



FERRIS FINANCIAL, LLC

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Overview

Split dollar life insurance is not a type of insurance, but rather a method for dividing the premiums, ownership interests, and benefits of a permanent life insurance policy between two parties. There are two basic forms of split dollar taxation: economic benefit regime and loan regime. Split dollar plans may be sponsored by an employer in a work setting, or an individual or trust in a private setting. This Guidepost discusses Private Split Dollar plans. A separate Guidepost is available that describes Employer Sponsored Split Dollar plans.

Description & Operation

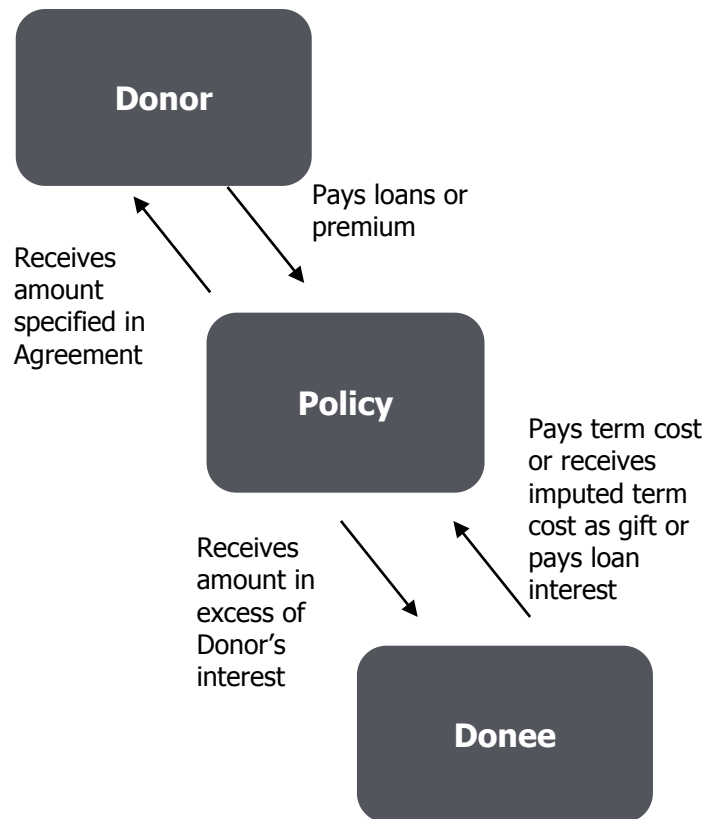
After it is determined to enter into a split dollar arrangement that will meet the client's life insurance and planning objectives, the client's legal counsel drafts, and the parties execute, an agreement that spells out each party's rights and responsibilities. Common items found in a split dollar agreement include: identities of the parties; premium payment responsibilities, death benefit distribution terms, right to policy cash value, and termination events. The terms of the agreement should be coordinated with the design of the underlying policy.

Economic Benefit Regime (EB): The donor is the actual or deemed owner of the policy in a private economic benefit regime split dollar arrangement. Generally, the donor pays the premium, and the donee receives the cost of the term insurance as a gift, or depending on the terms of the arrangement, the donee may actually pay the term cost equivalent portion of the premiums. Under an economic benefit arrangement, the donor's interest in the policy is the greater of his or her cumulative premiums paid or the policy's cash value. The donee or trust is entitled to the death benefit in excess of the donor's interests.

Loan Regime (L): The donee, or a trust, is generally the owner of the policy in a private loan regime split dollar arrangement. The non owner donor makes loans to the donee or trust at a stated interest rate. All equity in the policy in excess of the loan amount accrues to the benefit of the owner donee or trust. At death, the loan is repaid to the donor, and the donee or trust receives the death benefit in excess of the donor's interests in the policy.

Private Split Dollar Arrangement

1. Donor and Donee execute split dollar agreement.
2. If EB split dollar, Donor owns policy (or Donor is deemed owner for federal tax purposes); if L split dollar, Donee owns policy.
3. Donee is either imputed the term cost as a gift from Donor or pays the term cost or loan interest as applicable; and Donor pays or loans the premiums.
4. Lifetime policy surrender:
 - If EB, Donor is entitled to the policy's entire cash value;
 - If L, Donor is entitled to loan principal and unpaid interest, and Donee receives any remaining cash value.
5. Death proceeds:
 - If EB, Donee's beneficiary is entitled to any death benefit in excess of Donor's interest; Donor will receive the greater of premiums income paid or cash value.
 - If L, Donor is entitled to loan principal and unpaid interest, and Donee's beneficiary receives any remaining values.



Tax Implications

Income and Gift Tax Considerations

Income and gift taxation of a split dollar arrangement is governed by regulations contained in Reg. §1.61-22 (economic benefit regime) and Reg. §1.7872-15 (loan regime). The applicable regime is largely determined by who is the owner of the contract for split dollar purposes. If the donor or employer owns the contract, the arrangement is generally subject to the economic benefit regime. If the donee or employee (or a trust for either) is the owner, loan regime split dollar rules generally apply.

There is an exception to the general ownership rule in certain economic benefit split dollar arrangements. Even if the donee or a trust is the nominal owner of the policy, the donor will be treated as the owner of the policy for split dollar (but not estate) taxation purposes if the donor is entitled to all policy lifetime values, and the donee has no current or future interest in the policy's cash values.

Economic Benefit Regime: The owner or deemed owner (donor) pays the premium, which is considered investment in the contract (or basis). The non owner (donee) pays the term cost of the death benefit that is payable to his or her beneficiary, or treats the payment as a gift from the donor. The donee accrues no basis in the policy. Unless the donee is a grantor trust of the donor, term costs paid by the donee to the donor are generally income to the donor. Death proceeds are typically received income tax-free by both parties or their designated beneficiaries.

Loan Regime: The non owner (donor) pays the premium, which is considered a loan to the donee (or trust). The owner (donee or trust) pays interest on the loan, either annually or cumulatively. The loan principal paid to the donor is a tax-free return of investment; however, unless the donee is a grantor trust of the donor, loan interest is generally taxable as income to the donor, whether paid during the insured's lifetime or at death.

Estate Tax Considerations

Estate Tax: The final split dollar regulations do not address estate tax issues relating to split dollar arrangements. However, to the extent the insured possesses incidents of ownership in the policy, death proceeds will be included in the insured's estate, with a deduction for the part that goes to the donor. If the split dollar arrangement is between an insured donor and a trust established by the donor, the death proceeds will be included in the donor's estate if the donor has any incidents of ownership in the policy under the terms of the split dollar agreement or any other related document.

Insights and Caveats

- ◆ Split dollar plans in effect prior to September 18, 2003, that have not been modified are not subject to the final regulations and may be subject to different tax rules. The exchange of a policy subject to a grandfathered split dollar agreement will likely be considered a modification that will cause loss of grandfathering.
- ◆ The term insurance cost under economic benefit split dollar is determined by using IRS Table 2001 or a term charge from the issuing company's regularly sold, initial issue, standard one-year term policy, if less.
- ◆ In a loan regime split dollar, it is important for the stated interest rate to be at or above the applicable federal rate (AFR) that is in effect during any month in which a premium loan is made, as published by the IRS each month. Otherwise, the difference between the amount of interest charged under the arrangement and the minimum interest required by reference to the appropriate AFR will be imputed as gifts to the donee and, in the case of certain term loans, the undercharging of interest payable over the life of the loan may be treated as a gift by the donor to the donee in the first year on a present value basis.



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