Article 2: Understanding the Terms of the Split Dollar Agreement

Split dollar plans are arrangements that typically remain in place for the lifetime of the participating key employee. The longevity of the plan means the employer will be a party to the agreement potentially decades after the key employee has retired. Accordingly, a sound plan document must exist, so future leadership teams and Boards of Directors are not in the position of making interpretations years in the future.

Split dollar arrangments are customized transactions, and there are numerous ways to implement a compliant, carefully considered plan. That said, it is critical to document the terms of the deal with specificity in the Split Dollar Agreement (Agreement). While this may sound obvious, TRISCEND[NP] has encountered situations where the split dollar arrangement exists on what amounts to a "handshake," or the Agreement was vague, misunderstood or omitted key elements with the potential to cause conflict between the parties in the future. The best Agreements are explicit, written in clear language and leave no room for doubt as to the intentions of the parties.[1]

Below we discuss some of the more relevant terms in a typical split dollar agreement. We make these comments within the context of a loan regime split dollar arrangement. It is fundamental to understand that many of the contract terms are interconnected; that is, the various terms of the Agreement do not exist in a vacuum; they impact other parts of the Agreement. Further, the split dollar agreement should not conflict with other related documents, such as the key employee's employment agreement.

Plan Funding

Split dollar arrangements can be funded in one of two ways; fully at implementation or over a defined period of years. Either way is acceptable as long as the impact of the funding decision on the remainder of the agreement and the economics of the transaction are understood. Both funding methods have advantages and disadvantages, and the particular facts and circumstances of the employer and key employee are essential considerations when making this decision.

Fully funding the arrangement at implementation certainly has its benefits. First, making a single split dollar "loan" allows for the applicable federal rate (AFR) to be set and remain unchanged for the life of the Agreement eliminating a significant potential uncertainty. This funding method allows for greater design flexibility and overall plan efficiency. The primary disadvantage to funding the entire program at implementation is the effect on the employer's cash flow. Split dollar arrangements can require significant capital, and if the employer is cash flow sensitive, an installment approach may be more sensible.

Should the installment approach be elected, each loan tranche will bear the AFR in effect at the time of the payment resulting in the major drawback of funding the plan in this manner. While more favorable from a cash flow perspective; predicting what the AFR will be in the future is impossible. As a result, the plan design must anticipate increases in the AFR over the installment period to maintain compliance. Various forecasting methods can be used to predict future rates but, due to the potentially unreliable nature of these estimates, a significantly higher AFR should be assumed to maintain compliance.

Declaration of Interest Rate

The interest on a split dollar arrangement can be accrued and paid or forgiven. Determining an appropriate interest rate and the payment method is vital. The interest rate will be no less than the AFR in effect at the time of the loan and based on the anticipated term of the arrangement and other provisions in the agreement. If the Agreement stipulates the employer will be paid back at mortality, the interest rate will most likely be the long-term rate.[2] Fully funding the plan at implementation simplifies the determination of the interest rate as it will be the one in effect at the time. With one AFR in place, administration, financial reporting, and compliance are less complicated.

[1] Triscend[NP] does not provide tax or legal advice. Consult your independent advisers on these matters.

[2] Most loan regime split dollar arrangements assume the long-term AFR.

Occasionally we see "demand" loans[3] where the employer can force repayment of the split dollar loan at any time. The parties implement a demand loan structure when they wish to use the typically lower short-term AFR. While the short term rate can be seductive, it will fluctuate annually over the lifetime of the arrangement. Moreover, the level of uncertainty from the key employee's perspective that comes with a demand loan design may eliminate the benefits of the plan overall.

Vesting and Effect of Termination

Split dollar arrangements are commonly used to retain a key employee for a predetermined number of years. The period usually coincides with employment contract terms, critical projects, planned retirement or other events. The employer often ties access to the split dollar plan to continued employment in the same or similar capacity for the determined timeframe. The employee's vesting in the benefit can either happen incrementally or all at once, and the split dollar document should be clear on this matter.

Achieving full vesting means the key employee has access to all of the projected plan benefits, but it is important for the parties to consider the various events that could lead to partial or complete forfeiture of the benefit and craft the contractual language appropriately. Events typically affecting vesting are:

> **Disability:** The document should define disability and should not create a conflict with the key employee's employment or other related agreements. In most of the arrangements we have seen, disability results in some level of immediate vesting in the benefit but not always full vesting.
>
> **Voluntary Termination:** Voluntary termination will result in at least a partial forfeiture of the projected benefit, depending on the timing and the vesting schedule.
>
> **Termination for Cause:** The definition of this type of separation is usually quite precise. In all of the cases, we have encountered, termination for cause results in complete forfeiture of the projected benefit.
>
> **Change of Control:** Many industries are consolidating, including nonprofit organizations. Therefore, it is wise to consider the impact an acquisition or merger with another employer would have on the split dollar arrangement. Many organizations elect to define this term and in certain situations, wholly or partially vest the key employee in the projected benefit.

Limitations on Policy Access

The flexibility the key employee has in accessing the value in the life insurance policy requires significant thought. Similar to the allocation of death benefits discussion below, access needs to be negotiated into the final agreement and not left for future interpretation. While we see many variations, the terms fall into two categories. First, a key employee has limited access to policy cash flow and can access policy value up to a certain limit and for a specified period of years.

Alternatively, the employer can provide the key employee with unlimited access to policy values (both years and amount). This policy access should, of course, not threaten plan compliance. Specifically, this unlimited access cannot jeopardize the repayment of the employer's funding including interest if applicable. The employer and key employee should carefully consider this issue and find a balance between the executive's desired flexibility, the objectives of the employer and the need to remain compliant.

Allocation of Death Benefits

At a minimum, the policy associated with a split dollar arrangement must maintain a death benefit at least equal to the amount owed to the employer at all times. As discussed in the previous article, the sum owed can be limited to the funds paid by the employer or the funds could accrue interest. If interest accrues, it's difficult to impossible to design a life insurance policy with a death benefit that tracks the amount owed to the employer in any given year. Therefore, additional death benefit should be added to the policy to

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[3] Within the rules related to loan regime split dollar, loans are classified as term, demand or hybrid.

ensure there is always enough death benefit even if the policy underperforms. This extra amount can result in what we refer to as "excess" death benefit or death benefit at mortality that exceeds the amount owed to the employer.

Depending on the amount of value the key employee has accessed before death, this remaining death benefit can be significant. The sharing of this excess death benefit is a central matter and should be part of the split dollar document negotiations.

Questions to ask:

- Could someone without firsthand knowledge of the arrangement read your split dollar agreement and understand the intent of the parties?
- Are there any areas in the agreement that are vague or could lead to multiple interpretations?

Concurrent with negotiating the terms of the split dollar agreement, the insurance policies are designed, underwritten and placed. Next week, the topic shifts to other decisions commonly made as part of the design of a split dollar arrangement. These decisions will involve life insurance product selection, design variables, and managing volatility.

Understanding the most important factors influencing 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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