Good New From the IRS on Split-Dollar Life Insurance

For years, split-dollar life insurance has been considered a prime executive perk. It's one the IRS has had trouble with, however.

Breakthrough: In Notice 2002-8, the IRS sets down it latest thinking on the subject. It's good new.

The term "split-dollar" refers to an arrangement in which an employer and an employee share the cost of a life insurance policy. The following structure is common…

• **The company pays all of the premiums** on a cash value life insurance policy.

• **The executive (insured) pays tax on the "economic benefit"** received from this policy. This is the value of the life insurance protection.

Key: In many cases, the executive winds up paying little tax, relative to the life insurance protection he/she receives.

• **If the executive dies, the policy's beneficiary receives the death benefit,** after the premiums already paid have been returned to the company.

Example: ABC Co. has paid a total of $120,000 in premiums over 12 years for a $1 million policy on John Smith's life. John dies, the company gets back its $120,000 and John's widow collects the remaining $880,000.

• **If the executive retires, the split-dollar arrangement can be terminated** and the policy "rolled out" to the insured individual (or a trust that has been created).

Example: In the above situation, John Smith would pay his company $120,000 and take possession of the $1 million policy. Money for the rollout might come from the policy's cash value.

IRS on the Offensive

For years, split-dollar arrangements generated only slight income tax obligations. This has been clouded, though, by…

• A technical memorandum published by the IRS in 1996, and…

• IRS Notice 2001-10, issued in January 2001.

In both cases, the IRS indicated that the buildup of cash value inside a life insurance policy could be taxable to the insured individual. This would happen when the policy's cash value exceeded the amount owed to the employer.

IRS Retreats

This year, the IRS issued Notice 2002-8. It provides support for split-dollar arrangements. What's happening…

• Notice 2001-10 has been revoked.

• Proposed regulations on split dollar arrangement will be published later this year.

• In the meantime, Notice 2002-8 provides guidelines on how you can set up a split-dollar arrangement.

Two for the Money

The new notice recognizes two types of split-dollar arrangements, which will receive different tax treatment under the new regulations (yet to be published)…

• **Endorsement agreements.** The employer will own the policy.

• **Collateral assignment agreements.** The employee owns the policy.

Collateral assignments are move common than endorsement agreements. When the final regulations are published, all new collateral assignment arrangement will be considered a series of loans. By paying "interest" on these "loans," the employee can avoid being tax on imputed income.

Example: ABC Co. is paying $10,000 per year for John Smith's $1 million life insurance policy. The new regulations will treat each payment as a $10,000 loan to John (assuming John owns the policy).

John must pay a reasonable interest rate. At 5%, he'd owe only $500 on a $10,000 loan. Even when the total of the loans reaches $120,000, after 12 years, he'd by paying only $6,000, assuming a 5% rate.

Result: For a relatively small outlay, John has a great deal of life insurance protection. And…under these guidelines, buildup in the cash value won't be taxed.

This strategy works well in a closely held company, where the "interest" is merely being paid to the executive' own company. In that case, the only practical cost is the corporate income tax on the interest payment received.

Other tax attributes (large deductions, a net operating loss) may offset this tax obligation.

Use of IRS Tables

Endorsement arrangements may be appropriate in some cases, where the corporation wants to retain control of the policy. In these situations, the employee will continue to own tax on the economic benefit of the insurance coverage that's provided.

Under certain limited conditions, the government's old PS-58 term insurance rate table can be used to fix economic value.

Problem: The insurance values in this table tend to generate relatively high values, and tax obligations, so they're seldom used.

Another IRS table, PS-38, is more taxpayer-friendly. PS-38 may be used when the split-dollar arrangement involves a life insurance policy that pays after two people die (second-to-die policy), a tactic frequently used to provide estate tax liquidity.

Requirements: To qualify to use the PS-58 or PS-38 tables, the split-dollar arrangement must have been in effect prior to January 28, 2002. And it must provide the use of a specific table.

In most situations, you'll cut taxes by using the insurance company's term rates to set the economic value of the coverage received.

For split-dollar arrangements in effect before January 28, 2002, you can use the insurance company's term rates set by the former standard. Such rates must be publicly available from the same insurance company to all standard-risk applicants.

New rule: For arrangements established after January 28, 2002, the economic value will eventually be based on rates on policies that are regularly sold through the company's normal insurance channels. Such rates may be higher than the grandfathered rates, and thus more costly to taxpayers.

Getting Out

According to the new notice, not tax will be imposed on the growth of the policy's cash value, as long as the split-dollar arrangement was established before the final regulations are published…it remains in place…are the above guidelines are followed.

The notice also provides a two-year window, calendar years 2002 and 2003, in which to arrange for a low-cost exit from plans that were in place before January 28, 2002.

Termination: If the split-dollar arrangement ends before 2004, there will be no tax on the equity buildup inside the insurance policy.

Conversion: Rather than terminate an existing split-dollar arrangement, change the agreement terms, so it is structured as a loan. This must be done by January 1, 2004.

Example: ABC Co. has paid $120,000 in premiums for a $1 million policy on John Smith's life. The policy now has a cash value of $150,000, so John's equity in the policy is $30,000.

John can terminate the arrangement before 2004. He can pay the company $120,000 and own outright the $1 million policy with the $150,000 in cash value. No tax will be due.

Alternatively, John can convert the arrangement to a loan in 2002 or 2003. Now, he'd by paying he company interest on a $120,000 loan -- $6,000 per year, at 5% rate.

Key: Now may be a good time to lock in a deal, with interest rates at low levels.

After converting a split-dollar arrangement to a loan, you'll never have to pay tax on the growth of the cash value.

Example: After John converts to a loan, his equity in the policy might grow from $30,000 to $300,000, $500,000, or more, over the years. Eventually, he can roll out the policy, and perhaps tap the cash value via tax-free withdrawals and loans.

Going forward: If you are going to set up a new split-dollar arrangement, collateral assignment agreement structured as a series of loans may be a cost-effective way to acquire life insurance.

You Can Rely On It

IRS Notice 2002-8 says "no inference should be drawn from this notice: but adds "taxpayers may rely on this notice."

Translation: If a split-dollar arrangement is questioned during an audit, you can use these guidelines to support your position. But the IRS can't use this notice against you. (Of course, other provisions in the Tax Code are still in effect, so you need to play by the rules.)

Bottom line: If you already have a split-dollar arrangement in place, you have until the end of 2003 to use these guidelines to work out a favorable outcome.

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