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Split Dollar Primer

“Split dollar life insurance” encompasses a myriad of compensation arrangements ranging from conservative to highly aggressive. This is a compact overview of the history, key design elements, taxation and regulatory issues surrounding split dollar arrangements sponsored by hospitals.

History

Split dollar insurance began in the mid-20th century.[1] It provided a way for an employer and an employee to “split” the “dollars” provided by a cash value life insurance policy.

In its simplest form, the split involved only the death proceeds. Upon the employee’s death, the employer would receive death proceeds equal to the policy’s cash value, and the employee’s beneficiary would receive the balance. The employer retained all rights to the policy’s cash value.

Over the years, split dollar arrangements became more creative, and started directing a portion of the cash value to the employee. The employee’s portion of the cash value was intended to keep the insurance in force after termination of employment, or to provide supplemental compensation.

Key Design Elements

Policy Ownership – The employer, the employee, or both, can be the named owner of the policy:

- Employer-Owned – If the employer owns the policy, the arrangement is called “endorsement split dollar.” The employer places an endorsement in the policy specifying the employee’s interest.
- Employee-Owned – If the employee owns the policy, the arrangement is called “collateral assignment split dollar.” The employee collaterally assigns rights in the policy to the employer. The collateral assignment is the equivalent of a lien on the policy, guaranteeing employer control over the policy values.
- Jointly-Owned – Both the employer and employee can be named owners under a joint ownership arrangement. In that case, the underlying agreement defines the respective ownership rights.

Death Proceeds Split – The agreement specifies how the death proceeds are divided between the employer and the employee.

Cash Value Split – The agreement specifies whether the employee has any interests in the policy’s cash value and when and under what circumstances the employee can access those values. There are two choices:

- Non-Equity Split Dollar – The employee has no access to the policy’s cash value during life or at death.
- Equity Split Dollar – The employee can access all or a portion of the cash value through withdrawal or loan at the time or times specified in the agreement.

Tax Implications

The IRS struggled for decades to determine the proper taxation of split dollar. In the earliest rulings, the IRS concluded that irrespective of who owned the policy, the employer premium payments should be treated for tax purposes as loans to the employee.[2] Later, realizing that loans to employees generated no taxable income under the rules then in effect, the IRS changed its approach and characterized split dollar as providing death benefit protection, the value of which should be taxed annually.[3]

The key benefit subject to annual taxation was the value of the death benefit protection. The taxable value was based on the lower of the carrier's annually renewable term rates or an IRS table, both of which had rates that increased as the employee aged.[4]

In all of its rulings, the IRS failed to address how cash value interests should be taxed. This led to a variety of interpretations and designs expecting to qualify for tax deferral on the cash value accumulations.

Then, in the 1990s, the IRS issued a private letter ruling suggesting that the employee's interest in the cash value should be taxed as soon as it arises in the policy.[5] This ruling created an uproar that led to a multi-year IRS review that culminated in 2003 with the publication of new split dollar regulations.[6]

Under the 2003 regulations, the tax treatment depends on who owns the policy:

- Employer-owned – Economic Benefit Regime ("EBR")
- Employee-owned – Collateral Assignment Regime ("CAR")
- Jointly-owned – If the first listed owner is the employer, EBR applies. If the employee is the first listed owner, CAR applies

Annual Taxation – For non-equity split dollar and EBR arrangements, the value of the death benefit protection is taxable to the employee each year based on either carrier or IRS tables. The employee can (i) pay the taxable value to the employer each year, or (ii) report the value as additional taxable income each year.

Under CAR, each employer premium payment is deemed for tax purposes to be a loan to the employee. Interest on the "loans" must be (i) paid by the employee each year, (ii) imputed as income to the employee each year, or (iii) paid from the policy's death proceeds (in which case the interest must be compounded).

Cash Value Taxation

- Non-Equity Split Dollar – If the employee has no interest in the cash value, then nothing is taxable.
- EBR – The employee is taxed each year on any cash value that accrues to the employee's benefit and is accessible to the employee.
- CAR – The cash value is not taxable to the employee unless and until the employee withdraws cash in excess of the premiums paid on the policy. The employee can borrow against the policy's cash value without taxation.

Death Proceeds Taxation – At the employee's death, the death proceeds are not subject to income tax. This is true even under CAR for the portion of the proceeds used to repay amounts the employee has borrowed from the policy.

Regulatory Issues

Safety and Soundness – The primary regulatory issue is the impact of the split dollar arrangement on safety and soundness, such as:

- What portion of the hospital's assets is being placed in the policy (e.g., concentration concerns)?
    - This issue concerns both the total assets placed in split dollar arrangements and the total assets placed with any Specific carrier.
- What is the financial strength of the insurance carrier?
    - Rating agencies provide monthly updates of carrier financial strength.
- How quickly can the hospital recover the assets placed in the policy?
    - This requires reviewing both the split dollar agreement (to determine whether the hospital has any obligation to leave the funds in the policy for a specified period or until a specified event) and the policy (to determine if the carrier places any restrictions on withdrawals).
- What financial penalties apply to withdrawal of cash from the policy to repay the hospital's premium payments?
    - Policies typically have surrender charges that apply to withdrawals made within the first years after the policy is issued.
    - Several carriers provide riders that effectively waive any surrender charges, allowing immediate and full access to withdrawing the total premiums paid.
- What is the expected rate of return on the policy in comparison to other investments available to the hospital?
    - Is the policy a so-called variable policy where the cash value rises and falls with specific stocks or funds?
    - If so, does the policy provide any minimum return guarantees to protect against market losses?

Preferred Loan – Some states restrict loans to hospital executives on terms better than are available to the hospital's members generally. However, notwithstanding the "loan" characterization of CAR arrangements for tax purposes, whether an actual loan is involved depends on the structure.

For example, at one end of the spectrum are joint ownership arrangements. A joint ownership arrangement involves no actual loan. The joint ownership agreement gives the hospital sole and complete ownership and control of the premium dollars it has paid into the policy. The executive cannot access or assign the premium dollars or divert them for other purposes. Therefore, CAR arrangements under the joint-ownership structure should not be viewed as loans to the executive.

At the other end of the spectrum are arrangements where the executive is the sole owner of the policy and the documentation contains many characteristics typically associated with loans, such as promissory notes and express recourse “repayment” obligations. This type of arrangement is properly treated as a loan to the executive.

In the middle are many different arrangements that need to be evaluated individually to determine if the arrangement involves an actual loan rather than simply a deemed loan for tax purposes.

Conclusion

Split dollar life insurance remains a common executive compensation planning tool. Although varied in form and content, focusing on the essential elements of the arrangement should facilitate its regulatory review.

Endnotes

1. Rev. Rul. 55-713.
2. See *Id.*
3. Rev. Rul. 64-328.
4. Rev. Rul. 66-110.
5. TAM 9604001.
6. Treas. Reg. §§ 1.61-22, 1.7872-15.