Death proceeds from a life insurance policy are generally income tax-free and if properly structured, may be free from estate tax.

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