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Split Dollar Insurance Arrangements

Sharing the benefits of a permanent life insurance policy

As a concept, the applications of split dollar insurance arrangements are great and diverse. They are employed in circumstances where more than one party requires the benefits provided by a life insurance policy. One party may require a tax d eferred investment vehicle, while the other party may need to obtain life insurance protection at a low cost.

What are Split Dollar Arrangements?

Split dollar insurance arrangements are arrangements, under which the policy values, premium payments and death benefits associated with a permanent life insurance policy are allocated between two or more parties. This arrangement is not a type of insurance policy, or insurance contract. It is simply a way for parties to share the attributes of a life insurance policy by sharing the costs and benefits associated with that policy.

The split dollar arrangement is usually established by way of formal contract known as a split dollar agreement. This agreement sets out the rights and responsibilities of each party to the arrangement. In addition, it covers such issues as: ownership of the cash values, ownership of the death benefit, premium obligations, the right to assign the death benefit, and the conditions and terms under which the split dollar arrangement may be terminated.

"Conventional" Split Dollar

A conventional split dollar arrangement is usually employed by a company as a way of providing low cost permanent insurance for their employees. This type of arrangement allows an employee to obtain permanent insurance at a minimal cost, while the company can take advantage of the tax-deferred investment.

Under this arrangement, the employee would own the face amount of the policy, which is the death benefit established upon issuance of the policy, and as a result is therefore entitled to name a beneficiary of that policy. The company would own the cash values of the policy. In the case of a universal life policy where the total death benefit includes the level death benefit plus the policy's accumulated value, the employee would own the level death benefit and the company would own the accumulated value.

Reverse Split Dollar

As its name suggests, the rights, costs and benefits incurred under this type of split dollar arrangement is the mirrored opposite of the conventional arrangement discussed previously. Under this arrangement, the company owns the death benefit and the employee owns the cash values of the insurance policy, or in the case of universal life insurance, the accumulated values of the policy. This arrangement allows the employee to take advantage of the tax deferment of the cash values in the life insurance policy for future retirement, while the corporation has the life coverage on the employee as key person insurance (**see Key Person below**).

Taxation of Split Dollar Arrangements

The Canadian Revenue Agency (CRA) has stated that split dollar arrangements between a company and an employee may give rise to a taxable benefit in the hands of the employee. However, they have never indicated exactly how that benefit is to be calculated. Instead they have declared that **the taxable benefit is calculated by dividing the amount of the policy's premium based on the amount that the employee would have paid for analogous rights in an open market**. For many years, insurance practitioners have interpreted this statement to mean that term insurance rates are the measurement tool against which the determination of a taxable benefit could be made.

However, in the CRA Technical Interpretation Letter 2000-0036735 dated July 20, 2000, the calculation of the taxable benefit once again became blurred. While responding to an inquiry about split dollar arrangements, the CRA stated "…**the determination of a taxable benefit under a "split dollar" arrangement utilizing a universal life insurance product can only be made on a case by case basis after a review of the relevant facts.**"

Given this, it is evident that the CRA will determine the taxation of a split dollar arrangement between an employee and employer on a case-by-case basis.

Some common uses for Split Dollar Arrangements

RCA'S

A split dollar arrangement can be used to fund a retirement compensation arrangement (RCA). Under this arrangement the death benefit from the insurance policy could be made payable to the sponsoring employer. In this circumstance, the death benefit could be transferred to the company on a tax-free basis and may possibly (with proper planning) give rise to a credit to the company's (must be a private corporation) capital dividend account.

KEY PERSON

Key person insurance often referred to, as key man insurance is life insurance purchased by a company on the life of an employee or employees whose loss would have adverse effects on the company. Employees are valuable assets and the loss of some key employees could significantly impact the profitability, stability and progress of the company.

Since key person insurance is often required for a finite period of time (until the key person retires or leaves the company) term insurance is often purchased. However, if the key person required a significant amount of life insurance and a tax preferred investment vehicle, a permanent life insurance policy, purchased under a reverse split dollar arrangement, might be preferable. Under such an arrangement, the key person would control the cash values of the policy, and thus be responsible for paying the savings portion of the insurance premiums. The company would control the death benefit portion of the policy to fund its key person requirements, and its premium commitments would likely be tied to the equivalent of term insurance rates for comparable coverage.

BUY/SELL AGREEMENTS

Shareholders of closely held private corporations often enter into buy/sell agreements whereby provisions are made for the purchase and sale of the shareholder's interest in the company in the even of death. Typically, life insurance policies are acquired on the lives of the shareholder's to provide the necessary funding to execute these agreements. The corporation or the individual shareholders usually own these policies.

Circumstances may arise, however, where a split-dollar insurance arrangement may be of benefit to the corporation, the individual shareholder, or both. For example: If the corporate tax rate is significantly lower than the marginal tax rates of the individual shareholders, the shareholders may wish to establish a split dollar insurance arrangement so that they would not have to carry the full burden of the insurance premiums, should they be required to own the life insurance policies.

FAMILY

A split dollar insurance arrangement may be beneficial in facilitating the purchase of permanent life insurance in family relationships. An example would be where parents have investible assets, and their children, who are just starting out, have a large insurance need. The solution would be to jointly purchase a life insurance policy where the children could pay for and own the death benefit portion of the policy at comparable term insurance rates, and the parents could pay for and own the cash value portion of the policy, which accumulates on a tax-deferred basis.

HOLDING COMPANIES

Split dollar insurance arrangements can be applied where there is an operating company with a need for the death benefit portion of an insurance policy to provide the necessary funding for buy/sell purposes. The operating company pays for and owns the death benefit portion of the policy, and the holding company benefits from the tax-free accumulation of the investment income associated with owning the cash value portion of the permanent life insurance policy.

Note: The above information is based on the tax law in effect as of the date of this article. The article is for informational purposes only and should not be construed as offering tax or legal advice. Individuals should consult with a qualified tax and legal advisor before taking any action based upon the information contained in this article.