Principal®

Business solutions case study

Loan split dollar plan helps business retain key employees

Using multiple plan designs provided a business with a key employee benefit that offered a tax-efficient supplemental retirement income solution.

Client profile

Manufacturing company with a previously implemented nonqualified deferred compensation plan and annual contributions of $25,000/ participant.

A challenge leads to opportunity

Implementing a deferred comp plan was a beneficial start for the company. But the deferred comp benefit will create taxable income for participants of approximately 20% of their account balance in each of the first five years of retirement. This tax impact would be significant at retirement due to the five annual distributions. So, in addition to offering the deferred comp plan, the company wanted to explore plan design alternatives for a subset of key employees that would keep contributions the same but decrease the income tax impact at retirement.

An alternative solution

The financial professional presented the Principal® Loan Split Dollar plan using Principal Indexed Universal Life Accumulation II℠. This plan would have the business provide loans to select employees that allow both to share in the cost and benefits of the plan. Here's an overview:

Key features	Loan Split Dollar plan design
Contributions	• $25,000/participant paid annually for 15 years ($375,000 total premiums).
Financing strategy	• Each participant is owner and insured of a life insurance policy. • Premiums are paid by the company.
Loans	• Premiums will be characterized as non taxable demand loans to the participants. • Loans are receivables on the company balance sheet. • The initial imputed loan interest rate[1] is 0.5% ($125 in yr. 1). The rate can change annually based on market conditions.
Participant annual tax impact	• Participants will pay their loan interest each year, or income in the amount of the interest will be added to their compensation. • Participants' imputed interest income will grow as each premium is paid. • If the income tax liability on imputed interest included as compensation is a concern, the company can bonus income to participants to cover the liability.
Participant retirement or plan termination	• Participants could withdraw cash from their policy to repay their loan. Repayment of the loans can provide cost recovery to the employer. • Or the company could forgive the loan. The amount of the forgiven loans would be treated as taxable income to participants. The company would receive a corresponding deduction.

Result: Supplemental retirement income with lower taxes at retirement

Here are benefits the plan could provide a sample participant at retirement[2]:

- If the loan is forgiven, the participant has taxable compensation of $375,000, creating an income tax liability of $168,750.
- The participant can withdraw policy values needed to pay the tax, then at age 70 begin 15 annual distributions of more than $44,000 to supplement other income sources.
- The policy also provides survivor benefits to the participant's family if the unexpected happens.

This example shows how implementing a loan split dollar plan allows the company to achieve its goal of providing a key employee benefit with less income tax burden for participants, and with no additional cost outlay to the company. In this case, the tax liability is limited to the annual imputed interest. If the company chooses to forgive the loans in the future, participants will pay tax only on the premiums paid (amount forgiven) and not on any policy growth.

Value-add plan services

Principal® Business Market Administration can help make this plan a success from start to finish by providing the following comprehensive consulting and plan administrative services:

- Annual reporting of the imputed interest amount for each participant
- A dedicated plan administrator to assist with enrollments, policy adjustments, service requests, policy illustrations, and more
- Plan-level reporting with current coverage amounts, policy values, and premium information
- List billing that delivers consolidated payment reminders for all policies under the plan
- Online access for the company and participants to view policy information and make changes or initiate service requests

Key characteristics that help the plan work

Plans can be especially effective for your business clients with the following profile:

- Commitment of significant annual contributions from the company for each key employee
- Low turnover among group of key employees
- Goal to provide a benefit with a favorable income tax outcome for the participants
- Participants can be owners and key employees of C corporations, key employees and leaders of tax-exempt organizations, S corps, LLCs, and partnerships.[3]

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All guarantees and benefits of the insurance policy are backed by the claims-paying ability of the issuing insurance company.

[1] Imputed interest is the interest at a minimum level required by tax law.

[2] *Assumptions:* Principal IUL Accumulation II, age 50, unisex, Preferred Non-Tobacco, $25,000 annual premium for 15 years, $322,007 initial death benefit, 5.74% annual credited rate, 45% employee tax rate

[3] Executive officers of publicly traded companies, and certain entities required to file with the Securities and Exchange Commission, are not eligible due to the Sarbanes Oxley Act of 2002. Certain states prohibit nonprofit organizations from making loans to officers and directors, but some have exceptions for split dollar loan

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