

Insuring the Future

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John Jordan, CFP

CERTIFIED FINANCIAL PLANNER

Phone: (519) 272-3112
Toll Free: (866) 272-3112
Fax: (519) 662-6414
Email: john@johnjordancfp.com

WEBSITE

www.johnjordancfp.com

PROVIDING... ESTATE PLANNING ♦ CHARITABLE GIFT PLANNING ♦ BUSINESS SUCCESSION PLANNING

Split Dollar Insurance

Protection and an Alternative Tax Shelter for the Entrepreneur

Split Dollar is a concept that involves the splitting of the costs and the benefits of the Life Insurance policy between two or more parties. As a concept, the applications of Split Dollar are great and varied. The possible arrangements are limited only by the terms of the Life Insurance contract and the imagination of the parties.

Split Dollar Life Insurance is possible because a permanent Life Insurance policy has two main components to it: a Death Benefit and a Cash Value.

In a Split Dollar arrangement the Death Benefit and the Cash Value are divided between the parties to the arrangement. The face amount of the Death Benefit provides a tax-free amount to one party. The Cash Value provides a tax-sheltered savings and investment vehicle for the other party. The party that owns the Cash Value component of a Split Dollar policy can accumulate dollars inside that part of the

contract without the applicable mortality costs the individual would have to pay if they owned the entire policy. The Cash Value build up inside the savings and investment component of the policy can be accessed by its owner after accumulation via policy loan, surrender, or collateral assignment (leveraged life).

A Split Dollar arrangement effectively creates two Death Benefits – a face amount Death Benefit and a Cash Value Death Benefit. Different beneficiaries can be named for each of these components.

In a Split Dollar arrangement the rights with regard to ownership of each component of the policy are normally outlined in a separate contractual agreement entered into by the parties after the issue of the policy. The contract should include the following information: the rights and obligations of each party, the division of premium between the parties, and the beneficiary to each component of the policy upon death of the life insured. In a "standard" Split Dollar arrangement, the two parties are the Death Benefit owner and the Cash Value owner.

Split Dollar was a concept originally used with Whole Life Insurance policies. Today, Split Dollar Insurance is most effectively used in the context of a Universal Life plan.



Conventional Split Dollar

In a Conventional Split Dollar arrangement, the corporation would be the Cash Value owner of the policy and an employee (or executive/owner) of that corporation would be the Death Benefit owner. In the past, this type of Split Dollar arrangement was often established as part of a compensation package provided to a shareholder or a key employee. The employee received very inexpensive permanent insurance coverage while the corporation effectively received cost recovery for its cost for the policy. The agreement would provide that on the individual's death, the face

amount would be paid to the beneficiary designated by that individual and an amount equal to the cash surrender value immediately before death would be paid to the corporation's beneficiary. The agreement would normally spell out that the employee would be obligated to pay the premium for the policy less the increase in the cash surrender value in any given year. In most Conventional Split Dollar arrangements, this meant that the premium payment by the employee would reduce to zero in a fairly short time period as the cash surrender value inside the policy increased.



"...if that Cash Value owner designates the appropriate beneficiary (spouse, child, grandchild, or parent) there is possibility of creditor-protection for that Cash Value build-up inside the policy."

Reverse Split Dollar Insurance

The evolution of the Split Dollar concept has seen the Conventional Split Dollar arrangement reversed so that the "standard" arrangement established today has the corporation as the Death Benefit owner under the policy and the individual shareholder or key employee as the Cash Value owner. This scenario is probably more commonly used today.

Benefits to the Cash Value Owner

The shareholder or key employee who is the Cash Value owner under the Split Dollar arrangement has a number of potential advantages available to them because of this structure. The individual has access to a tax-sheltered investment account without having to pay the applicable mortality costs. Because of that, investments made into the Cash Value component of a Life Insurance policy have the potential to receive significantly enhanced after tax rates of return due to the tax-sheltering feature of a Universal Life policy.

The Cash Value owner can access the accumulated value inside the policy while that individual is alive on either a taxable or non-taxable basis, depending upon the structure that individual chooses. Cash Values can also be of benefit to that individual's estate, as the Cash Value will be paid out tax-free upon the death of the insured. In addition, if that Cash Value owner designates the appropriate beneficiary (spouse, child, grandchild, or parent) there is possibility of creditor-protection for that Cash Value build-up inside the policy.



Benefits to the Death Benefit Owner

The corporation who is the Death Benefit owner under what we now refer to as a Reverse Split Dollar arrangement has the ability to obtain permanent insurance protection at term insurance costs. This in addition to the flexibility with regard to premium payment on a Universal Life contract also enables the Death Benefit owner to have mortality charges paid over a shorter period of time or over a unique period of time in order to satisfy potential cash flow needs.

Types of Split Dollar Arrangements

Reverse Split Dollar Insurance can be applied in a number of different situations. Application is primarily focused upon the business marketplace. Its use, however, is not limited only to this environment.

Family Protection Split Dollar

Split Dollar Insurance can be used in a family context. Family Protection Split Dollar is classically used between two generations. The Death Benefit owner may be the younger generation and the Cash Value owner the older generation of a family. A parent accustomed to assisting children financially, be it with their education, with their home purchase or with regard to the raising of grandchildren, may desire to enter into a Split Dollar arrangement with a child who has a need for insurance protection. That second generation may have a significant need for insurance protection when they are first married with children or have first acquired a new home with a mortgage and debts. It is at this time that the younger generation is least able to afford the cost of permanent insurance, yet may be in the greatest need. In this environment, the parent, with the desire to assist a child, may also have his or her own needs with regard to accumulations for retirement.

A parent wishing to buy Universal Life Insurance for their own purpose with a primary focus upon its tax advantages in an investment context, may not be able to fully realize those benefits due to high mortality costs attributable to their age or health or may not be able to secure insurance at all because of health reasons. That individual, however, may be able to benefit from the tax-sheltered features of a Universal Life contract by entering into a Split Dollar arrangement with a younger child who has a need for insurance protection. In that scenario, insurance could be purchased on the life of the younger generation. The parent could then enter into a Split Dollar arrangement with their child and be the owner of the Cash Value component of that policy. The parent could

contribute additional funds into the Cash Value component up to the limits set out by the MTAR (Maximum Tax Actuarial Reserve) gap and accumulate those dollars inside the policy in a tax-sheltered environment. Under this arrangement, the child would pay the mortality costs for the insurance and be the life insured and the owner of the Death Benefit. The parent could be the Cash Value owner and build accumulations inside the policy on the tax-sheltered basis. Under this arrangement, the younger generation gets permanent insurance at term insurance costs and the older generation gets a tax-sheltered investment vehicle that could be used to enhance retirement savings.

This form of Split Dollar could also put into place, an "asset shift" from the older generation to the younger generation. The mortality tables will obviously indicate that the older generation will die before the younger generation. In this situation, the younger generation will automatically become the owner of the tax-sheltered investment account. The funds have now been transferred tax-free and probate free to the next generation. The younger generation is free now to use the funds as they see fit. They could use these funds to pay down debt, use for education, or if there is enough cash in the plan, let the growth on these investments pay for the mortality charges in the policy.

Under this arrangement, there is benefit to both the older and younger generations brought about by the Split Dollar arrangement.





Business Arrangements – Key Persons Split Dollar Insurance

An employer may wish to protect their business in the event of the death of a key employee. The death of a key employee may cause the business to experience diminished profits, costs with regard to hiring a replacement, and costs with regard to interruption in the normal operation of that business. In this environment businesses will often purchase term insurance on a key employee to deal with the financial burdens brought about by the untimely death of that person.

At the same time that an employee in this situation has a need for key person insurance, that employer may also wish to provide additional employee benefits in order to retain a key employee in the operation of the business.

The employee, who is usually reasonably high paid, is often looking for ways to supplement their normal pension and/or registered retirement plan savings. If possible, the employee would like to do this in a fashion that creates the maximum tax advantage. An employee with an income in excess of \$75,000 a year will have maximized their RRSP, Registered Pension Plan, and other pension benefit entitlements at \$13,500 per year.

The solution to the two problems of an employer needing key person protection and a key employee needing to further enhance retirement savings is a key person Split Dollar insurance approach.

The Scenario:



“Kathie is prepared to invest \$10,000 per year over the next 20 years to enhance her accumulation for retirement.”

Kathie is 45 years old and President of XYZ Corporation. XYZ wants to purchase \$500,000 of term insurance to age 65 to cover the life of Kathie should she die during her employment and to allow them the appropriate transition after that event. At the same time Kathie is prepared to invest \$10,000 per year over the next 20 years to enhance her accumulation for retirement.

In this situation, XYZ Corporation and Kathie could enter into a Split Dollar arrangement. XYZ Corporation would pay the cost of insurance for Kathie and be the owner of the Death Benefit portion of the life insurance policy. Kathie could contribute an additional \$10,000 per year into the universal life contract and be the Cash Value owner. Kathie would have a tax-sheltered savings vehicle and could use the Cash Value build-up inside that policy to supplement her retirement income.

protected from the employer’s creditors through the appropriate beneficiary designation established by Kathie with regard to the Cash Value component of the life insurance policy. Establishment of the appropriate preferred beneficiary would also protect that Cash Value build-up from Kathie’s creditors. The arrangement could also be structured so that XYZ Corporation transfers its interest in the Death Benefit portion of the policy to Kathie at her retirement.

The arrangement could be structured such that the death benefit of the life insurance policy was transferred to her at a cost of \$1 upon her retirement at age 65. Kathie would then become the owner of both the Death Benefit and investment portions of the policy. An arrangement structured in this fashion would have no tax consequences on the transfer.



“An arrangement structured in this fashion would have no tax consequences on the transfer.”

In addition to the above benefits, there are some additional positives to this type of Split Dollar arrangement. The Cash Value build-up inside the policy could be

Buy/Sell Split Dollar Insurance

It is common for privately held business to have a shareholders agreement in place that sets out the rights and obligations of each of the shareholders with regard to the operation of that business. In a properly documented shareholders agreement, clauses should be inserted that deal with the death of a shareholder and the structure with regard to the purchase and sale of shares then held by the estate of the deceased. It is funded at either the shareholder/partner level through the use of criss-cross insurance or at the corporate level by corporate owned insurance.

If the buy/sell agreement is funded with life insurance, there is also an opportunity for the application of a Split Dollar arrangement.

First, determine the audience of the newsletter. This could be anyone who might benefit from the information it contains, for example, employees or people interested in purchasing a product or requesting your service.

Corporate Owned Insurance

It is common in a buy/sell structure for the corporation to own insurance on the lives of each of the shareholders. The insurance used as part of the buy/sell agreement may be term insurance or may be cash value insurance.

If the insurance choice for the corporation is cash value insurance, there may be problems that come about from the ownership of cash value insurance inside an operating company. If the business owning the insurance is a Canadian Controlled Private Corporation (CCPC) with under \$200,000 of active business income, that business may be entitled to a reduced corporate tax rate. To keep that reduced corporate tax rate that business in all likelihood is required to have 90% of its assets actively engaged in the business. If the business holds a life insurance policy with significant cash values inside the operating company, there is a risk that the value of the policy could exceed 10% of the value of the business and thus cause the business to lose its reduced corporate tax rate.

In addition, if a business holds a significant cash value life insurance policy inside an operating company, it may be difficult to remove that policy from the business if and when that business is sold to a third party. Moving the policy from ownership by the

corporation to ownership in the hands of an individual shareholder, upon the sale of the business, may trigger a policy disposition and result in the payment of significant taxes.

There are a number of solutions to this problem including the use of a holding company to own the insurance. For an individual who does not own a holding company or chooses not to proceed in that fashion, the use of Split Dollar insurance is another viable option.

Under this arrangement, the corporation would own the Death Benefit portion of the life insurance policy that was being used to fund the buy/sell agreement. It would receive permanent coverage at term insurance costs. The shareholder could then be the Cash Value owner of the policy and use the Cash Value component to build assets for retirement, through the use of a tax-sheltered investment.

In the case of a business owned by multiple shareholders, Split Dollar insurance may have special advantages that it provides the ability to customize a plan for each shareholder based on their needs for retirement planning. It would be difficult to develop a special plan for each shareholder with policies that were owned by the corporation alone.



"In the case of a business owned by multiple shareholders, Split Dollar insurance may have special advantages..."



“A business owner with a personal life insurance policy may choose to enter into a Split Dollar arrangement with their business and split only the death benefit component...”



Collateral Insurance Split Dollar

A business owner who is required to assign insurance to a financial institution as collateral for a loan taken out by a business may also have a use for the Split Dollar concept. A business owner with a personal life insurance policy may choose to enter into a Split Dollar arrangement with their business and split only the death benefit component of the insurance policy.

If, for example, an individual owning an insurance policy with a face amount of \$500,000 was required to pledge \$250,000 as collateral insurance to a financial institution in exchange for a loan, the Split Dollar arrangement could be structured as follows. The business owner would enter into a Split Dollar arrangement with the corporation. The corporation would own, by agreement, \$250,000 of the death benefit of the insurance contract; the

individual would own personally the other \$250,000 of the death benefit of the policy. The \$250,000 owned by the business via the Split Dollar arrangement will be pledged as collateral to the bank in exchange for the loan.

This structure would provide some unique advantages. Firstly, it would provide a means by which collateral insurance could be assigned to the bank without the shareholder having to purchase additional insurance in the name of the corporation. Secondly, because a portion of the insurance is now collateral insurance, part of the cost of that policy would now be deductible. The deductible amount would be the lesser of premiums paid and the net cost of pure insurance (NCPI) prorated to the amount of the insurance assigned.

Methods of Splitting Premiums

A splitting arrangement usually provides one party with the equivalent of term insurance and the other party with the benefit of accumulating cash values. In establishing this arrangement, the parties must also provide for a reasonable sharing of premiums. This is not only a matter of fairness between the parties but also an issue that has tax implications.

The most important factor in

calculating the sharing of premiums between the parties is usually to determine an appropriate cost for term insurance coverage acquired by the Death Benefit owner. The balance of premiums is then payable by the Cash Value owner. Premium allocation could therefore be determined in one of the following fashions (Method #3 being the most common practice using Term to 100 costs of insurance):



Methods of Splitting Premiums...continued



Involve the Professionals...

The Split Dollar concept is a very involved and complex concept. When planning is initiated for this concept, all of the professionals including the accountant, lawyer, insurance professional, and financial planner will need to be involved and consulted before proceeding with the implementation process.

1. The Death Benefit owner could be required to pay the lesser of the Net Cost of Pure Insurance (NCPI) and the total premium, with the balance of the premium being allocated to the Cash Value owner. The NCPI increases each year and will ultimately exceed the total premium. In addition, many policies eventually become "paid up" and require no further premium payments. In these situations, mortality costs are funded out of the cash surrender value of the policy. Where the Death Benefit owner in this case is an employee or shareholder, this could result in the assessment of a taxable benefit.
2. The Death Benefit owner could be required to pay the lesser of the mortality charge stipulated in the insurance contract and the total premium. This could represent the actual insurance cost being charged by the insurer. In some insurance contracts this charge increases each year, like the NCPI. In other contracts, the insurer charges a level mortality cost. As above, where policies in this category become paid-up, a taxable death benefit could be assessed to the Death Benefit owner in certain circumstances.
3. The Death Benefit owner could be required to pay a premium based upon the premium payable for equivalent term insurance available in the marketplace for the face

amount of insurance being obtained. Where rates used are those of 5-year or 10-year term insurance, as with some of the above examples, increasing costs for the Death Benefit owner would result. On the other hand, level costs would be applicable if a Term to 100 premium were used as a benchmark. Any of these would be acceptable.

It is Canada Customs and Revenue Agency's position that, where an employee or shareholder enters into a Split Dollar arrangement with an employer or corporation, a taxable benefit will arise if the premium paid by the employee or shareholder is less than that which would be paid for comparable product in the marketplace. It is now generally accepted that the conventional Split Dollar arrangement will result in a taxable benefit to the employee or shareholder because the amount of premium generally paid by the individual under such an arrangement is less than the cost of equivalent coverage in the marketplace.

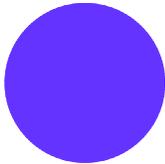
In all other cases, CCRA has stated that it is a question of fact in any given case as to whether a benefit arises. Generally, if the individual is accountable for premium related to the coverage being obtained, a taxable benefit should be avoided. An argument clearly exists that in the examples shown, that a taxable benefit would be avoided.



Phone: (519) 272-3112
Toll Free: (866) 272-3112
Fax: (519) 662-6414
Email: john@johnjordancfp.com

WEBSITE

www.johnjordancfp.com



Documentation

Split Dollar is a marketing concept rather than a specific arrangement designed the same way each time. For this reason, complete documentation prepared at the outset, is critical to ensuring that a proper plan is implemented. If the concept is not properly implemented with the appropriate documentation, many years later an administrative nightmare may arise as the parties try to sort out their respective rights and obligations under the contract.

To properly put a Split Dollar arrangement in place, the following steps need to be taken:

1. Life Insurance Application – Universal Life is most commonly used
2. Issuance of the Life Insurance policy – Split Dollar insurance cannot be implemented without a policy.
3. Split Dollar Agreement – an agreement should be executed which sets out the rights and obligations.
4. Assignment – the ownership should then be split between the two parties through the insurance company's appropriate forms.
5. Beneficiary Designation – both parties will assign their appropriate beneficiaries.
6. Board Resolution – If a corporation is involved, a resolution should be prepared to authorize the corporation to enter into the agreement.
7. Power of Attorney – a power of attorney would relate only to the split dollar arrangement between the two parties. Caution should be exercised.

For more information...

If you need to have any specific information in relation to these articles or any other insurance related matters, call or email me and I'll provide you with the information needed to help solve these and other estate and business planning needs.

Regards,

John Jordan, CFP