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19 Years After the Final Regulations: Where Are We with Split Dollar Premium Financing?

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I. SCOPE AND INTRODUCTION

A. Split Dollar Is More Popular Than Ever

Nineteen years ago, the Treasury Department issued the final split dollar regulation. This was the first comprehensive guidance concerning this method of life insurance premium financing. Previously, the IRS had issued often changing revenue rulings, private rulings and notices without overall guidance. That changed in 2003. Particularly with regard to income and gift tax consequences, this regulation deviated considerably from its prior ruling positions which were grandfathered for split dollar arrangements entered into before the date of the new final regulation. Many practitioners thought that the regulation would be the death knell for split dollar. However, the contrary has occurred since the regulation finally gave guidance that practitioners had been longing for. Loan regime split dollar blossomed under the regulation. Thus, after nineteen years, split dollar premium financing is still very much used and popular.

B. Background

The first split dollar arrangements appeared in the 1940s. Originally, they were designed to have an employer assist an executive in obtaining life insurance coverage by paying all or part of the insurance premiums. Basically, it was a compensation perk provided by the employer. Sometimes the split dollar arrangement was between a corporation and shareholder, quite often to help the shareholder finance a buy/sell agreement. In more recent years, split dollar arrangements have been used in a wealth transfer context where the insurance policy is owned by an irrevocable life insurance trust (under the loan regime) or the death benefit is owned by such trust (under the economic benefit regime). In this manner, the annual gift to the trust is the applicable Federal interest rate ("AFR") or term premium economic benefit, depending upon whether the loan regime or the economic benefit regime is used, rather than the much larger total premium payment. For wealth transfer purposes, the premium payer may be the employer, a closely held family company or even the insured or family member of the insured.

C. Thus, the Name

The name comes from the non-owner and the owner of the policy splitting the death benefit and quite often (but not always) the premium payment or policy cash value.

D. The 2003 Final Regulations

The split dollar regulations became effective on September 18, 2003. For split dollar arrangements entered into prior to that date, for historical reasons, the IRS had taken the position that the arrangements were not loans but an investment in the policy by the employer. This was true whether the employer owned the policy under an endorsement method or the employee or third party owned the policy under a collateral assignment method. Under the final regulations, most collateral assignment split dollar arrangements will now be treated as loans subject to IRC Section 7872. The endorsement split dollar arrangement may measure economic benefit by the term premium, but the equity will be subject to income/gift taxes unless it is owned by the employer, or other premium payer. The tradeoff under the new rules is clear. Under the loan regime split dollar arrangements, the equity buildup is not subject to income/gift taxes, but the AFR must be charged. Although the economic benefit regime split dollar arrangement may continue to measure current economic benefit by the term premium, the employer (or other premium payer) should own all of the cash value and other rights in the policy to prevent income/gift taxes to the executive. Traditionally, the term premium was lower than the AFR except for older insureds. However, in today's low interest climate, the AFR may be lower than the term premium even at younger ages of the insured. However, recently the AFR has been increasing. Thus, under the final split dollar regulations, almost all premium loans will fall within the loan regime split dollar arrangement. However, economic benefit regime split dollar arrangements will not be treated as premium loans. This outline will discuss developments in planning techniques that involve economic benefit regime split dollar or which apply to all split dollar techniques but which are not peculiar to loans. The premium financing portion of this outline will discuss developments in planning techniques which are particularly applicable to premium loans, although they may also be loan regime split dollar arrangements.

E. Other Premium Financing Techniques.

Before proceeding further, it should be noted that there are many other ways of paying insurance premiums other than through the economic benefit regime split dollar and premium loans. Perhaps the policy can be bought by the insured with existing funds. If for wealth transfer purposes a third-party owner is required, perhaps the policy can be bought by an existing life insurance trust, family partnership or family LLC with sufficient assets to pay the premiums, but with little or no ownership by the insured in the purchasing entity. Again, for wealth transfer purposes, with a policy owned by a life insurance trust, premiums can be paid by outright gifts from the insured grantor, the use of GRATs or sales to defective life insurance trusts or a combination of these techniques.

F. Exit Strategy.

Even if the split dollar or premium loans are involved, it is a temporary premium payment technique and quite often some sort of exit strategy is needed to pay off the policy owner under the economic benefit regime arrangement or the lender under the loan regime. In this situation, gifts, GRATs or sales to defective trusts might be useful exit strategies.

For a more detailed discussion of premium financing, *see* Brody and Jansen, "Leveraging Life Insurance Premium Payments – Using Split-Dollar and Related Party Premium Financing Techniques," American Bar Association Section of Real Estate, Trust & Estate Law (2017).

Title search: 19 Years After the Final Regulations: Where are We with Split-Dollar Life Insurance Financing?

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