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## BEWARE...ACT BEFORE YEAR-END TO AVOID BIG TAXES ON SPLIT-DOLLAR INSURANCE

**A** year-end deadline is fast approaching for participants in split-dollar life insurance plans.

In IRS Notice 2002-8, split-dollar arrangements in effect before January 28, 2002, were given three options...

1. Such arrangements may be terminated by December 31, 2003, without adverse tax consequences.

2. They may be adjusted by December 31, 2003, to treat cumulative employer premium payments as a loan.

3. Or the arrangement may remain in place.

**Impact:** If you don't act now, you may find yourself owing large amounts of income tax in the future.

**Note:** The new split-dollar regulations just published affect only plans established or modified after September 17, 2003. Remember that IRS Notice 2002-8 applies to all arrangements in effect before the final regulations were published.

### GROUND RULES

To make the right decision, you need to understand split-dollar basics. The term "split-dollar" refers to arrangements in which the costs and benefits of life insurance are shared (split) between two parties.

Such arrangements often involve a business or a professional corporation, which helps key employees obtain needed coverage.

Of the many types of split-dollar arrangements, the *collateral assignment equity* plan has been the most common. *In these arrangements...*

- The employer pays most or all of the premiums.

- The employee pays a modest amount of income tax, compared with the coverage received.

- The employee (or a trust created by the employee) owns the policy.

- The employer eventually will 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 his/her family members. *Note:* The "equity" in these plans refers to the excess cash value to which the employee is entitled.

**Example:** Over the years, your company has paid \$50,000 worth of premiums for a policy on your life under a split-dollar arrangement. Your latest statement shows cash value of \$65,000.

The \$15,000 excess is considered your equity in the policy. But IRS Notice 2002-8 has declared that this excess may be subject to income tax if the split-dollar plan is terminated after 2003.

If you have such a plan, one that was in effect before January 28, 2002, you may terminate the split-dollar arrangement by year-end.

**Strategy:** Repay the premiums to the company, perhaps by borrowing from the cash value. This is a good choice if your split-dollar arrangement has been in place for 10 years or longer and the cash value far exceeds the premiums paid.

**Example:** Your 15-year-old split-dollar policy now has \$800,000 in cash value and you owe your company \$300,000 for

premiums it has paid. You might borrow \$300,000 from the cash value tax free and repay the company.

**Windfall:** If you act before January 1, 2004, the equity in the policy will be untaxed. In this case, you would wind up with a policy that still has \$500,000 in cash value (after taking out the \$300,000 loan)—and never owe income tax on the previous accumulation.

**Caution:** Only consider ending the split-dollar arrangement—not the policy itself. Canceling the policy might trigger a sizable income tax bill, as well as deprive you of the insurance coverage.

### MEND IT, DON'T END IT

You can change the terms of the split-dollar agreement so that it is structured as a loan.

**Example:** Your company has paid \$60,000 in premiums for a \$1 million policy on your life. The policy now has a cash value of \$80,000, so your equity in the policy is \$20,000.

You can convert the arrangement to a loan by year-end 2003. Going forward, you'll be paying the company interest on a \$60,000 loan (the premiums the company has already paid).

**Key:** With today's low interest rates, your obligation could be modest. At 4%, you would owe \$2,400 on a \$60,000 loan.

So, this might be the time to lock in low-rate loans, based on current interest rates published by the IRS.

### ONE POCKET TO ANOTHER

Another strategy will work well if you're the principal of a closely held company, where the loan interest is being paid to your own company.

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In that case, the only practical cost is the corporate income tax on the interest payment received. And, other tax attributes (large deductions, a net operating loss) might offset this tax obligation.

**Loophole:** After converting a split-dollar arrangement to a loan, you won't have to pay tax on the growth of the cash value, as long as you don't cancel the policy. Your equity in the policy might grow from \$20,000 to \$100,000 or more over the years. Eventually, you can roll out the policy, tax free, and perhaps tap the cash value via tax-free withdrawals and loans.

#### **LEAVE WELL ENOUGH ALONE**

In many collateral assignment equity split-dollar arrangements, cash value has

not had time to accumulate in excess of the premiums paid. Thus, there is no equity in the policy to tax, and that might be the case for many years.

**Strategy:** Continue the arrangement as before. IRS Notice 2002-8 permits employees in pre-January 28, 2002, plans to continue paying relatively little in tax for substantial amounts of insurance coverage.

**Caution:** If your company is publicly traded, no further insurance premiums should be paid by the company under a collateral assignment split-dollar arrangement. Such payments may be illegal loans under the *Sarbanes-Oxley Act of 2002* designed to prevent corporate abuses.

**Strategy:** Employees at closely held companies may keep their split-dollar plans in place. Assuming the plan was established before January 28, 2002, such employees won't have to pay tax on any equity buildup while the split-dollar arrangement remains in effect.

#### **DON'T PUSH THE DEADLINE**

Act now. If you are in a split-dollar arrangement, seek expert advice from your insurance professional or attorney well before the year-end deadline. Any problems won't be solved in a week or two. Many parties may have to be involved if all the paperwork is to be done correctly, and that takes time. ■ ■