

Split Dollar “Rescue”

An Alternative to Collateral Assignment Split Dollar Arrangements

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For years, many organizations have provided split dollar plans as a benefit to attract and retain key employees. However, recent regulatory changes have retracted some of the major advantages of such plans. As a result, organizations are seeking available alternatives.

In its most common form, a collateral assignment split dollar plan offers the participant a life insurance policy paid for by the employer. By making premium payments on the participant’s behalf, the employer provides an “interest-free loan” to the participant, who then assigns the cash value in the policy back to the organization as collateral until the loan is repaid. At retirement or the participant’s death, the employer receives from the policy an amount equal to the premiums paid. The cash value inside of the policy accumulates tax-deferred and the death benefit is non-taxable.

Under the old rules, the participant was only required to recognize the value of the death benefit as taxable income each year based on the cost of 1-year term insurance (either using PS 58, Table 2001, or carrier alternative rates) – a relatively low cost to participants. However, all plans entered into or “materially modified” after September 17, 2003, must now characterize each employer-paid premium as a loan and attach a standard market interest rate to the total loan amount (total premiums paid). The participant must pay taxes each year, based on that imputed interest rate, on the foregone interest on the total loan balance. Therefore, each year the participant’s tax liability increases as the total loan amount increases.

For example, assume total employer-paid premiums in a split dollar policy are \$200,000 to date, the applicable federal interest rate is 6%, and the participant is in a 40% tax bracket:

Total Premium	Interest Rate	Total Interest	Tax Rate	Taxes Owed Each Year
\$200,000	6%	\$12,000	40%	\$4,800

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The participant pays \$4,800 in taxes in the current year alone. If we assume the employer contributes \$10,000 per year into the plan, the taxes owed by the participant in the current year represent nearly half of the employer’s annual premium contributions. As the participant’s tax burden increases each year, the value of the split dollar benefit lessens.

Pre- September 17, 2003, “grandfathered” split dollar arrangements may continue to operate under the old rules, wherein participants pay taxes on the value of the death benefit. However, these arrangements carry several significant limitations:

- Once the cash value of the policy exceeds total premiums paid, conservative participants most likely face two options:
 - Convert to the loan regime and pay taxes on the imputed interest.
 - Continue paying taxes on the death benefit and also pay taxes on the annual cash value increase in the policy each year.
- Tax costs on the value of the death benefit escalate substantially for older participants (as term insurance rates increase with age). For example, following are sample Table 2001 costs:
 - For a 55-year-old, roughly \$4.15 per \$1,000 of insurance protection.
 - For a 65-year-old, roughly \$11.90 per \$1,000 of insurance protection.
 - If a 65-year-old pays taxes on the Table 2001 cost in a \$2M policy and is in a 40% tax bracket, this individual could be paying as much as \$9,500 per year in taxes.
- Employers cannot add new participants to grandfathered plans; thus, they cannot serve as a benefit tool to attract new talent.

Employers currently holding policies under a collateral assignment split dollar design have several options if they wish to preserve a valuable benefit for their key employees:

- 1) **Hold the policies** – The employer can continue to maintain these split dollar contracts and participants can continue paying taxes either on the imputed interest on total premiums or on the death benefit costs plus cash value increases over total premiums (for “grandfathered” plans).
- 2) **Terminate the policies** – The employer can terminate the policies and release the cash surrender values in the policies to the participants. The participants recognize all premiums paid by the employer as income and pay taxes on the total employer contributions from the origination of the plan.

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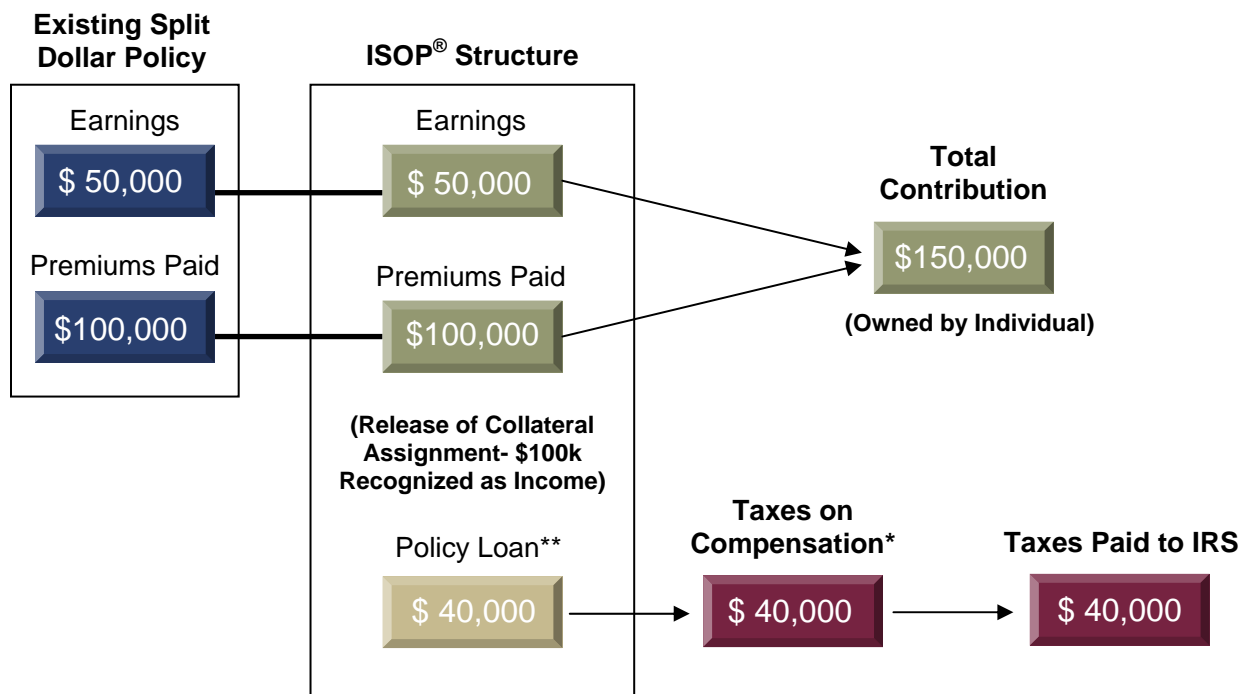
- 3) **Transfer the policies** – The employer can offer a new program called the Insured Security Option Plan (ISOP[®]), which allows the participants to transfer the cash surrender values of the policies into the ISOP[®] structure. The participants recognize all premiums paid by the employer as income; however, in the ISOP[®], participants have the option to exercise a unique policy loan rider to pay their tax obligation and restore the cash value to the pre-tax amount.

The ISOP[®] Structure

Using a unique, institutionally-priced variable universal life insurance policy¹, the ISOP[®] provides a mechanism that allows the participant to leverage the power of pre-tax contributions.

Assume a policy in the split dollar plan has \$150,000 of cash surrender value (\$100,000 of premiums paid and \$50,000 of earnings). The employer transfers the \$150,000 into the ISOP[®] structure via a 1035 “tax-free” exchange. Then the employer cancels the “collateral assignment” portion of the policy and releases the \$100,000 of premium to the participant as taxable income. The participant then elects to pay the taxes owed by utilizing a unique loan rider feature of the ISOP[®] structure. Assuming the participant’s tax bracket is 40%, the structure loans \$40,000 to the individual to pay the taxes.

The following chart describes this process:



*Assumes 40% tax bracket

**Loan is optional and non-recourse and could also come from an outside lending source.

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The \$40,000 paid by the ISOP[®] structure is a non-recourse “policy loan”² collateralized by the cash value. Assuming the policy is held until maturity, the participant does not have to pay back the loan until death³ – it is simply deducted from the policy’s death benefit upon the participant’s death. The policy loan’s interest rate or carrying charge is the lesser of the 90-day LIBOR + 1.5% (LIBOR = 5.36% on 3/14/07) and the average Moody’s rate for corporate bonds (5.88% for Feb. 2007)⁴. The participant owns 100% of the policy’s cash value and all premiums continue to grow in a tax-deferred environment with a non-taxable death benefit.

Conclusion

As new regulations continue to change the landscape of traditional benefit plans, organizations should continue exploring current best practices and innovative alternatives such as the ISOP[®] to continue their momentum of attracting and retaining top talent.

¹ This is a variable life insurance contract. Performance of the underlying accounts could affect the policy’s cash value and death benefits. Loans, interest accruing on loans, and withdrawals reduce available cash value and reduce the death benefit or cause the policy to lapse. Actual returns may vary. Variable life insurance is sold with prospectus only.

² Initial amount limited to a maximum of 50% of total premium. Loan balance must maintain a loan-to-cash value of no greater than 65% or an automatic transfer from the separate accounts to the money market account will occur.

³ Loan amounts and unpaid interest may be paid out of death proceeds with the balance to be paid to beneficiary.

⁴ The policy loan interest rate’s floor is 4.25%.

Investors should consider the investment objectives, risks and charges and expenses of the contract and underlying investment options, risks carefully before investing. The prospectus contains this and other information about the investment company and must precede or accompany this material.

Please be sure to read it carefully.