Principal®

Best Practices with Loan Split Dollar

Loan split dollar is a key employee benefit that has unique appeal for enhancing retirement security and limiting current income taxation. There are several key features and best practices to understand.

How does it work?

Generally, a loan split dollar plan begins with a written agreement between the employer and the employee, where the employer pays the premium on a cash value policy owned by the employee, but the employee is not taxed on the premium. Instead, the premium payments are treated as a loan, and an appropriate amount of interest is either added to the employee's taxable compensation or is actually paid by the employee.

The loan is repayable in the future, and to ensure that the employer can recover the principal, the life insurance cash value or death benefit provides the collateral for the loan.

One benefit of this plan design is that it uses corporate cash, rather than the employee's personal funds, to pay the premium on the employee-owned policy.

Often employers may wish to provide additional benefits to employees, including various deferred compensation arrangements. If those are in place, they may help the employee repay the split dollar loan obligation when it comes due.

Alternatively, the employer may choose to forgive the loan in the future.

Demand loan or term loan?

A demand loan is payable upon the demand of the employer, while a term loan is repayable at a specific time in the future – typically at the earlier of termination of employment, death, or over a specific term of years. The difference is important because the interest rate charged to the employee depends on this distinction.

Demand loans

With demand loans, all the premium payments constitute one loan, with interest charged at the blended annual rate. The interest rate on the combined total of all loans will vary annually, based on market conditions.

Term loans

With term loans, each premium payment is a new loan, subject to the applicable federal rate (AFR) in effect when the premium is paid.

Example

Rob and Joan both have loan split dollar arrangements with their employer. Rob's loan is a demand loan, while Joan's is a term loan, payable in 10 years. The annual premium for each loan was $50,000. In the first four years, Rob's interest was just over $9,000, while Joan's totaled more than $12,000.[1]

Best practices

- The Business Market Administration team at Principal is able to offer complimentary administration (including tracking of taxable amounts) for demand loans.
- The right of the employer to call the demand loan at any time may make employees feel more at risk, but demand loans nearly always result in a lower interest amount and simpler administration.
- There's a common misconception that term loans "lock in" interest rates. This is true for each premium payment, but every premium payment is a new loan with its own interest rate. The only way to "lock in" an interest rate for all premium payments is to make one large loan of all the premiums at the onset of the arrangement. Like any other loan split dollar arrangement, this lump sum approach requires proper administration to accurately account for the loan interest.

How is interest handled, and can it be accrued?

Two best practice approaches are for the participant to either pay the interest or be bonused (and taxed on) the interest throughout the period the loan is in effect. The interest is taxable income to the employer but is also deductible, if treated as a bonus to the employee (as additional compensation, and assuming reasonable compensation requirements are met). Also, if interest is treated as a bonus, the employer can elect to bonus an extra amount to pay any tax the employee incurs.

The accrual of interest over the term of the loan is not a suggested practice because the size of the loan may create a potential risk to the policy funding the arrangement: the cash value and death benefit must be sufficient to repay the loan (including any accrued interest), provide retirement income to the employee, and keep the policy in force.

What is the exit plan?

When the agreement terminates and the loan is extinguished, the split dollar arrangement is concluded. Some arrangements call for a repayment of the loan only at death. However, it is possible that the agreement for the employer to pay premiums might terminate prior to death (such as if the employee retires or leaves, or some other event) and holding the loan and paying interest on it until death may not be appealing. Furthermore, an exit plan that is relatively far in the future is likely to place the burden on individuals who are not even involved in the business at the inception of the arrangement, creating additional challenges for the next generation. As such, a best practice is to design the plan to accumulate sufficient cash value for repayment at the participant's termination of employment.

Don't promise forgiveness.

Some employers wish to promise forgiveness of the future loan at the inception of the plan. If that is the intention, a bonus arrangement may be a better option, because promising future forgiveness essentially creates a separate nonqualified deferred compensation benefit – unfortunately, one that is likely to be viewed as funded, since the employee already owns the life insurance policy securing the loan. Alternatively, the employer can decide to forgive the loan at retirement, which would result in a lump sum benefit, taxable as compensation to the employee in that year. The employer and employee may incur additional tax consequences if the payment of accrued income is forgiven. Consult with counsel to ensure that the loan and forgiveness of accrued interest comply with applicable Code and Treasury Regulations.

Can the policy be jointly owned by the employer and employee?

Although generally split dollar arrangements provide that the employee own the life insurance policy, some have suggested joint ownership instead. In that set-up, only the portion of the premium attributable to the employee's ownership percent would be treated as a loan (reducing the final loan amount). While joint ownership has certain benefits (such as increased control over the policy by the employer), if the employer and employee disagree about a decision involving the policy, no decision can be made. In addition, the employer would need to obtain ongoing administrative services to track the specific implications of any ownership percentage changes throughout the term of the loan.

What about a two-policy approach?

If the arrangement is structured to terminate at death, a two-policy approach may be considered. In such case, the employee owns two separate life insurance policies: one for accumulation of cash values for retirement, the second with minimal accumulation, but sufficient death benefit for full collateral to the company for the loan.

Generally, in this two-policy approach, the loan interest is accrued and added to the loan, and the collateral policy pays back the loan at the death of the executive. If such a technique is used, the collateral policy must be designed to pay back a larger loan amount at death and must perform as illustrated. If the policy lapses or does not have sufficient death benefit at the executive's death to pay all the loan and accrued interest, there may be cash flow challenges and negative tax consequences. A detailed loan split dollar agreement is needed to document the existence and purpose of both policies and the terms of the loan.

To avoid a loan split dollar arrangement, an alternative strategy may be to have the second policy be owned by the employer, rather than the employee. Additionally, instead of treating the premium payments on the accumulation policy as a loan, the employer could bonus the premium payment on the employee-owned policy. This would result in additional compensation to the employee (though the employer could bonus additional funds to pay any tax incurred) and a corresponding deduction to the employer. Then the second, employer-owned, policy can provide future cost recovery.

Target market:

- Employer objective includes providing a supplemental retirement benefit with a favorable income tax outcome for the participants;
- Employer is committed to making significant annual contributions from the company for each key employee;
- Turnover is low among the key employee participants;
- Owners and key employees of C corporations, key employees and leaders of tax-exempt organizations, S corps, LLCs, and partnerships.[2]

[1] For details, see example in Loan Split Dollar sample proposal (BB12185-02).
[2] The exceptions are that (a) certain states prohibit nonprofit organizations from making loans to officers and directors, (but some have exceptions for split dollar loans) and (b) in the for-profit marketplace, publicly traded companies and certain other entities required to file with the Securities and Exchange Commission are prohibited under the Sarbanes Oxley Act of 2002 from making certain loans to directors and executive officers.

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