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Whole Life or Indexed Universal Life for Split-Dollar Loan?

by Scott Richardson, Founder /CEO

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Split-dollar loan (SDL) remains a popular form of executive benefit, driven by more favorable financial impact on the CU vs. other benefit forms as well as the potential for income-tax-free benefits for the executive.

Split-dollar loan uses a life insurance policy owned by the executive and paid for by the CU. The CU's payments are treated as a loan under IRS regulations (hence the name), and if the CU is to be repaid premiums plus interest at the IRS-determined Applicable Federal Rate (AFR), there is favorable tax treatment.

Simply put, SDL captures the spread between policy performance (which varies) and the AFR (which is fixed for each CU advance). While actual spread matters the projected spread has far more influence on expected benefits. Therefore, the projection rate you use is crucial to designing and monitoring SDL. Insurance illustration rules limit the maximum projection rate, however, prudent design demands a planning rate below that maximum.

One of the key decisions in designing SDL is what type of policy to use – whole life (WL) or indexed universal life (IUL). We use both types, helping clients match the executive's profile to the appropriate product.

Whole Life is the oldest form of life insurance. It has strong guarantees with an annual dividend rate set by the carrier that doesn't change much from year to year. With a 25+ year general decline in fixed income rates, it's no surprise that dividend rates have changed. The table below shows the number of decreases from 2002-2021. The maximum projection rate in WL is the current dividend rate. We recommend a WL planning rate 0.5%-0.75% below the carrier's 2021 dividend scale.

Guardian	Mass Mutual	New York Life	Northwestern Mutual	Penn Mutual
12	11	8	12	5

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Indexed Universal Life has a crediting rate based on the change in an external index, most commonly the 1-year change in the S&P500™. An author of a recent article wrote that IULs are "expected to lose money about half the time." This is a stunning lack of understanding of how IUL works since cash values are never exposed to the index and there is a guaranteed minimum or "floor" rate. The table below is based on 25 years of 1-year measuring periods.

Dec 4, 1995-Dec 3, 2020 (25 years)	S&P 500™	IUL at 9% Cap (1% Floor)	IUL at 8% Cap (1% Floor)
Number of 1-year Periods	6,042		
Negative Periods	1,383	0	0
Average	8.19%	6.35%	5.78%

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If the IUL floor is 1%, then a 30% drop in the S&P (see March 2020) means the crediting rate is 1%. On the flip side, there is a maximum or "cap" rate in IUL. If that cap is 9%, then a 30% increase in the S&P means the crediting rate is 9%. In between, you get what the index change is. We recommend at least monthly calculations (vs. just once per year).

The maximum projection rate in IUL is a function of the IUL cap rate, and like WL dividend rates IUL cap rates have declined. While you can still actually get a 9% crediting rate for any measuring period, the projection rate is lower. We recommend an IUL planning rate that is 0.5%-0.75% below the maximum, and are currently using 5%-5.25%.

So which is the "right" product? While neither WL nor IUL is inherently better the key for us is the first distribution date. If you have less than 10 years before the first scheduled distribution, we generally favor WL as it provides greater confidence in meeting the projection. Beyond that, the upside of IUL may be more desirable. Whichever you choose, stress the initial planning rate by running two lower alternatives to see the impact on the targeted distribution.

There are other features of WL and IUL that are key to a sound SDL plan. Call IZALE Financial Group for a free consultation.

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