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LIFE INSURANCE: MORE TAX-SAVING OPPORTUNITIES

In our March issue, life insurance expert Lee Slavutin discussed three costly tax pitfalls. He returns this month with his thinking on current developments in his field...

LIFE SETTLEMENTS

Many people reach a point where their life insurance is neither needed nor wanted. That's especially true if the policy is not paid up—and premiums must still be paid.

Trap: Canceling an unwanted policy that has cash value may trigger a tax bill. You'll owe tax on the investment income that has accumulated inside the policy.

Alternative: Instead of surrendering your policy, consider selling it. A robust secondary market has developed for the sale of life insurance policies.

"Life settlements," as policy sales are known, may be available to insured individuals over age 70 with some medical impairment. This might be, say, heart disease or a cancer history.

Result: In such a situation, policyholders might sell an unwanted life insurance policy for more than its cash value. Buyers include banks, insurance companies, and hedge funds.

Example: A hypothetical Harry Smith, age 75, had prostate cancer diagnosed and treated three years ago. He has a \$5 million life insurance policy that was purchased to pay estate taxes on his real estate holdings.

Harry has liquidated those properties and has no need for the insurance now. The policy is a universal life contract with a cash value of \$350,000.

Grim outlook: The policy has performed poorly as an investment and the

premiums required to maintain the policy will increase sharply.

Faced with this scenario, Harry's insurance broker offers the policy to several buyers. The best offer is \$875,000.

Tax treatment: Selling the policy for \$875,000 will generate a \$525,000 gain—\$875,000 minus the \$350,000 in cash value. This gain is most likely to be treated as a capital gain. If state and federal capital gains tax adds up to 20%, the total of those taxes will be \$105,000.

There also will be ordinary income tax on the excess of the policy's cash value over its basis (cost for tax purposes). Assuming a basis of \$250,000 for the purpose of this example, ordinary income of \$100,000, and a 40% tax rate, this tax would be \$40,000.

Total tax: If Harry pays \$105,000 (on capital gains) plus \$40,000 (on ordinary income), the total would be \$145,000. From an \$875,000 selling price, he would clear \$730,000, minus any commission to the broker.

Bottom line: In this example, Harry would wind up way ahead of where he would be if he cashed in his policy for \$350,000 and paid 40% tax on his \$100,000 in realized investment income.

State of affairs: It is now routine to consider a life settlement whenever an older individual is about to cancel or replace an existing insurance policy—even term insurance.

If you have a policy to sell, have your adviser get several bids and compare the after-tax proceeds to what you would clear from a policy surrender.

SPLIT-DOLLAR ARRANGEMENTS

The term "split-dollar" refers to arrangements in which the costs and benefits of life insurance are shared (split) between two parties.

How they worked: In prior years, such arrangements involved a business or a professional corporation, which helped key employees obtain needed coverage. Often, the out-of-pocket cost to the insured individuals was modest in relation to the insurance coverage.

IRS crackdown: In Notice 2002-8, the IRS cracked down on perceived abuses. Income tax on split-dollar deals rose sharply, effectively chilling the market.

Loophole: Employees at closely held companies were allowed to keep their split-dollar plans in place. Assuming the plan was established before January 28, 2002, such employees could avoid many of the new tax rules.

How things stand: In regulations issued in 2003, the IRS clarified its views on split-dollar arrangements.

Latest news: Proposed regulations on nonqualified deferred compensation plans, issued in 2005, affirmed the IRS stance...

- If the only benefit provided to the executive is life insurance protection, the only tax will be on the implied value of the coverage, which may be insignificant.

- If the company lends money to the executive to purchase the policy, no tax will be owed by the insured executive unless there is a below-market interest rate or an agreement to forgive the debt.

Thus, there may still be opportunities to acquire valuable life insurance with little tax cost through these arrangements.

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Tactic: Consider exchanging an old universal life or whole life policy, acquired via a split-dollar arrangement, for a new guaranteed universal life (GUL) policy also acquired via a split-dollar arrangement. Such an exchange can be tax free under Section 1035 of the Tax Code.

Benefit: A GUL policy builds little cash value long term. Most of the premiums—which will be paid by the company—go toward providing a death benefit.

Such a split-dollar plan can provide you with more coverage for less money even though you've given up a grandfathered split-dollar policy.

LIFE INSURANCE TRUSTS

Irrevocable life insurance trusts (ILITs) have been popular estate planning vehicles.

How they work: A policy on the insured individual is held by a trust. At his/her death, the policy pays off.

Loophole: Because the policy is not owned by the insured person, it is not in his taxable estate. The proceeds are not subject to estate tax—the money may be used to pay the estate tax obligation.

A worrisome case: In a 2005 case (*Chawla vs. Transamerica Occidental Life Insurance Co.*), a federal district court ruled that a Maryland ILIT did not have an “insurable interest” in the decedent because the trust did not have a substantial economic interest in the individual staying alive. Such a ruling, if upheld, might annul the value of many ILITs.

Better news: On appeal, the court decided that the insurance company did not have to pay the death benefit. However, the Appeals Court said that this holding was due to the insured individual misrepresenting his health on the policy application.

Key: The lower court's comments on the trust's insurable interest were vacated as unnecessary.

How things stand: Life and the use of life insurance trusts goes on. The lower court's ruling is not likely to be used as a legal precedent against ILITs.

Moreover, legislation has been proposed in Maryland to support the use of ILITs—it already has passed the state's House of Representatives.

Strategy: If you are concerned about a future challenge, set up your ILIT in Delaware, Virginia, or Washington, where state law already gives these trusts an insurable interest. If you already have an ILIT in a state where ILITs don't have such backing, ask your attorney about transferring the trust to one of those three states. ■ ■