Tax deadline looms for split dollar life insurance arrangements

BY DON STALLINGS

Owners of life insurance policies subject to split dollar arrangements implemented before January 28, 2002 must take action by December 31, 2003 to keep their equity interests income tax free. In Notice 2002-8 (2002-4, I.R.B. 398) the IRS outlined rules expected to be included in forthcoming proposed regulations. The IRS published the proposed regulations 16475-01 on July 3, 2002.

Under the guidance of Notice 2002-8 and the proposed regulations 16475-01 the owner of a policy subject to a split dollar arrangement would appear to have at least five options to try to save the tax-free status of his/her equity in the policy:

1. Rely on Notice 2002-8's "No Inference" provision: In Notice 2002-8 the IRS takes the position that equity in a collateral assignment split dollar arrangement is taxable income if it is removed from the policy before the insured's death. Policy owners can challenge the IRS's position in administrative hearings and in court, but this is a very expensive and risky approach. Unless the policy owner has a big pocketbook, is determined to prove the IRS wrong, and has no other reasonable options, I do not see this as viable.

2. Die out of the problem: Try convincing a client that he/she could just die out of any problem and look at the expression on their face. Two big risks associated with this option are: Your client may need the equity before death for retirement, emergency, etc. and rising economic benefit rates. In the proposed regulations the IRS had made it clear they will challenge unreasonable insurer's lower published rates used to value the economic benefit to the employee. Although insurer's lower published rates can still be used provided they meet certain guidelines, the IRS included Table 2001 (Interim Table of One-Year Term Premiums) that can be used without IRS challenge. Under this table, an 85 year old would have taxable income of $88,760 for the annual economic benefit on a $1,000,000 life insurance policy. A 95 year old would be taxed on $228,350. As you can see, the cost of living too long can be extremely high.

3. Repay any premiums paid on the policy: The policy owner can reimburse the company for all the premiums the company has paid prior to January 1, 2004 and there will be no taxation on the rollout. Policy cash values or personal funds could be used to repay premiums. If a policy loan is used to repay the premiums the effect of the loan on the policy should be considered. Loans can affect the cash value of some policies and the cash values may fall below the amount necessary to maintain the policy, causing the policy to lapse. Another option would be to reduce the death benefit of the policy to an amount that the net cash value after loan can support.

4. Pay taxes on the premium advances: The company could cancel the obligation to repay the premium advances, but the employee will have to pay tax on the amount. If the company has paid $400,000 in premiums and the obligation to repay is cancelled, the tax would be $160,000 assuming a 40% income tax rate for the employee.

5. Terminate the Split Dollar Arrangement and execute a note for the premium payments: A demand loan or a term loan can be executed between the employee and the company for any premium payments and the split dollar arrangement can be cancelled. Again, this must be done by January 1, 2004 to be covered under the "safe harbor" provisions. The policy would remain assigned to the company as collateral on the loan. As long as the "market loan rates" are applicable to the loan, there will be no income tax consequences on the loan. The loan will have to include past premium payments. Any future premium payments will increase the loan.

Any existing Split Dollar Life Insurance arrangements should be reviewed with your tax advisor well in advance of December 31, 2003 to give you plenty of time to consider the best alternative. Each situation should be reviewed based on the facts. There are no easy answers. IRS Notice 2002-59, 2002-36 IRB outlines the IRS position in regard to certain split-dollar and reverse split-dollar arrangements used to fund family gifts. If you are a party to one of these split dollar arrangements, you also need to consult with your tax advisor. **DBJ**

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