Article 3: Product Selection, Design Variables and Managing Volatility

In the previous articles, we have examined issues related to split dollar compliance and plan documentation. Once the plan is structured in a compliant manner, and the terms of the agreement are understood and meet the requirements of the parties, we turn our attention to product selection and design. First and foremost, the parties must select product types that are congruent with their respective risk tolerances. Remember, there are two objectives in a split dollar arrangement; retirement cash flows and repayment of the obligation to the employer. These conflicting goals could result in the key employee and employer having different tolerances as to risk, especially as it relates to the rate of return (policy crediting). That is, the employee may be willing to take on a higher level of risk to maximize retirement cash flows, where the employer may be more conservative to protect its position.

Product Selection

Risk tolerance should drive product selection. Split dollar arrangements require the use of permanent insurance, and there are several product types from which to choose that offer varying levels of risk and expected policy crediting. On the low-end of the risk continuum are products with fixed crediting rates such as whole life (WL) and universal life (UL) insurance products. Crediting rates on these products are determined annually and based on the performance of the life insurance carrier's general account investments. On the opposite end of the risk continuum, are variable universal life (VUL) insurance policies that credit based on the performance of separate accounts which are similar to mutual funds. The policy owner selects the "separate accounts" to which the cash value of the policy is allocated and can change these allocations from time to time. The crediting on these policies fluctuates and can result in negative returns in addition to positive returns. In the middle of the continuum are indexed universal life (IUL) insurance products. These policies credit based on the changes in a major market index but within an established range referred to as a "collar." As an example, a typical approach to IUL crediting is based on the changes in the S&P 500 Index on an annual basis with a minimum crediting rate of 0% and a maximum crediting rate of 12%.

The higher the assumed crediting rate, the lower the amount of capital the employer has to commit to funding the arrangement. As a result, it is important for the parties to remain disciplined and avoid falling into the trap of being overly optimistic with crediting assumptions as a way to reduce the amount of capital required to implement the split dollar arrangement.

Select Design Variables

Crediting

Once the policy type is selected, the parties should give ample consideration to the crediting rate assumed for the life insurance illustrations. Even in situations where a whole life or universal life policy is elected, the parties should evaluate the likelihood that the crediting/dividend rates will not fall below current levels for an extended period. If there is a concern, a lower crediting rate should be assumed to ensure the plan remains compliant and the projections are realistic throughout its lifecycle. For policy types where crediting is not "fixed," a rational method for determining an expected crediting rate should be employed.

Access to Policy Value

In loan regime split dollar arrangements, the key employee intends to access the cash value of the policy at a future point, such as during retirement. There are two ways for the key employees to gain access to the policy's cash value, withdrawal or policy loan. Understanding the impact of each and some of the key decisions within the loan option are important and affect the success of the plan.

Withdrawals remove cash value from the life insurance policy permanently and are limited to the basis in the contract. Withdrawals over basis are likely to have tax implications for the key employee. Permanent removal of cash value from the policy can also have negative performance implications which the parties should consider. The other option is a policy loan. In this case, the key employee borrows from the insurance company and uses the policy as collateral. The insurance company charges interest on the policy loan, but the cash remains in the policy where any positive crediting can provide an offset to the interest. Regardless of the method chosen the key employee should avoid overly aggressive access to policy value. Insurance companies tend to offer more than one type of policy loan option (such as fixed, indexed and variable) and the parties need to understand the implications of each option.

Applicable Federal Rate (AFR)
As described in a previous article, the AFR is the rate at which the premiums paid by the employer (considered a loan for tax purposes) will bear interest. This interest can either be paid (generally at death) or forgiven (resulting in income inclusion for the key employee). It is also one of the important considerations when the parties address the volatility of the plan and ways to mitigate the potential for changes in the AFR.

Managing Volatility

It is crucial to understand the types of volatility that can affect the success of a split dollar plan. Being materially wrong on any of these discrete assumptions or a combination of assumptions could lead to issues with the plan going forward. As a result, the parties should take measures to account for and manage volatility at the outset. The goal is to build a plan that is resilient and achieves its objectives even in the face of less than expected policy performance.

Crediting
Based on our experience, we will not implement a split dollar plan that utilizes VUL in its design. We believe there is simply too much risk from a crediting perspective and no reliable way to mitigate such risk without the possibility of negative returns. This leaves UL, WL, and IUL as prudent choices for a split dollar arrangement. While WL and UL crediting rates fluctuate over time, these changes tend to be gradual. Given the low-interest rate environment, we believe that assuming current crediting rates for these product types is reasonable for the long-term.

While IUL is a viable option for split dollar, its crediting will vary more than UL and WL options. Much of the volatility in an IUL is reduced because of the collar, but crediting will still fluctuate. We believe the potential for higher policy crediting is a practical trade-off, but we encourage our clients to take a prudent and reasonable approach to determining the crediting rate for projections. The most common methods we see are internal rates of return (IRR) and confidence intervals over a relevant historical period. Once you have derived the crediting rate, check that rate using other financial and statistical methods to confirm reasonableness. It is also wise to “stress test” your projections with lower rates of return to ascertain the effect on plan performance.

Borrowing Rate
Fixed policy loans provide for both the interest rate and the crediting rate on the borrowed funds to remain unchanged. This loan type is the least volatile choice regarding a policy loan. Indexed loans allow for the crediting to float within the collar but the loan interest rate remains the same. Finally, variable loans allow both the interest rate and crediting rate to fluctuate. With indexed and variable loans there is a possibility that the loan interest will exceed policy crediting. This negative arbitrage can have a significant effect on policy performance and may lead to the selection of a more conservative option.

Again, the key employee and employer should carefully evaluate the options and ensure their choice reflects their respective risk tolerances.

Applicable Federal Rate (AFR)
One of the key areas of volatility in a split dollar arrangement is the movement in the AFR over time. Certain design decisions allow this rate to fluctuate over the life of the plan, which could lead to plan failure or adverse tax consequences to the key employee. To eliminate the variability of the AFR over the life of the arrangement the solution is to fund the arrangement fully at implementation and select the long-term AFR as the interest rate. Using this approach, the rate is static for the life of the plan, and the associated life insurance policy can be designed with greater precision and confidence.

Final Note

Two tests define life insurance policies for tax purposes, the guideline premium test (GPT) and the cash value accumulation test (CVAT). In general, GPT designs tend to be more efficient from a cash accumulation perspective, and CVAT works best for the provision of death benefit. Herein lies a tension for split dollar plans using a single life insurance policy. The key employee desires cash value efficiency, and the employer requires a sufficient death benefit so it can recover its capital.

While the definition of life insurance (GPT or CVAT) is not subject to change once the choice is made, it is a critical factor as to the policy's ability to withstand other volatile elements. In particular, selecting the CVAT design eliminates the availability of an overloan protection rider (or similar) which can prevent the policy from lapsing due to key employee borrowing. Should the policy lapse during the key employee's life, all policy loans to date are likely to be includible in the key employee's income. Adding a rider to the policy that protects the key employee from this outcome is a critical element that must be part of evaluating the design of a split dollar plan.

With the split dollar plan properly structured and populated with the proper insurance products, our focus changes to life after implementation. Like any other plan, split dollar arrangements require consistent maintenance not only as to the life insurance policies but also financial reporting. Next week, we look at the ongoing service requirement of split dollar arrangements and the factors that influence plan accounting. Lastly, we review ways to revise existing plans to eliminate weaknesses and increase the probability of success going forward.

Understanding the most important factors impacting the success of a plan equips the parties to make wise decisions and structure the plan to achieve its goals with increased probability. Our purpose is to educate both nonprofit employers and executives participating in or considering participation in a split dollar plan.

Contact us for a plan review and assessment.

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