I. An Overview of Split-Dollar Premium Financing

Split-dollar financing of life insurance premium payments has been around for more than 80 years. It is useful in any situation where one person or entity has the cash to pay the premiums and another person or entity has the need for life insurance coverage. Originally, split-dollar arrangements were used in the employment and shareholder context; the objective was to allow the employee or shareholder to acquire the policy for a lower premium or tax cost than without the arrangement. The policy premiums, death benefits, and cash value were split between the parties (hence the name). Normally, the employer's or corporation's share of the death benefit or cash value was designed to reimburse it for the premium payments made under the arrangement, without interest. The employer would assist the employee in obtaining life insurance coverage by paying all or part of the insurance premiums. In the shareholder context, the corporation would help one or more of its shareholders obtain life insurance, quite often to help finance a cross-purchase stock agreement.

In more recent years, split-dollar arrangements have been used in a wealth transfer context: the insurance policy is split between an irrevocable life insurance trust (ILIT) and the employer, corporation, or (in a private split-dollar arrangement) donor. This allows the annual gift to the ILIT to be much less than the entire premium payment because the employer, corporation, or donor is entitled to recover its advances from the cash value or death benefit.

The current split-dollar rules came into effect with the final split-dollar regulations, effective September 18, 2003 (the "Final Split-Dollar Regulations" or the "Regulations"). For historical reasons before that date, the Internal Revenue Service (IRS) held that the arrangement was not a loan but an investment by the employer, corporation, or donor. This was true whether the premium payer owned the policy under the endorsement method with all or part of the pure death benefit endorsed to the employee, shareholder, or ILIT or under the collateral assignment method where the policy was owned by the employee, shareholder, or ILIT, with the policy cash value and death benefits securing repayment of the premiums advanced by the premium payer. As discussed later, these rules still apply to life insurance split-dollar arrangements grandfathered from the Final Split-Dollar Regulations. Under the Regulations, however, most (but not all) collateral assignment arrangements are taxed under the loan regime and all endorsement arrangements are taxed under the economic benefit regime, with considerably different tax and ownership consequences. In either case, the cash value and death proceeds are still split between the premium payer and the other party.

This book discusses the peculiar rules, tax consequences, and planning techniques for both premium financing regimes. The tax and other issues affecting split-dollar arrangements grandfathered from the Final Split-Dollar Regulations are also analyzed.