



Lee Slavutin, MD, CPC, CLU/Stern Slavutin-2 Inc.

WHAT TO DO ABOUT SPLIT-DOLLAR LIFE INSURANCE PLANS

For years, split-dollar life insurance arrangements have been favored by corporations and professional practices. In such arrangements, costs and benefits of life insurance are “split” by employers and employees.

In many split-dollar arrangements, the company pays most or all of the premiums. The executive pays relatively modest income taxes compared with the life insurance coverage received.

NEW RULES

Last year, several events shook up the world of split-dollar life insurance...

- In January 2002, the IRS issued Notice 2002-8, which provided guidance for split-dollar arrangements.

- Last July, proposed regulations stated that Notice 2002-8 could be relied upon until final regulations are issued, which might take years.

- Also in July, the *Sarbanes-Oxley Act of 2002* was signed into law, prohibiting certain loans from public corporations to executives. This could affect split-dollar arrangements (see below).

- Last August, the IRS issued Notice 2002-59, dealing with “reverse” split-dollar life insurance, where the parties attempt to avoid taxes by using techniques that understate the value of policy benefits.

In light of these changes, how are existing split-dollar arrangements affected? Split-dollar arrangements entered into before January 28, 2002, are grandfathered. Thus, they are entitled to special tax treatment.

Collateral assignment equity split-dollar: This may be the most common type of arrangement. *Features...*

- The employee (or a trust created by the employee) owns the policy.
- The company will eventually be repaid for the premiums it has paid.
- The policy’s cash value, in excess of the premiums paid, belongs to the employee or to family members.

The “equity” in equity split-dollar arrangements refers to the employee’s access to the excess cash value. Notice 2002-8 has indicated that this excess may be subject to income tax in the future.

OPPORTUNITIES

What should you do with this type of arrangement? That depends largely on how long an arrangement has been in place.

Old plans: In some cases, split-dollar arrangements have been in place for 10 years or longer, and the cash value far exceeds the premiums paid.

Strategy: Terminate the split-dollar plan and repay the premiums to the company, perhaps by borrowing from the cash value.

Example: Your old split-dollar policy now has \$1.6 million in cash value and you owe your company \$600,000 for premiums it has paid. You might borrow \$600,000 from the cash value, tax free, and repay the company.

Loophole: If you act before January 1, 2004, the equity in the policy will be untaxed. In this example, you’d wind up with a policy that still has \$1 million in cash value (after taking out the \$600,000 loan)—and *never* owe income tax on that accumulation, as long as the policy is not canceled or lapsed.

STAY THE COURSE

In many collateral assignment equity split-dollar arrangements, cash value has not had time to accumulate in excess of the premiums paid.

Strategy: Continue the arrangement as before.

Loophole: Notice 2002-8 permits grandfathered plans to continue to use low term insurance company rates when calculating the value of the protection received. This permits the employee to pay relatively little in tax for substantial amounts of insurance coverage.

Exception: If your company is publicly traded, no further premiums should be paid. Such payments may be illegal loans under Sarbanes-Oxley.

Tactic: Suspend payments until this issue is clarified.

SPECIAL PLANS

Not all split-dollar plans conform to the above outlines. *Variations include...*

- **Nonequity plans.** The corporation will be repaid the premiums paid or the cash value, whichever is greater. Excess cash value does not go to the executive.

- **Endorsement plans.** The corporation owns the policy while the employee will get most of the death benefit.

Strategy: As long as these plans are nonequity, income taxes won’t arise as an issue. These arrangements can continue.

Loophole: If these arrangements were in effect before January 28, 2002, they can continue to use low insurance rates to determine the value of the coverage received. Thus, the income tax burden on the insured executives can remain relatively low.

Tax Hotline interviewed Lee Slavutin, MD, CPC, CLU, chairman of Stern Slavutin 2 Inc., an insurance and estate planning firm, 530 Fifth Ave., New York City 10036. Dr. Slavutin is author of *Guide to Life Insurance Strategies* (Practitioners).

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NEW ARRANGEMENTS?

What about split-dollar arrangements entered into after January 28, 2002? Or split-dollar arrangements now being contemplated? *Considerations...*

• **Taxation of cash value.** In equity arrangements, the buildup of cash value in excess of premiums paid may be subject to income tax.

• **High current income taxes.** After 2003, artificially low insurance company rates cannot be used to determine the value of the insurance protection received. Higher rates must be used, so the insured executive will pay higher tax bills.

Bottom line: The proposed regulations are not favorable for split-dollar plans established after the final regulations are published, so there now seems to be little advantage in creating new split-dollar arrangements.

Exception: Endorsement arrangements, described above, may continue to be a good idea if the object is to reward a valued employee who is not a principal in the company. Such split-dollar plans

eventually may be used to fund deferred-compensation payments.

LOANS

New split-dollar plans might be replaced by straight loans.

Example: George Johnson owns 100% of ABC Co. To help George buy life insurance, ABC lends him \$10,000 a year. As long as each transfer is treated as a true loan, the \$10,000 outlays won't be taxable compensation to George.

Key: At today's low rates, George would have to pay only a small amount of interest to ABC. Money is essentially being shifted from one pocket to another, and ABC may owe a modest amount of income tax on the interest income received from George.

PRIVATE SPLIT-DOLLAR

Another form of split-dollar life insurance is known as "family" or "private" split-dollar. Generally, these arrangements are between family members and entities they create, such as trusts or partnerships.

If these are nonequity plans (described above), which they often are, they probably

can continue as in the past. Equity plans, though, may create tax problems.

Strategy: Equity arrangements can be recast as loans. As mentioned, these likely will be low-cost, lightly taxed loans among family members, resulting in considerable life insurance protection.

REVERSE SPLIT-DOLLAR

Notice 2002-59, though, attacked reverse split-dollar insurance arrangements in which artificially high life insurance rates are used. Such plans may have been designed to shift money between parties while minimizing gift tax consequences.

The notice effectively prohibits such practices. In addition, this ruling casts doubts on employer-to-employee reverse split-dollar arrangements, which are sometimes designed to avoid income tax on money transferred to executives.

Reverse split-dollar plans may have to be unwound with the aid of a tax professional.

Bottom line: In the future, new split-dollar arrangements will rarely be worthwhile. But the new rules provide some good news for old split-dollar plans. ■ ■