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Help build retirement security while securing cost recovery

A whitepaper overview of the **loan regime split dollar** agreement from an accounting, tax and competitive perspective.

The backdrop

Executive retention is now at an inflection point as businesses seek to reward and recruit highly valuable employees. Recent economic events have accelerated the need for a business to hold onto their best talent, while other competitive factors have put strains on the traditional employer-employee relationship. Modern qualified plan arrangements still provide a financial connection between employers and employees, but today's marketplace demands something much different to secure highly valued employees to a company.

The financial professional that understands this dynamic and takes the necessary steps to meet the demand, can help provide a unique value-add for their business-owner client. And having a firm grasp on the world of non-qualified arrangements can be key. A mountain of research supports the wisdom of this foresight. **For example, a recent survey has shown an uptick in non-qualified plans being used by companies to keep their compensation and benefits attractive and competitive.**[1]

What is a non-qualified benefit? Though there is no formal definition, a **loan regime split dollar life insurance plan** (split dollar) is not subject to most of the participation, vesting, and reporting requirements of the Employee Retirement Income Security Act (ERISA). Note, these plans are not typically used to replace tax-qualified plans like 401(k)s and profit-sharing arrangements, but they selectively offer additional employer-sponsored incentives for high-ranking executives.

> **"The loan regime split dollar life insurance arrangement offers an attractive value-add that a company and its key employee can both benefit from."**

Retaining the right to cherry-pick key employees adds to the sense of exclusivity that many key executives seek in return for their services. In fact, exclusivity is a necessary prerequisite for these plans.[2] The loan regime split dollar life insurance arrangement offers an attractive value-add that a company and its key employee can both benefit from.

Employers and their tax advisors must be aware that split dollar is classified as a welfare benefit plan under the ERISA. Therefore, there are no participation, vesting, or funding requirements. But there are limited reporting, administration and fiduciary obligations. Compared to the rigorous protections and procedures of a qualified plan, split dollar can be an attractive option. A consideration of its legal, tax, and accounting attributes will provide further clarity.

The legal and tax perspective

Split dollar arrangements are a type of non-qualified agreement between two parties to allocate the rights and responsibilities of a life insurance policy. Though no single strategy fits all situations, **this particular non-qualified plan is particularly effective at providing valuable life insurance protection for key employees while securing cost recovery for a business**.

The final regulations for a split dollar life insurance arrangement are effective for arrangements entered into after September 17, 2003. They create two mutually exclusive regimes for this particular non-qualified executive benefit:

1. **The policyowner provides economic benefits to the non-owner.**
2. **The non-owner makes loans to the owner.**

This whitepaper focuses on an application of the second scenario in which an insured employee is the owner and a business is the non-owner of the policy. In this scenario, the business pays the premium on behalf of the executive, with each payment treated as a loan.[3]

Under the loan regime split dollar, the insured employee owner collaterally assigns the policy back to the employer to secure eventual reimbursement of the premium advances. This is an important selling point for a business seeking cost recovery. However, a business may not take a tax deduction for the annual premium. While this may seem obvious as each premium, rather than deductible compensation, is categorized as a loan of which the business is the eventual beneficiary, it remains a point worth highlighting.[4]

"Ensuring cost recovery often grabs the attention of the business owner."

With every loan, the topic of interest must be addressed. Each premium payment by the employer is treated as a separate loan to the employee and an adequate rate of interest must be charged. If the employee fails to pay adequate interest, premium payments are classified as below market split dollar loans. Any forgone interest will then be taxable as compensation income to the employee at the appropriate Applicable Federal Rate (AFR).[5] This in turn causes a series of imputed transfers between the parties, which makes tax tracking a challenge.

The sufficiency of this interest is measured by its classification as a **demand** or **term** loan using the AFR. A demand loan is due in full upon request of the employer and measured for adequate interest by comparing the interest rate to the blended AFR that is published every July. On the other hand, term loan rates published monthly are measured by the length of the loan, allowing for a choice of either a short, mid or long-term AFR.[6] Speaking of interest, the topic of non-recourse loans needs attention.

Non-recourse loan split dollar is the most prevalent category of split dollar and will be addressed further when accounting is discussed. This strategy secures repayment of premiums by the policy values only. While this form of split dollar seems innocuous, it may result in interest payments under a split dollar loan being treated as contingent, which then causes the payments to be ignored for purposes of testing for adequacy of interest, regardless of whether the arrangement calls for payment or accrual of interest. The result? A non-recourse split dollar loan may be considered to provide contingent payments and be deemed a "below market loan," subjecting the arrangement to income tax on forgone interest, even if adequate interest is charged.[7] (See above) However, this unfortunate result can be avoided if both parties in a split dollar agreement describe in writing what a reasonable person would expect of all the payments under the loan to be satisfactory. This is referred to as a "non-recourse representation" and must satisfy certain substantive and procedural requirements to be effective.[8]

The economics

Though seemingly complicated, the key to understanding loan-based split dollar arrangements is to know that, as the actual legal owner of the policy, the employee is not taxed on the equity build-up within the policy. Compare that to an endorsement split dollar treatment where a transfer of a policy to a non-owner (i.e. employee) is a fully taxable event with no offset for basis.[9] Most executives are not especially motivated by the "reward" of additional taxable income in return for their services. However, these same employees are very interested in obtaining access to tax advantaged cash value with no additional income tax burden.[10] Adding a non-qualified benefit such as loan split dollar on top of a current qualified plan provides a tax diversification scenario that most rarely enjoy from their employer.

Split dollar interest rates as measured by the AFR are especially attractive because they are typically less than those charged by commercial lenders. The term loan structure is often preferable, as it counter balances the unpredictable nature of interest rates on a demand loan. More specifically, the long-term AFR is typically higher, so it allows loans to be locked in for longer periods of time and provides certainty to most split dollar loan arrangements. For this reason, it's typically the popular choice of tax professionals.

Lastly, a decision must be made on how to handle the interest. Interest can be accrued rather than paid annually. This relieves the insured employee from the financial burden of continuous payments. Keep in mind that when this interest is added to the principal, it produces a larger loan payoff amount, resulting in reduced cash value and/or death benefit for beneficiaries. Alternatively, a simple and common option is for the employees to pay appropriate interest out of pocket. In this scenario, there is no growing interest balance, and it only leaves the loan principal to be repaid. This can ultimately present the most leverage for the loaned premium dollars.

The two "rollout" scenarios for split dollar arrangements are lifetime exit and death. During life, the split dollar agreement is terminated, and the collateral assignment is satisfied by reimbursing the employer for cumulative loaned premiums and any accrued interest. If designed properly, this leaves the executive who possesses a solely owned policy with cash value and the remaining death benefit protection. In a similar way, termination by death provides the employer with cost reimbursement, while the remaining death proceeds are allocated to the insured's family, income-tax free.

"If structured correctly, the employee is not taxed on the equity build-up."

The accounting

The transactional side of split dollar is always of special interest to those versed in business financials, such as accountants, business managers, or tax attorneys. Keep in mind that all collateral assignment arrangements that include benefits other than term life insurance protection are taxed as loans.[11] However, loan treatment for tax purposes does not depend on the level of risk sharing between an employer and employee. In contrast, loan treatment for accounting purposes is heavily dependent on the risk of policy ownership by an employee. These risks of ownership include the possibility of default and the chance that additional premiums will be necessary to avoid a coverage lapse.

This whitepaper focuses on an application of the second scenario in which an insured employee is the owner and a business is the non-owner of the policy. In this scenario, the business pays the premium on behalf of the executive, with each payment treated as a loan.[3]

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Maintaining proper loan accounting is crucial for an employer because it provides predictability to measure the financial impact of a split dollar loan. However, an employer can jeopardize this certainty by agreeing to maintain the policy, or guaranteeing a death benefit in the event of an insurer's default.[12] **Why?** Because these actions are inconsistent with true split dollar loan accounting, as it shifts excess policy ownership risk back to the employer. These actions in turn may inadvertently disqualify an otherwise well-constructed split dollar arrangement from loan accounting, and may instead cast it into the larger arena of retirement benefit expense accounting, where it will be subject to the full gambit of ERISA plan requirements.

Now let's briefly examine what the "books" look like for an arrangement that qualifies for a typical split dollar loan accounting treatment. This requires a brief examination of phrases like: non-recourse, limited recourse, and full-recourse arrangements.

- A **full-recourse loan split dollar arrangement** allows an employer to pursue an employee for a recovery of principal and interest shortfall without first seeking recourse from the life insurance policy.
- A **limited recourse loan split dollar arrangement** seeks to obtain recovery from the life insurance policy. If there is a deficit, the employee (or the respective estate) will be called upon to make up any difference.
- A **non-recourse loan split dollar arrangement** looks solely to the life insurance policy for repayment of all principal and interest. The employee or the estate is not responsible for any deficit. Nonetheless, the deficit may be subject to taxation to the employee as forgiveness of indebtedness income.

Keeping these distinctions in mind, be aware that the majority of collateral assignment split dollar arrangements are non-recourse.

The good news is that, whether the arrangement is a non-recourse, or the less common limited-recourse, the ledger entries are similar. Once the promissory note from the employee is exchanged, the transaction meets the definition of a loan, and is quantified at an amount equal to the cash outlay of the business as a loan receivable. The accrual of interest is treated in a similar fashion, as a loan receivable–accrued interest.[13] This business should scrutinize these entries at the end of each fiscal period for possible collection issues. Appropriate allowances to establish the appropriate carrying value of the receivable balance should be made.[14] The proper journal entry then depends on the type of note discussed previously.

Let's revisit the recourse issue. As a non-recourse loan is secured by only the cash surrender value of the policy, there's a potential for loss if the loan itself outpaces the available cash value. This is not uncommon, especially in the early years of a split dollar plan. For example, if the cumulative loan is $2 million and the cash surrender value of a policy is $1.5 million, the company would then need to reduce the carrying value of the loan receivable to $1.5 million and accept a loss for the difference. Contrast this to a limited recourse loan in which an employer has access to collateral outside the cash surrender value. In this instance, the carrying value remains equal to the outstanding loan.

There are more split dollar accounting considerations to make. However, understanding the distinction between loan accounting and loan tax treatment puts the elements that tax and legal professionals should first grasp during the implementation and administration of a successful loan split dollar strategy into perspective.

Specialized applications of split dollar - an excise tax alternative for tax exempt organizations?

Certain split dollar arrangements received a boost, thanks to Section 4960 of the Tax Cuts and Jobs Act of 2017. Though enacted into law and clarified by subsequent IRS Notices and Regulations, this provision has still received relatively little attention in the executive benefits arena.

The section imposes a 21% excise tax on applicable tax-exempt employers (ATEOs) for remuneration above $1 million paid to certain covered employees.

A few definitions will be helpful here:

- **ATEO coverage** is broad and includes, hospitals, colleges, universities, and larger governmental organizations.[15]
- For purposes of the cap, **remuneration** applies to wages and deferred compensation that becomes vested and are no longer subject to a substantial right of forfeiture.[16] However, compensation paid to medical professionals is excluded.[17]
- A **covered employee** includes an employee who is one of the five highest compensated employees for the taxable year.[18]

Consider the following scenario:

A CEO of a tax-exempt organization that wants to retain and reward her through a 457(f) plan. She receives $500,000 in wages, and in 2023 she will receive a $1 million payout from her 457(f)[19] deferred compensation plan. As the highest paid employee, the tax exemption qualifies for § 4960 treatment and the employer is now subject to the 21% excise tax with an additional tax burden of $105,000.[20]

> **"Loan split dollar for tax-exempts can serve as an appealing substitute for 457(f) arrangement."**

This result is far from ideal, but loan split dollar life insurance arrangement may be a better alternative. The ATEO can enter into a loan split dollar arrangement with this CEO and pay the premium on her behalf. Structured appropriately, she can receive income to help supplement retirement while her ATEO acquires cost recovery of premium dollars, all while avoiding the excise tax and immediate taxation of the CEO's 457(f) benefits at retirement. To be clear, the premiums lent to her would not be defined as remuneration under § 4960. (See the legal and tax perspective section above.)

Loan split dollar allows ATEOs to avoid an organizational excise tax, provide a tax-advantaged retirement income and death benefit for a key employee, and bypass an immediate personal income tax for covered employees. This strategy can serve as an appealing substitute for a 457(f) plan and can be used as another tool in a financial professional's toolbox.

Owners of C Corporations - a dividend substitute?

Owners of C Corporations, particularly sole owners, received a further potential benefit from the Tax Cuts and Jobs Act, which reduced the corporate income tax rate from 35% to 21%. This allows a company to generate more after-tax earnings every year.

For example, let's say that a company earned $2 million every year in pre-tax profits. This 14% reduction would generate $280,000 in additional after-tax earnings.[21] How can this "windfall" be best deployed? One common option is to declare a dividend. Especially in the case of sole-shareholders, this tempting option can provide an immediate extra source of income, but keep in mind that this new–found tax windfall is accompanied by another layer of taxation. As a qualified dividend, this extra income would be subjected to a qualified dividend rate of 23.8 % and an additional state income tax ranging from 0% to 13.3%.[22] While this after-tax money can be invested in the market, its compounding potential is muted by the aforementioned taxes.

> **"Loan regime split dollar can be an especially effective tool for the C Corporation owner."**

Instead, the corporation could enter into a loan split dollar life insurance arrangement with the owner and deploy these tax savings differently.

Now, rather than the C Corporation acting as a catalyst to increase taxation, it serves as a resource to provide premium dollars lent to the owner. These pre-tax funds can instead be used to provide the loan funding for a personally owned life insurance policy.

Through time, these untaxed pre-tax funds can provide greater equity in a life insurance contract at retirement, even after the assignment is repaid. This in turn provides a potentially greater retirement income stream than the owner would receive merely investing in after-tax money. Of course, the life insurance death benefit is available during the entire course of the arrangement. Also, keep in mind that both the interest and principal are being paid back to the very corporation that the insured owns. Loan regime split dollar can be an especially effective tool for the C Corporation owner.

Summary

A loan split dollar arrangement can offer a "best of both worlds" scenario in the non-qualified executive benefits arena. A key employee can be chosen to receive potential funds to help supplement retirement income retirement income and death benefit protection in a tax-efficient manner, while the employer enjoys cost reimbursement for loaned premium dollars. With minimal ERISA requirements, this flexible strategy offers lower costs and complexity to an employer who wants to retain a key employee in the competitive employee benefits marketplace.

Every financial professional should consider adding this powerful tool to their financial planning toolbox.

1. Acensus Report-Newport/PLANSPONSOR Executive Benefits Survey Reveals Latest Trends in the Nonqualified Deferred Compensation Markets 9-16-22. Fifty (50%) of such companies in 2020 compared to eighty (80%) in 2022.
2. The employee must belong to a select group of management, which includes quantitative and qualitative elements. To meet the quantitative standard, plans should be limited to the top 15% of the workforce. To meet the qualitative test, a significant disparity should exist between the average compensation of the top-hat group and the average compensation of all other employees.
3. Reg. §§ 1.61-22(b)(3)(i).
4. IRC 264(a)(1).
5. Forgone interest is not only taxable to the employee but deductible by the employer. However, any foregone interest is then imputed back to the employer without a corresponding deduction for the employee as its deemed personal interest.
6. Short term loan are three years or less, mid-term loans are between three and nine years, and long-term loan are nine years or greater.
7. Reg. § 1.7872-15(j).
8. Reg § 1.7872-15(d)(2)(i).
9. Treas. Reg. §1.61-22(g).
10. In some situations loans and withdrawals may be subject to federal taxes. North America does not give tax or legal advice. Clients should be instructed to consult with and rely on their own tax advisor or attorney for advice on their specific situation. Income and growth on accumulated cash values is generally taxable only upon withdrawal. Adverse tax consequences may result if withdrawals exceed premiums paid into the policy. Withdrawals or surrenders made during a Surrender Charge period will be subject withdrawal charges, processing fees, or surrender charges, and may reduce the ultimate death benefit and cash value. Surrender charges vary by product, issue age, sex, underwriting class, and policy year.
11. Treasury Reg § 1.7872-15.
12. Financial Accounting Standards Board Accounting Standards Codification, Subtopic 715-60.
13. Ibid, ASC 310-10-30-2.
14. Ibid, ASC 325-30-35-1.
15. Tax Cuts and Jobs Act, § 4960(c)(1), "ATEO" includes an organization that has income excluded from taxation under Section 115(1) or an organization that is exempt from taxation under section 501(a).
16. Ibid, 4960(c)(3)(A).
17. Ibid, 4960(c)(3)(B).
18. Ibid, 4960(c)(2).
19. Nonqualified deferred compensation plans available to employees of state and local governments and tax-exempt organizations. Deferred amounts are now included in the participant's taxable income upon expiration of a substantial right of forfeiture.
20. {$1,500,000-$1,000,000} X 21%.
21. 35%-21%=14%
    14% X $2,000,000=$280,000.
22. https://taxfoundation.org/publications/state-individual-income-tax-rates-and-brackets/. (California is the highest taxed state using this 2023 table)

Under a loan split-dollar agreement, the employee enters into an agreement with the employer. Midland National® Life Insurance Company is not a party to this agreement and Midland National's only obligation is to administer the policy it issues (consistent with the policy's terms and conditions).

The parties to the loan regime split dollar arrangement should seek their own independent legal and tax advice as to whether and how to enter into an economic split dollar arrangement based on the employer's and employee's unique circumstances.

Under a split dollar agreement classified as a welfare benefit plan, the employee must belong to a select group of management, which includes quantitative and qualitative elements. To meet the quantitative standard, plans should be limited to the top 15% of the workforce. To meet the qualitative test, a significant disparity should exist between the average compensation of the top-hat group and the average compensation of all other employees.

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