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LIFE INSURANCE
PERSONAL PLANNING

WHITE PAPER

CORPORATE LOAN REGIME SPLIT-DOLLAR

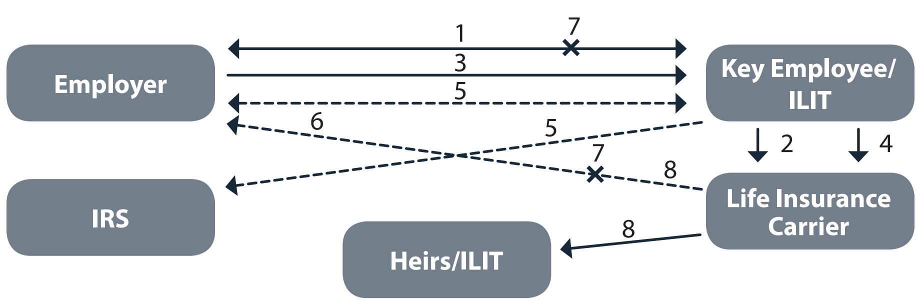
In today's increasingly competitive business environment, finding a cost-effective way to reward key employees can be challenging. Qualified plans have preferential tax treatment, but they also have strict administration requirements. They must include all employees and reward them to the same degree, regardless of the benefit those employees bring to the business. Nonqualified salary deferral plans and supplemental executive retirement plans (SERPs) allow a business owner to reward key employees in a discriminatory fashion, but they still require plan documents and ongoing administration — and must meet the requirements of Section 409A of the tax code. A corporate loan regime split-dollar agreement (§7872 Loan), on the other hand, may be a more attractive option for rewarding a business's most productive employees in a way that's flexible, cost effective and simple to administer.

WHAT IS A §7872 LOAN?

A §7872 Loan is a nonqualified benefits program to recruit, reward and retain key talent. In a typical §7872 Loan agreement, the employer pays all or a portion of the life insurance premiums on behalf of the policy owner (e.g., the key employee or his/her irrevocable life insurance trust [ILIT]) and is entitled to repayment from the policy's cash value or death benefit. The premium payer (employer) is deemed to have lent the premium payments to the policy owner. The plan offers the key employee immediate death benefit protection, tax-deferred growth of policy values and a potential source of tax-free retirement income in the future.

A §7872 Loan can provide significant death benefits and tax-advantaged cash value accumulation for key employees, allowing them to meet personal financial goals.

HOW DOES IT WORK?



1. The key employee/ILIT and the employer enter into a loan agreement. Under the terms of the agreement, the employer will make annual loans to the key employee/ILIT, which will be used to pay the premiums on a life insurance policy.
2. Key employee/ILIT applies for a life insurance policy on key employee's life.
3. Employer loans an amount equal to the premium to the key employee/ILIT.
4. Key employee/ILIT pays the premium to the life insurance carrier.
5. The policy owner (the key employee/ILIT) is deemed to have paid interest at the applicable federal rate (AFR) under IRC §7872, and the employer is deemed to have received the same amount back from the policy owner. The key employee is subject to federal income tax on the deemed interest, or in an arrangement involving an ILIT, the arrangement will be subject to both federal income tax and gift tax.
6. The policy is collaterally assigned to the employer as security for the loan.
7. At some point in the future, the loan may be repaid from either policy cash values or outside funds, and the collateral assignment is released and the split-dollar agreement canceled.
8. At the key employee's death, the employer will receive a portion of the life insurance policy's death benefit equal to the outstanding loan balance. The remainder of the death benefit will pass to the heirs/ILIT income tax-free.*

BENEFITS TO KEY EMPLOYEE

- Employee owns a "portable" life insurance policy.
- Employer can "double bonus" employee to offset any tax liability.
- Pre-retirement, the employee enjoys cost-effective death benefit protection for their heirs.
- The gift to the ILIT, if any, is equal to the amount of loan interest — not the entire policy premiums.
- The employer's interest in the policy is limited to the cumulative premiums loaned, so the key employee/ILIT is entitled to all the equity in the policy.
- Depending on the performance of the policy after several years, the cumulative loan may be repaid from policy cash values, leaving the key employee/ILIT with rights to all the remaining policy values and death benefits.
- Policy cash value grows on a tax-deferred basis and can be accessed to supplement retirement or other income needs once the employer is repaid its cumulative loan.

BENEFITS TO EMPLOYER

- Employer gets a program to recruit, reward and retain key talent.
- Employer has freedom to select participants.
- Repayment of the cumulative premiums, whether from policy values or death benefits, is income tax-free.
- Bonuses are tax-deductible, as long as the employee's total compensation package is "reasonable."
- There's no impact on existing plans.
- IRS approval is not required; this program avoids most of the costs and administrative requirements associated with establishing a qualified plan under ERISA.
- §7872 Loans can be less expensive to set up and administer than nonqualified deferred compensation plans.
- The program provides an attractive employee benefits program for a not-for-profit company, where deferral plans are limited under I.R.C. § 457.

CONSIDERATIONS FOR THE EMPLOYEE

- Unless additional planning is done, the death benefit of the life insurance policy will be included in the key employee's estate.
- Interest continues to be imputed to the key employee until the loan to the employer is repaid, even after premiums cease.

CONSIDERATIONS FOR THE EMPLOYER

- The employer bonuses should be discretionary. Any understanding to pay bonuses, either contractual or implied, could subject the arrangement to IRC § 409A, as a deferred compensation plan.
- The premium loans are not tax-deductible expenses.
- The policy's cash value may be reachable by creditors of the employer.

THE BOTTOM LINE

A §7872 Loan is an attractive option for rewarding a business's most productive employees in a way that's flexible, cost effective and simple to administer. A §7872 Loan can provide significant death benefits and tax-advantaged cash value accumulation for key employees, allowing them to meet their personal financial goals.

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