Split-Dollar Life Insurance

Risks, Benefits and Key Considerations

Health care organizations are facing increased pressure as they try to recruit and retain top talent. At the same time, the onset of the 2017 Tax Cuts and Jobs Act and the introduction of a 21% employer-paid excise tax on compensation over $1 million for top-paid executives has left some hospitals and health systems asking the following question: ***Is there a more cost-effective way to deliver compensation and benefits?***

These challenges have triggered renewed interest in split-dollar life insurance, although limited adoption rates have been observed to date based on SullivanCotter's 2018 *Benefits Practices in Hospitals and Health Systems Survey Report*. While, under certain circumstances, split-dollar life insurance has the potential to reduce costs for the employer while delivering a similar or greater benefit for the executive, it is a much more complex approach than cash-based compensation structures and carries risks that must be carefully evaluated.

For some, split-dollar life insurance evokes memories of past programs that did not deliver on the promises made or, worse, resulted in a cost to the executive rather than a benefit. Proponents of contemporary approaches cite refinements to the design, potential excise tax savings and reductions to operating expenses as reasons to consider such a program. However, a balanced review will also examine the long-term cost impact, inherent complexities, risks, optics, capital requirements and regulatory uncertainty.

The key is understanding the nuances of today's split-dollar life insurance arrangements and under what circumstances they might warrant consideration.

What is Split-Dollar Life Insurance?

Split-dollar life insurance is fundamentally different from cash-based compensation programs. Contemporary split-dollar life insurance programs are typically structured as follows:

- In lieu of cash-based programs, the employer funds a life insurance policy with a single up-front premium. This is treated as a loan to the executive where the principal and interest is typically repaid upon death.
- If the loan accrues interest at the Applicable Federal Rate (AFR) and is repaid, it results in no taxable income for the duration of the arrangement.
- The executive can receive tax-free withdrawals from the policy each year during retirement.
- The loan is not considered a cost from an accounting perspective, resulting in reduced operating expenses.
- Since the arrangement is not considered taxable income, excise taxes may be reduced.[1]

What are the Key Benefits of Split-Dollar Life Insurance?

The potential benefits of split-dollar life insurance programs are primarily financial in nature:

- Split-dollar life insurance commonly results in reduced operating expenses and, due to the accounting treatment, a shift from investment income to operating income. The long-term cost impact will depend on the investment income opportunity cost relative to the operating gains.

[1]Legislation specifies that regulations will be prescribed to prevent avoidance of the excise tax. As such, the potential reduction in excise taxes through use of split-dollar life insurance is uncertain, pending excise tax final regulations.

- Availability of retirement income from split-dollar life insurance is typically adjusted to be higher than the alternative cash-based program. Due to the risks involved with split-dollar programs, executives must consider timing, amount of cash flow and potential variability in those amounts when deciding whether or not this arrangement is right for them.

There is no simple way to identify the financial impact without modeling projections under different scenarios. The financial impact can vary significantly based on the size of the loan, the age of the individual, interest rates, life insurance policy features and tax rates. How comparisons are made, including when retirement income is expected to be available and over what period, can have an impact as well.

What are the Key Risks Associated with Split-Dollar Life Insurance?

Any expected financial benefits should be assessed against the following costs and risks associated with split-dollar life insurance:

- **Complexity and degree of confidence with impact to executive's assets.** Program tends to be a voluntary alternative to a simpler cash-based program and adopted only by those who can afford to accept the inherent risks.
- **Long-term commitment.** The program may be in place for several decades, during which time there could be several unanticipated events impacting the program's performance with no viable exit strategy.
- **Retirement income needs and cash flow.** Program is only available through regular annual payments and not lump sums. This reduces the ability to adapt to an executive's evolving financial needs and preferences.
- **Corporate cash flow.** In many cases, the organization must increase its cash outlay to make the program attractive to potential participants. This can call into question whether tying up additional assets in the split-dollar program is a good use of funds by a not-for-profit organization. While there may be financial benefits, the optics could be challenging to defend as the size of loans reportable on the Form 990 Schedule L can be significant – albeit without any reportable income on Schedule J.
- **Life insurance policy performance.** The success of the split-dollar program hinges on the life insurance policy performance. Policy illustrations include assumptions about market-related factors, such as S&P500 index performance, as well as elements controlled by the life insurance company, including policy charges and crediting rates. Illustrations typically show one scenario based on current policy charges and another based on guaranteed charges – and the results can be substantially different. The ability to maintain current policy charges is contingent on the insurance company's profitability.
- **Plan administration.** Few organizations have the infrastructure necessary to administer the program internally and rely instead on outside administrators with associated expenses. Maintaining an understanding of these arrangements within the organization will be important as inevitable staff turnover occurs throughout the life of the program.

How Should Organizations Proceed?

Those interested in pursuing split-dollar life insurance should follow a process that ensures robust analysis and engagement with all stakeholders.

Engage an independent advisor. Many organizations rely on advisors who can financially benefit from the placing of the insurance in the form of commissions. It is rare for organizations to have internal resources to evaluate these programs given how seldom they are currently being used. Acting on the organization's behalf, an independent advisor can work with the individual brokers to ensure key objectives are being met and the proposals appropriately reflect the costs, benefits and risks of the arrangement. The independent advisor can then provide an assessment of the proposals, ensuring that the organization receives a balanced perspective and understands the critical aspects of the program that impact decision-making.

Organizations should assess these five considerations and reevaluate interest after each step:

1. Review of executives who might be suitable candidates and which cash-based programs could be exchanged for split-dollar life insurance. If multiple executives may potentially participate, one or two individuals may serve as test cases.

2. Initial engagement with stakeholders to identify the level of interest from executives, the Board's or Compensation Committee's perspective on risks and optics, and determination of how program costs will be evaluated by the organization's finance leaders.

3. Identification of one or more experienced insurance brokers who can develop a detailed proposal that supports the key strategic objectives. The proposal should include design features, cost analyses, benefit projections and stress testing of multiple assumption sets.

4. Independent assessment of the proposals that ensures a clear, unbiased summary of the program's operation, impact on operating income/expenses and investment income, considerations for participants, program optics and disclosures, key risks and additional insights regarding assumptions.

5. Consideration of the proposals and independent assessment by all stakeholders, including potential participants, Board or Compensation Committee members and finance leaders.

If a split-dollar life insurance program is under consideration, a thorough assessment of potential risks and rewards must be conducted. Having an independent expert who can facilitate the process, deliver a balanced evaluation of options and ensure each party is asking the right questions and getting the answers they need is critical to making an informed decision.

Note that SullivanCotter does not sell insurance or receive commissions, referral fees or payments from those who do.

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