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Split Dollar Life Insurance & Alternatives After the 2003 Final Regulations

by
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For almost 40 years, split dollar life insurance offered an attractive way for employers to subsidize the cost of permanent life insurance for key employees and business owners. With certain arrangements, it also enabled large intergenerational family wealth transfers for little or no gift tax cost.

Two features of these plans especially benefited taxpayers and drew increased attention from the IRS over a 7-year period beginning in 1996. The IRS scrutiny culminated in a series of pronouncements that sharply curtailed the future efficacy of the most common split dollar plans. Technical Advisory Memorandum (TAM) in 1996 and two Notices – one in January 2001 and another in January 2002[1] laid the foundation for Final Regulations on the subject issued in September 2003. While some uncertainty remains, it is now possible to predict, in most cases, what will and likely will not pass muster with the IRS for existing and future split dollar plans.

The first of the controversial features of old split dollar plans that motivated IRS review was the tax-free and interest-free treatment of advances of premium costs by the employer under "equity" split dollar arrangements, other than for the relatively low imputed cost of the term insurance portion of the premium. The rest of the premium payment by the employer escaped treatment as either taxable compensation or an interest-free loan, provided the employer was eventually reimbursed for its premium outlay from the cash value or death benefit of the policy. The policy "equity" (cash value in excess of the employer-paid premiums) accrued to the employee without taxation where the employee, or a trust for the employee, owned the policy. In those situations, the employer paid for a benefit for the employee that escaped taxation as compensation. Assuming the employee never withdrew cash value in excess of his or her own basis in the policy, the equity was never taxed.

For policies owned by a trust, the value of policy equity also avoided gift taxation. The ability to transfer substantial policy equity with almost no gifting consequence, other than the very low imputed term insurance costs of a policy at most ages, was attractive not only in an employment context, but also as a "private split dollar" wealth transfer technique for wealthy families. In these cases, the policies were generally owned by irrevocable trusts and are largely funded by the insured or other senior family members on an equity split dollar basis for the benefit of younger generations.

The second common plan feature that the IRS questioned concerned the use of term insurance rates in calculating imputed income ("economic benefit") for these plans that understate the actual cost or value of term insurance. Many insurers have used what can only be characterized as artificially low

[1] Technical Advisory Memorandum 9604001, Notice 2001-10, and Notice 2002-8.

imputed term insurance rates on split dollar plans in an attempt to make their products attractive in minimizing taxable compensation and gifts.

1. Split Dollar after Final Regulations

The Final Regulations require the administration of new split dollar plans under one of two alternative "regimes," which will largely depend on policy ownership. The landscape for the most common equity split dollar plans of the past now looks starkly different, while it is not dramatically altered for employer-owned policies in endorsement plans.

Employer-owned ("endorsement" method): If the employer owns the policy (what has traditionally been known as "endorsement" split dollar), the arrangement will be largely accounted for in the usual way. The employee will either pay the "economic benefit" (the term insurance value of the policy) directly or will be taxed on this value as imputed income if that cost is paid by the employer along with the rest of the premium.

The endorsement method will still work for employers retaining the cash value of a policy and using it as a source to fund deferred compensation or similar non-qualified retirement benefits for an insured employee. Prior to the employee's retirement, the policy death benefit is endorsed to the employee's beneficiaries, or to a trust for their benefit. The transfer of all or a portion of the cash value in a policy, or the policy itself, as a bonus at retirement or otherwise, will be taxed to the employee and deductible to the employer.

It should be noted, however, that the Final Regulations deprive endorsement split dollar of some of its appeal and value by the tax treatment of the term insurance portion of the premium. In a "contributory" plan (i.e., where the insured pays the term insurance portion of the premium), the insured will henceforth receive no tax basis by paying the term costs of the policy, on the theory that no basis increase should extend to a non-owner of a policy. Nor will the insured obtain a basis increase for the imputed tax value of the employer-paid term cost. Worse yet, contributory payments of the term insurance costs by an employee will be considered taxable income to the employer. For this reason, contributory plans will make no sense except where a non-profit entity owns the policy. Endorsement plans fully paid by the employer will likely be the rule.

Employee-owned, or third-party-owned ("collateral assignment" equity plans): If the employee (or a trust or other third party) owns the policy and has any interest in the cash value, traditional split dollar rules will no longer apply. The employer-paid premiums will need to be treated as a series of loans, subject to the rules primarily of Section 7872 if below market interest rates are used or, where applicable, the original issue discount rules of 1271-1275. The use of market interest rates, as determined by the Applicable Federal Rates, will avoid the application of these rules. Given the complexity of the below-market rate loan rules and the fact that an employer cannot receive a deduction for such imputed income granted to an employee, split dollar loans will likely use market rates in virtually all cases.

Term loans will likely prove more popular than demand loans. With a demand loan, interest will be calculated at rapidly fluctuating blended annual rates. With a term loan, the duration can be as long as the insured's life expectancy as determined by the IRS annuity tables of Regulation §1.72-9. A low interest rate for a particular premium payment can be locked in for the full term of the loan. Term loans may be advantageous at a time of low interest rates, and an existing loan balance might be renegotiated as a lifetime term loan when interest rates seem especially low. However, the market rate must be determined anew for each additional premium payment. Even with the greater control over term loan interest rates, these rules leave considerable uncertainty as to the impact of variable loan interest rates on the future viability of a split dollar loan (or any other premium financing alternative, as noted below).

The loan rules for new plans (or continued plans that took advantage of the year-end 2003 “safe harbor” deadline) have eliminated the ability to pass along the “equity” in a life insurance policy (cash value in excess of employer-paid premiums) to the employee without taxation. Employer-paid premiums will be treated as loans. Loan forgiveness at retirement or otherwise will be taxed. Thus, a benefit from such a loan arrangement will only be realized where the rate of return from the insurance investment exceeds the loan interest rate, or effective combined interest rates, used. This will happen if the insured dies prematurely. Whether it will happen for an insured who lives to life expectancy or beyond will depend on the loan interest rates used and the nature and performance of the insurance policy (see below for a discussion of policy performance).

Exception to Loan Treatment Requirement for Non-Equity Collateral Assignment Arrangements: The Final Regulations provided additional flexibility for non-equity collateral assignment split dollar plans in comparison with the prior IRS pronouncements. Economic benefit treatment, rather than a mandatory loan arrangement, is allowed for policies owned by employees, donees (and other third parties such as trust) provided there is no transfer of policy equity. The requirement that collateral assignment plans now follow the prescribed loan rules rather than the traditional economic benefit approach is limited to equity arrangements – those passing a cash value interest in the policy to the employee or other donee– and does not extend to those which merely pay for or otherwise split out the term insurance (“economic benefit”) portion of the policy. The September, 2003 Final Regulations went beyond the May, 2003 Proposed Regulations and the 2002-8 Notice in this regard.

This additional alternative partially overcomes a vexing problem that the initial rules posed for split dollar policies on the lives of majority owners of businesses. Policy ownership by the business means inclusion of the proceeds in the estate of the majority owner/insured. To avoid this result, the earlier Notice and Regulations would have forced a loan arrangement with a trust-owned split dollar policy. Provided a split dollar plan is a non-equity arrangement, the Final Regulations continue to permit traditional economic benefit treatment for such plans and any others where the insured or other third party (such as a trust) is the owner.

The fact that this exception is allowed only for non-equity plans, however, means that they are only a short-term solution for keeping insurance proceeds out of the insured’s estate. A more permanent plan must include a viable means of having the ILIT repay the premium payer for its interest in the policy’s cash value at some point.

New term insurance rates to govern the calculation of economic benefit: The Final Regulations somewhat altered previous IRS pronouncements regarding the valuation of term insurance costs in split dollar economic benefit plans. The 2002 Notice had reaffirmed that the rates incorporated in the 2001 Notice should govern the calculation of economic benefit. These rates are substantially lower than the old PS 58 rates but also significantly higher than the somewhat artificial rates used by many life insurers as the standard for measuring the economic benefit. For example, at age 55, the 2001 Table rates are less than one-third of the PS 58 rate but also almost four times one insurer’s alternative individual term rate.

The Final Regulations require the use of “life insurance premium factors” to determine the value of term insurance. These are not yet available but will be issued periodically in the monthly IRS Bulletin. Until the first premium factor rates are known, the use of the 2001 Table rates should be permissible. It can also be expected for now that these premium factors will at least approximate the 2001 rates.

Where survivorship policies are concerned, the 2002 Notice did indicate that the 2001 Table can be used, with proper adjustments, for the calculation of the "economic benefit" (term insurance value) of split dollar second-to-die policies. The use of the Table for this purpose results in rates well below the current PS 38 rates, which, in turn, had been based on the PS 58 rates.

Private split dollar: Although the IRS has not officially sanctioned the use of split dollar arrangements in non-employment situations, the 2002 Notice acknowledged the practice without questioning it. In discussing the rules for employment-based plans, it said that the same principles apply in "other contexts… including arrangements that provide benefits in gift and corporation-shareholder contexts."

The consensus view suggests that it is safe to pursue private split dollar arrangements that observe the new rules. As a result, it would not be surprising to see an increase in private split dollar and intra-family loans where permanent insurance is contemplated as a source of supplemental retirement savings. In the early years, the death benefit can be endorsed to, or the policy can be owned by, an irrevocable insurance trust to avoid estate taxation during this period at least.

For long-lived insureds, however, the economic viability of a loan or of economic benefit treatment that can succeed in eventually providing insurance proceeds outside of a taxable estate is questionable at best. As is discussed in greater detail below, achieving this result will require a strategy for paying off the loan, terminating an economic benefit plan, or gifting or selling the premium payer's interest in the policy before the long-term borrowing or economic benefit costs of these various alternatives become prohibitive.

2. What to Do with Old Split Dollar Plans

Existing endorsement plans (e.g., employer owns the policy and its cash value; employee pays or is taxed on the "economic benefit" of the term insurance value) require relatively little modification as the result of the Final Regulations. Term insurance accounting and taxation rules have changed somewhat, as discussed above, but the traditional practices regarding endorsement plans can otherwise continue. They can still be used to fund insurance benefits for valued employees with the cash value eventually serving as an informal source of funding supplemental retirement benefits.

Collateral assignment equity split dollar arrangements (e.g., the insured or insured-created trust owns the policy and its cash value in excess of premiums paid), which pre-dated the Final Regulations, were and are grandfathered if certain requirements were met *and* if the plans are not "materially modified" in the future. If these plans were terminated or converted to loans by January 1, 2004, the "equity" in them was not or will not be taxed upon plan termination.

The only good candidates for termination or conversion to loans were split dollar plans involving policies with substantial policy equity. This equity (again, cash value in excess of premiums paid) had accrued to the policy owner and could be retained without income taxation under these grandfathering rules if the plan was terminated before the end of 2003. If the plan was converted to a loan, the accrual of interest on the premiums already advanced by the premium payer only began on January 1, 2004.

Among all existing equity split dollar plans, the percentage of them with sufficient cash value equity to make them suitable for termination was probably very small. The percentage of collateral assignment plans converted to loans would have been larger than the percentage of terminated plans, but even this number was probably not great since conversion to a loan only made sense where there was significant existing policy equity to protect from future taxation. Given the manner in which most policies are structured (i.e., with high sales charges and slow cash value growth in the early years), they would generally need to have been in effect for many years (e.g., more than 15), *and* the policy or policies would need to have performed well enough for meaningful policy equity to have accrued.

Whether to Continue Old Collateral Assignment Plans and Policies: Since the vast majority of split dollar collateral assignment plans lacked sufficient policy equity to warrant termination of conversion to a loan, it is fair to assume that most of them have continued as economic benefit arrangements under the new rules. This is acceptable as a short-term step to buy time to analyze how the economics of the new split dollar rules will affect the future viability of these plans. But these plans and policies should not be allowed to collect dust. Their future, in most cases, is not promising, and it is better to face that truth now than later.

We venture to suggest that, for split dollar policies with no or little equity, the policies themselves, and not just the plans, should be terminated in many cases - unless the insured is in impaired health, needs insurance, and may have difficulty obtaining coverage on the same underwriting terms as it was procured when the policy was issued. If a current plan has no or little cash value equity in it, the future policy equity that will accrue may not be worth the investment of the premium payer, especially if it is assumed that the equity will have to be taxed when the plan is terminated.

If the plan is converted to a loan when policy equity is about to materialize, (the “Switch Dollar” approach suggested by some commentators), one has to assess how, under various assumptions, the cash value in the policy will grow in comparison with the combined premium loan and interest charges. Will there, in fact, be a favorable arbitrage between premium loan interest rates and a rate of growth in policy values sufficiently great to justify a continuing investment in the policy? With most policies and with traditionally high sales charges, that is a dubious assumption.

If the policy continues as an economic benefit arrangement, one must examine how the projected policy equity, after probable taxation upon plan termination, will compare to the cost of the increasing economic benefit cost as the insured ages, and to the total cost of the policy both to the policy owner and premium payer. If the Table 2001 or similar term insurance rates must be used in valuing the economic benefit, these rates are quite a bit higher than the cost of term insurance for reasonably healthy non-smokers. If the insured must contribute the term insurance costs to the split dollar plan at Table 2001-type rates, he or she may want to forgo the possible accrual of policy equity and simply purchase alternative term insurance or other coverage independently. The present value of the higher economic benefit costs for the insured at Table 2001 rates might outweigh the likely after-tax net equity that the insured might accrue. In any case, an employer with a split dollar plan may want to assess whether the after-tax policy equity conveyed to the employee or executive as a benefit is worth the continuing investment of premiums in these policies.

Quite likely, most policies will not look very attractive when subjected to these kinds of analyses. With a loan plan, unless the insured dies prematurely, it may never be possible to repay the full premium loan and interest. Even if the loan can eventually be repaid from the policy, little residual value may remain. Similarly, with a continuing economic benefit arrangement any policy equity, especially if eroded by ordinary income taxation upon future termination of the plan, will not likely amount to much in light of the costs incurred to maintain a policy indefinitely into the future for a potentially long-lived insured.

Those who are insurable on favorable terms and need insurance should at least examine the alternative of individually obtained term insurance or new permanent coverage of a competitive, efficiently structured nature (see below) without the constraints of policy loan debt higher than cash value or unfavorably high term insurance costs for ongoing plans now that the rules governing these arrangements have changed.

Term Insurance ("Economic Benefit") Rates for Old Plans: The analyses of continuing collateral assignment ("economic benefit") arrangements will vary with assumptions about the term insurance rates that must be used. The 2002-8 Notice seemed to indicate that an insurance company's alternative term insurance rates could continue to be used for imputing term insurance costs (the "economic benefit") under pre-existing split dollar plans. Even though certain respected commentators still hold this view, it may be an aggressive assumption on which to base long-term planning. An attorney who is a frequent columnist for the National Underwriter, Life and Health/Financial Services Edition made the quite logical prediction, after the issuance of the Final Regulations, that "based upon the comments it is soliciting, the IRS is moving toward a solution where all taxpayers determine the economic value based upon the same rates – so the tax treatment will be the same regardless of the carrier." [2] Therefore, the safer and perhaps more conservative assumption to use in evaluating future alternatives for continuing economic benefit split dollar plans is that Table 2001, or similar rates based upon soon to be issued "life insurance premium factors," will eventually be uniformly required in valuing the economic benefit (i.e., annual term insurance values) of all split dollar plans.

3. Increased Need for Competitive Policies in Split Dollar Plans

Under any circumstances, a life insurance company and policy likely to offer the highest "risk-adjusted" rate of return should be selected (see related article on our web site, "How to Make Life Insurance a Good Investment"). This general advice will take on special importance with split dollar loan arrangements or other premium financing transactions.

There is no benefit to borrowing money to purchase a life insurance policy, unless the after-tax cash value or tax-free death proceeds exceed the loaned premium payments by more than the interest cost. Furthermore, the projected net benefit after loan repayment should be sufficiently great to offset the risk of a loss on the transaction.

This principle applies to any consideration of borrowing money to make an investment. To pan out, its rate of return must exceed the interest cost. An insurance investment is unusually complex because a policy's rate of return stems from four factors, not just one or two – investment results, mortality charges and sales and administrative expenses within the policy, and the timing of the insured's death.

Even when the underlying investments of two policies and the health and life spans of the insureds are identical, rates of return on permanent life insurance policies can vary considerably - by 2 percent (200 basis points) or more. That is because differences in the mortality charges of an insurance policy can account for variations of at least 100 basis points. In addition, the savings from a policy with a low commission versus a standard commission premium structure can reduce

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[2] Douglas I. Friedman, "The Final Split-Dollar Regulations – What To Do?", National Underwriter, Life & Health/Financial Services Edition, October 20, 2003, p. 14.

commissions by 80 percent or more and can also enhance the investment return by 100 basis points or more. Special care and advice is therefore required to select policies with the lowest commissions and other policy expenses. (See related web site article, "How to Make Permanent Life Insurance A Good Investment").

Those considering a split dollar plan that will now require a loan arrangement may also want to consider variable life. The investment returns from an underlying investment in equities rather than the insurance company's fixed income-oriented portfolio *may*, over the long life of an insurance policy, increase the margin between the policy's eventual death proceeds and the cost of the loan used to pay the premiums. However, this is far from a risk-free proposition, as all equity investors should now be aware, and the need to minimize sales commissions and other policy expenses and charges will also be paramount with these policies.

4. The Future of Split Dollar and Its Alternatives

It would be an exaggeration to say that split dollar is dead. Equity split dollar has ended for new plans, and loans that take its place will not be nearly so advantageous and will require careful analysis and planning. Endorsement split dollar remains more than viable, in spite of the less favorable tax treatment of the term costs. Here are some passing thoughts on the implications of the Final Regulations for the future of split dollar and its alternatives.

Split Dollar Loans and Other Premium Financing: The new requirement that split dollar plans involving policy and cash value ownership by the insured take the form of loans happens to coincide with a surge of interest in premium financing generally as the result of low interest rates. Premium financing looks relatively attractive currently because the differential between very low loan rates and higher policy earnings rates creates a perceived arbitrage opportunity.

However, anyone considering premium financing of any kind needs to analyze - very carefully, cautiously, and with a healthy degree of skepticism - the potential future impact of the several variables involved. These include the loan interest rate and any other loan charges on the one hand and the investment performance and internal charges of the life insurance policy on the other.

The viability of the loan transaction will also depend on the insured's longevity unless there is a way to repay the loan during the insured's life – and better sooner than later. For loans repaid from death benefits (an uncommon and highly risky approach), the accumulated debt of loan principal and interest could grow to exceed the death benefit. In any case, the amount of the net death benefit, if any, is so uncertain as to make any meaningful planning impossible.

More frequently, the ongoing payment of annual loan interest charges is proposed, with the eventual repayment of loan principal from the death benefit or from other sources. Even with this approach, it is likely that the annual interest charges will eventually exceed the premium payment. It is also quite possible, if the insured lives a long time and loan interest rates increase relative to the policy's rate of return, that the net present value cost of the interest charges will exceed the cost of the premium expense that was avoided by borrowing. Appendix A illustrates how this can happen. The unpredictable duration and amounts of annual interest charges also frustrate the ability to plan on payments to a trust to cover these expenses that will stay within the gift tax annual exclusions and exemption.

The unpredictability of loan interest rates is illustrated by trends in the indexes used to determine them over the last several years. Commercial loans are often geared to LIBOR (the London InterBank Offered Rate) plus perhaps 1.75 percent and a loan origination fee of .5 percent. At this writing, that would total around 4.35 percent for interest charges geared to a one-year LIBOR rate of about 2.35 percent (110 basis points higher than a year ago). With a split dollar plan using the required Applicable Federal Rates, the "AFR" that one could use for a short-term loan of less than three years is currently 2.25 percent, about 3.6 percent for a duration of three to nine years, and 4.8 percent for a long-term loan of more than 9 years.

The rates look quite attractive for AFR based loans. However, historic and possible future trends in interest rates must be considered, among other variables. Four years ago, the one-year LIBOR rate was 6.6 percent, more than 4 percent higher than the current level, which would push the total commercial loan cost to 8.95 percent. All AFRs at that time were in the 6 percent range. Even the best performing regular portfolio life insurance policy, because of the fixed income nature of most of its underlying investments, could not be counted on to produce a rate of return for a long-lived insured that would exceed this AFR. It would lag well behind the short-term LIBOR-based commercial loan rate of four years ago. Perhaps a loan geared to AFRs would work for the best-performing and most efficiently structured (i.e., minimum sales charges) regular portfolio policy. Those with a high risk tolerance might also consider a variable policy. However, all equity investors with even short-term memories would need to acknowledge the potential downside of this alternative.

Even more clearly, the long-term rising value of "economic benefits" in a non-equity collateral assignment plan will make it impossible to keep the policy proceeds out of the estate of the insured who lives a long time. In a private split dollar context (e.g., policy is owned by ILIT and insured owns the cash value interest), the value of the economic benefit paid by the insured is a gift, and, at some point, the economic benefit will exceed the annual premium. For example, assume that a non-equity collateral assignment split dollar plan on an older insured has been in existence for a considerable period and now has $1 million of cash value and a $2 million death benefit. As in all cases, the economic benefit is calculated on the difference between the death benefit and the amount (here, the $1 million of cash value) owned by the insured/premium payer. Even with a high cash value policy (this problem will be greater for policies with low cash values relative to the death benefit), the economic benefit will eventually exceed the actual premium – and by a significant multiple if the insured lives long enough. Under the 2001 Table, the economic benefit on net insurance proceeds of $1 million would be $54,000 at age 80, $88,000 at 85, $144,000 at 90, and $228,000 at 95. Therefore, an exit strategy of having additional assets in the ILIT in order to terminate the split dollar plan and pay the *greater* of cash value or premiums advanced by the premium payer/insured will be essential well before the insured reaches any such older age.

Short-Term Loans and Rollout Strategies for Non-Equity Collateral Assignment Plans: Given the uncertainty and risk of adverse results with long-term premium financing, short-term loans at low interest rates and economic benefit arrangements with a clear repayment or policy buyout strategy are the preferable alternatives. To repay a loan within a limited time period or to have the funds to purchase a policy's cash value interest will require other assets in the trust that will generate income or growth that can cover loan interest and pay off the principal or that will grow to equal the policy's value.

Such plans will most often entail the use of income generated by assets – frequently business interests - that are gifted or sold to a trust at discounted valuations. The discounts can significantly increase the effective investment returns of the assets after their transfer at these lower values. Common techniques to produce the income necessary to repay loans or reimburse a premium payer will involve family limited partnerships and transfers of these interests with gifts to GRATs with the remainder passing to the ILIT and with sales of these interests to defective grantor trusts. The combination of the discounted gift and sale valuations, plus the ability with a grantor trust to shift the tax burden from the trust back to the grantor, can, as mentioned, substantially boost the yield of the trust-owned investments, thus shortening the period of time in which the premium lender or payer can be repaid.

These strategies can be successful *if* the underlying investments perform as expected. Advisors and their clients must be mindful of the risks if investment returns falter and the exit strategy is frustrated. When there is no easy escape, even the seemingly lower cost economic benefit arrangements will become prohibitively expensive over time.

Trust Purchases of Existing Endorsement Split Dollar Policies: The use of effectively high-yield assets in a grantor trust can be used not only to repay a loan or the split dollar rollout cost of a policy owned by a trust. It is also possible to structure the initial arrangement as an endorsement plan with the death benefit endorsed to the trust in case the insured dies prematurely. As cash in the trust is generated by its high-yield assets, the policy can be purchased at one time for cash or for a combination of cash and a note, with the note retired as the trust assets continue to generate more cash in future years.

Carrying this idea one step further, it has been suggested that the policy might be purchased in fractional interests over a limited period of years, with discounted valuations for such minority and unmarketable interests in the insurance policy.[3] If this policy discounting strategy works, it creates an ability to finance insurance purchases outside of a taxable estate that may be nearly as effective as equity split dollar plans of a now bygone era.

Bonus Plans and Other Alternatives: Employers who previously might have considered equity split dollar plans might now weigh several alternatives. The simplest and perhaps most effective is a bonus plan. The insured employee owns the policy. The employer pays the full premium and receives a deduction. The employee is taxed on the premium as compensation. The employer might also pay an extra bonus to “gross up” the tax impact of this additional compensation to the employee.

To add a “golden handcuffs” feature to this benefit, the employer can impose a restrictive endorsement on the policy that prevents the employee from accessing the policy cash value at least during the employment period.

Depending on the employer’s tax bracket, the upfront cash flow requirement for the employer for a gross-up bonus plan may not be much greater than for an equity split dollar plan considering that, in this case, the premium and gross-up bonus are deductible to the employer. The employee ends up with the full policy value, rather than only the equity in the policy after a rollout from a traditional plan.

This alternative lacks two features and potential advantages of equity split dollar plans. The first is the ability to pass along “equity” in the policy without it being treated as compensation, a dividend, or a gift. The second missing benefit, which resulted from the first advantage of the old plans, is the leverage opportunity to transfer a significant amount of wealth for a very low gifting valuation.

Straightforward bonus plans will find their best use with key employees and executives for whom a valued benefit – insurance in younger years and potential supplemental retirement income – is desired. In most of these situations, assuming a sizable and perhaps growing estate tax exemption, tax-driven wealth transfer strategies of the kind that motivated many equity split dollar plans will be of much less, if any, importance.

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[3] Brad Bauer, Director of Advanced Planning, Northwestern Mutual Life Insurance Company, Presentation to Chicago Estate Planning Council, January 16, 2002.

Endorsement plans are, of course, another alternative to equity plans. The fact that the employee does not own the policy, at least in the early years, adds complexity if a policy is to be transferred in later years. However, if the clear goal is to use the policy cash values to help fund supplemental retirement income, endorsement plans may seem like a clear choice.

If the overriding benefit planning objective is to assure that key employees with dependents obtain adequate life insurance coverage, and there is no ancillary goal of accumulating a reserve with which to pay supplemental retirement benefits, a compensation bonus simply to fund term insurance coverage may be the most logical alternative of all. It is certainly the easiest and least expensive option.

5. Conclusion

The traditional rules governing employer-owned ("endorsement") split dollar emerge largely unchanged under the Final Regulations except for the less favorable tax treatment of the term insurance costs. Employee-owned ("collateral assignment") equity split dollar has ended, however, except for grandfathered plans and with the important additional exception that collateral assignment plans with traditional economic benefit treatment are still permitted where no equity changes hands. Loan arrangements have taken the place of some of the old equity plans, but, presumably, only where there was substantial existing policy equity to protect from taxation. Other old plans should be reviewed now to determine whether they will ever produce a net benefit that justifies the ongoing cost of maintaining them.

For new economic benefit or loan-based plans, only the use of the most competitive policies with low policy charges and sales costs will make them viable over the long term. To fulfill their purpose, these alternatives will also require far-sighted planning at the outset for a source to repay the loan or the rollout cost of a policy's full cash value or advanced premiums. The typical non-competitive features and heavy sales loads of the average retail policy make it unlikely that most existing plans and policies will be worth maintaining on the lives of insureds who may live a long time.

The new regulations for split dollar and its alternatives are much less favorable than the practical application of the old revenue rulings. However, they do not preclude the use of split dollar and related premium financing in a variety of situations where these methods can still provide an effective means of funding life insurance. Advisors will simply need to be much more selective in helping to identify situations where they will most likely work.

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