

Loan regime split dollar

The basics

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Key highlights

- Loans and the Internal Revenue Code
- Types and features of split dollar loans
- Supplemental executive benefit
- Other considerations

There certainly has been a lot of buzz about split dollar life insurance arrangements over the past few years. There is still an awful lot of confusion, too, about how to design and implement an appropriate plan for a particular employer and key employee. Much of the literature has either added to the confusion or has been aimed at a single design for everyone. When it comes to executive benefits, one size does not fit all. This paper will address only loan regime split dollar arrangements in the employment context.

Loans and the Internal Revenue Code

Without going into the history of split dollar life insurance, suffice it to say that, until 2002, there was no comprehensive guidance from the IRS on the taxation of the various split dollar designs that were being used. That changed with the promulgation of the proposed and then final regulations in September 2003. Under these regulations, split dollar arrangements (entered into after September 17, 2003¹) are taxed either under the economic benefit regime or the loan regime.²

Internal Revenue Code (“Code”) section 7872 governs the treatment of loans with below-market interest rates. If a loan has a market rate of interest, then it is governed by Code sections 1271 to 1275. We will assume that the split dollar arrangements we discuss in this paper are all below-market loans and Code section 7872 applies.

For the loan regime taxation method to apply to an arrangement, the employee must own the life insurance policy, the employer’s interest is limited to the premiums it pays, and the premium payment is treated as a loan to the employee. Beyond that, the confusion begins as to how to structure the loan. The following chart outlines the three types of loans and how they are taxed under the regulations.

Types and features of split dollar loans

	Demand	Term	Hybrid
Description	Payable in full at any time on the demand of the lender	A split dollar loan that is not a demand loan (but note exceptions under “hybrid”)	A hybrid loan is a term loan that is (a) payable no later than the employee’s death; or (b) conditioned on the future performance of substantial services; or (c) is payable on the later of a term certain or (i) death, or (ii) for loans under (b) above, the date on which the condition to perform services ends ³
Test for sufficient interest (If not sufficient, then it is a below-market loan)	Sufficient interest is charged if the rate at which interest accrues is no lower than the blended annual rate ⁴	Sufficient interest is charged if the PV of all payments due under the loan equals or exceeds the amount loaned ⁵	The test for sufficient interest is the same as for a term loan For loans payable under (c) above, the term of the loan is the term certain
Calculate foregone interest if sufficient interest is not charged	The amount of foregone interest is deemed compensation paid to the employee by the employer, and (simultaneously) paid by the employee to the employer as interest on the loan Both “transfers” are deemed to occur on the last day of the calendar year The interest rate deemed to be paid is the blended annual rate	The interest rate will be the AFR on the date the loan is made and for the term of the loan (short, mid, or long term) The employee will have imputed income equal to the amount of the loan minus the PV of all future payments required	If interest is not sufficient, the loan is treated as a below-market demand loan, except the rate used to determine forgone interest is the AFR appropriate for the loan’s term as of the month in which the loan is made ⁶ (Do not use the blended annual rate) For loans described in (b) above, if unstated, the term of the loan will be deemed to be seven years ⁷ For loans described in (c) above, the appropriate AFR is for the longer period ⁸
Special notes			If the loan is payable at death and the insured outlives his/her life expectancy (or if the loan described in (c) remains outstanding longer than the term certain), the loan is treated as retired and reissued for an amount of cash equal to the loan’s adjusted issue price on that date ⁹
Advantages/ Disadvantages	The blended annual rate will fluctuate from year to year. Depending on the length of the loan, imputed interest charges could exceed what would have been charged under a hybrid loan Employee takes a risk that the employer will call the loan at any time	This type of loan is rarely, if ever, used. The amount of imputed income to the employee could be very high	Interest rate is fixed at the time of the loan Employee is not at risk of loan being called by future owners or managers of the business

Supplemental executive benefit

In the employment context, loan regime split dollar arrangements can be useful as a supplemental executive benefit without the burdens of some other types of benefits. Properly designed, this type of arrangement can provide the employer with repayment of the loan while also providing tax-free withdrawals and loans from policy cash values to the executive after retirement.

Examples of employers that may adopt such an arrangement are:

- Nonprofit, tax-exempt organizations that have highly-paid executives who need a source of supplemental retirement savings. Caution: State statutes regulate charitable organizations that are tax-exempt, and some states prohibit loans to executives or insiders. The alternative for tax-exempt organizations is an ineligible deferred compensation plan under Code section 457(f). Organizations that are concerned about the 21% excise tax on compensation paid to an employee in excess of \$1 million would probably prefer a split dollar arrangement, if it's available to them.
 - o Loan regime split dollar is recognized by the National Credit Union Association as a viable executive benefit.
 - o State universities have entered into loan regime split dollar arrangements with coaching staff.
- For-profit companies looking for supplemental executive benefits. These employers have many options from which to choose: executive bonus plans, nonqualified deferred compensation arrangements, and equity arrangements. Each of these types of plans have advantages and disadvantages and should be analyzed in terms of the needs and goals of both the employer and the executive.



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Other considerations

Recourse or nonrecourse?

An employer that loans premium payments to an employee will have a security interest in the policy in the form of a collateral assignment against the cash value and death benefit. Some loans may also require that if the cash value or death benefit is insufficient to repay the entire outstanding loan when due, then the borrower is personally responsible for repaying the remaining balance. This means it is a recourse loan. Alternatively, if the employee (borrower) is not responsible for any shortfall, it is a nonrecourse loan

and to avoid adverse tax treatment, both the employer and employee must represent in writing that a reasonable person would expect that all payment under the loan will be made.¹⁰ The representation must be submitted with each party's Federal income tax return for any taxable year in which the lender makes a loan to which the representation applies.¹¹

Code section 409A

A split dollar loan agreement that waives, cancels or forgives any part of the loan may be deferred compensation and subject to Code section 409A.¹²

Administration

"Keep it simple" may be something to keep in mind when designing a split dollar arrangement. These are usually long-term plans. The more complicated they are, the more likely that, without regular monitoring, they will not accomplish the goals that were desired in the first place.

Conclusion

A loan regime split dollar life insurance arrangement can be an appropriate tool for an employer to recruit, reward and retain key employees. Non-profit organizations should consider whether they are able to offer this type of benefit to key employees. For-profit companies should analyze and compare various alternatives to determine which is the best one for their circumstances. In any event, the employer should retain the services of a knowledgeable CPA, attorney or other financial advisors.



¹ Special rules apply to agreements entered into prior to 9/17/2003 and to agreements materially modified after that date. These subjects are beyond the scope of this paper.

² The taxation under the economic benefit regime is governed by Code sec.61 and Treas. Reg. 1.61-22.

³ Treas. Reg. sec. 1.7872-15(e)(5)

⁴ Treas. Reg. sec. 1.7872-15(e)(3)

⁵ Treas. Reg. sec. 1.7872-15(e)(4)(ii)

⁶ Treas. Reg. sec. 1.7872-15(e)(5)(ii)(B)

⁷ Treas. Reg. sec. 1.7872-15(e)(5)(iii)(C)

⁸ Treas. Reg. sec. 1.7872-15(e)(5)(v)(B)(3)

⁹ Treas. Reg. sec. 1.7872-15(e)(ii)(D) and 1.7872-15(e)(5)(v)(C)

¹⁰ Treas. Reg. sec. 1.7872-15(d)(2)

¹¹ Treas. Reg. sec. 1.7872-15(d)(2)(ii)

¹² IRS Notice 2007-34

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