

Split Dollar – Employer Loans

Essentials 2018

There are many benefits to using a split dollar arrangement for an employee-owned life insurance policy depending on the need for life insurance. Sometimes employers are seeking ways to retain and reward their top employees and other times they are looking to merely reward them. In split dollar planning, a loan arrangement may be established for (1) retaining/handcuffing the employee to the employer; (2) rewarding the employee for services provided; or (3) both with appropriate planning.

Split Dollar Loan Arrangements Can Be Beneficial

- The employer can structure the loan to primarily tie/handcuff the employee to the employer. The promised benefit should be available as long as the employee does not leave prior to the agreed upon time. However, if the employee terminated his/her employment prior to the agreed upon time, the benefit may be forfeited. This is typically accomplished with a Demand Loan.
- Alternatively, the employer can structure the loan to primarily reduce the overall cost(s) associated with the employee purchasing life insurance coverage. This can be especially useful when the policy is purchased in the employee's irrevocable life insurance trust. By using a Term Loan, the interest rate risk associated with borrowing money can be mitigated.

Types of Split Dollar Loans

1. **Demand Loans** – A demand loan can be called, in whole or in part, at any time by the lender. This gives the employer (lender) the ability to forfeit the benefit (i.e. loan balance) if the employee (borrower) does not fulfill his or her requirements under the agreement. This can be an effective handcuff designed to retain the top employee while at the same time rewarding him or her for their services and loyalty.

The minimum required interest rate on a demand loan is adjusted each July by the IRS resulting in a certain amount of interest rate risk since the rate adjusts each year. If the employee does not pay the minimum rate of interest each year to the employer, the amount will be imputed as follows: (1) an amount equal to the adequate rate of interest for the year imputed as compensation to the employee; then (2) that same amount imputed as required interest from the employee to employer. The imputed transfers typically result in a compensation deduction and interest income for the employer, and compensation income for the employee.

2. **Term Loans** – A term loan is a commitment by the employer (lender) to advanced money for a certain period of time (the loan cannot be called like a demand loan). The minimum required interest rate is (1) fixed for the entire duration of the loan; (2) determined when the loan is made; and (3) varies depending upon the term/length of the loan. If the term is for three years or less the short-term applicable federal rate ("AFR") is used; if the term is more than three years but not more than nine years the mid-term AFR is used; and if the term is more than nine years the long-term AFR is used.

Considerations

- The employer loan must provide for payment for adequate interest (or it will be imputed) and contemplate repayment of the loan proceeds.



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- Typical loan repayment strategies include: (1) using policy cash values; (2) Grantor Retained Annuity Trusts; (3) side fund with earnings in excess of rate on borrowed funds; and/or (4) policy death benefit.
- The life insurance policy is collaterally assigned to the employer as security for the loan.

Essentially

Split dollar loan arrangements between employers and employees can be very effective in helping employees purchase life insurance to meet their retirement and estate planning goals. A demand loan structure can help employees take advantage of lower interest rates (employees need to be comfortable with volatility in interest rates) while giving the employer handcuff leverage over the employee. Employees who want their arrangements to have predictable costs and results may choose a term loan structure that has stability but higher interest costs. Both split dollar loan arrangement structure will allow employees to use business dollars to pay life insurance premiums to enhance their financial security.

