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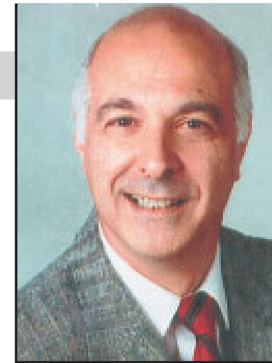

*Bart A. Basi*

# Is Good Help Hard to Find?

## *Split-Dollar Life Insurance Arrangements Can Help*

Life insurance rates continue to go up, and let's face it, none of us are getting younger. For years, the government has provided an incentive for employers to pay for the cost of life insurance for their employees. This incentive is known as "split-dollar life insurance." This is not a specific type of insurance, rather it is a payment plan created for the benefit of both employer and employee. It is not, however, limited to employers and employees; it extends to include relationships between a corporation and a shareholder, a donor and donee, and even private arrangements between family members. The bottom line is that the party that pays the annual premiums may be able to recoup all of its premium costs, while the covered party is provided with life insurance at a minimal cost. And in today's market, employee benefits are difficult to create, and even more difficult to afford. Knowing about split-dollar arrangements can be a "win-win" situation for employers and employees. Accordingly, this is a concept that you should take the time to fully understand.

Recently, the IRS and the Treasury Department issued a set of proposed regulations substantially affecting the way in which the IRS treats split-dollar life insurance arrangements. Let's take a look at the basics of split-dollar insurance arrangements, the tax aspects and finally, the real benefit of such arrangements, especially for the closely held, private company.

### What is Split-Dollar Life Insurance and What Are The Advantages?

First of all, the insurance arrangement must not be part of a group term life insurance plan, but is between two individuals, i.e., the owner of the life insurance contract and a non-owner (beneficiary) of the same contract. In the arrangement, the parties agree that one will pay all or part of the insurance premiums. The arrangement also identifies who is entitled to recover the benefits and how much they are entitled to recover.

For example, an employer may take out a $1,000,000 policy on an employee, with the employer paying all of the annual premiums. When the employee dies, the employer is reimbursed for the payment of the premiums and the beneficiary (identified by the employee) receives the remaining proceeds. During the employee's life, the employee is taxed on the "value" of the policy, minus any premiums that have been paid.

As can be observed from the example above, the proceeds received from the insurance policy are "split" between the party that pays the premiums and the party that can identify who is to receive the benefits. However, the determination of the "value" of the policy is where there is some confusion. To provide some relief, the IRS issued new regulations. More about this later.

Split-dollar life insurance offers many advantages to both parties. It provides affordable life insurance protection, prevents un-insurability in later years due to health issues, proceeds are income tax exempt, the policy can provide for extended coverage after retirement, and finally, the arrangement can create locked-in premium rates on the policy's issue date.

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## The Tax Treatment of Split-Dollar Plans

The regulations presently issued by the IRS are "proposed." However, such regulations are recently in effect and can be relied on by everyone until the IRS changes them or makes them permanent. Do not be fooled by the fact that the regulations are called "proposed."

The proposed regulations provide for two different ways of taxing a split-dollar life insurance arrangement:

1. The economic benefit method, or
2. The loan method.

Under the economic benefit method, the owner (most likely the employer) of the life insurance policy is giving economic benefits to the non-owner (employee) of the contract in exchange for the performance of services. There is a special rule that requires this method to apply when the arrangement is entered into in connection with the performance of services, and the employee is not the owner of the life insurance contract or, if the arrangement is entered into between a donor and a donee and the donee is not the owner of the life insurance contract (an example of this is a life insurance trust).

***The owner of a life insurance policy is the person named on the policy as the owner. However, if there are two people named on the policy as owners, the general rule is that the first named person is considered the owner. But if the two people named as owners on the policy have the same rights and benefits to the policy, then the IRS will treat each person as separate owners of the policy and therefore the policy may not be eligible for tax treatment as a split-dollar life insurance arrangement.***

The loan method basically operates as if the owner of the contract (employer) provides a loan to the non-owner (employee) from which the owner makes the premium payments on the life insurance policy. The two methods have substantially different taxing consequences that need to be considered carefully before an arrangement is entered into so there is no confusion as to the taxability of the transaction.

## Who is the Owner of the Life Insurance Contract?

The owner of a life insurance policy is the person named on the policy as the owner. However, if there are two people named on the policy as owners, the general rule is that the first named person is considered the owner. But if the two people named as owners on the policy have the same rights and benefits to the policy, then the IRS will treat each person as separate owners of the policy and therefore the policy may not be eligible for tax treatment as a split-dollar life insurance arrangement.

There are two exceptions to the general rule that the person named as the owner is the owner for split-dollar purposes:

1. First, if the arrangement is entered into in connection with the performance of services, and the only economic benefits available to the employee are the value of the life insurance protection. In this situation, even if the employee is named as an owner, the employer will be considered the owner of the contract.

2. The second exception deals with a donor - donee situation. If the only economic benefit that is derived from the arrangement is the value of the life insurance, then the donor is treated as the sole owner of the contract.

A non-owner of the contract is any person who may have an interest in the contract, whether direct or indirect, and who is not considered an owner of the contract. The most common example is that of an employee's spouse named as beneficiary. The interest in indirect and therefore a third party beneficiary is considered a non-owner.

## More About the Economic Benefit Method and Taxes

Under this type of an arrangement, the owner of the life insurance contract is treated as providing economic benefits to the non-owner of the contract in exchange for services rendered. However, the value of the benefits is reduced by any amount the non-owner pays to the owner. For example, if the employee pays some of the yearly premium, then the economic benefit that he is receiving is reduced by the amount of the yearly premiums that he paid. The regulations suggest that this type of an arrangement is taxed differently depending on the relationship between the two parties; it may be considered payment for compensation, a distribution of profits, a gift, or some other type of taxable transfer. The IRS proposed regulations could be one of two types: Non-Equity arrangements and Equity arrangements.

### The Non-Equity and Equity Arrangements

In a non-equity arrangement, the only benefit that the non-owner has is the current life insurance protection. The amount that the non-owner is taxed on each year under a non-equity type arrangement is the excess of the average death benefit of the life insurance contract over the total amount payable to the owner, calculated each year. The excess amount is then multiplied by a life insurance premium factor to determine the amount of income that must be included as gross income for the year.

The equity arrangement is where the benefit includes, but is not limited to, a right to the cash surrender value

of the policy. The amount that the employee includes in his income each year is the value of any interest in the cash surrender value of the contract provided to the employee during the taxable year. This concept is consistent with the idea of reporting all of the economic benefits received from the arrangement each year. Determining the value of these benefits is still under review by the IRS.

**Taxation of Amounts Received**

Any amount other than a death benefit, which the non-owner receives from a split-dollar life insurance contract (such as a policy dividend), is treated as if the funds are paid to the owner and then given by the owner to the non-owner. The non-owner must take the amount either as payment of compensation, a dividend distribution is he is an owner, a gift, or other transfer depending on the relationship of the parties.

***Remember, a split-dollar arrangement falls under one of two methods, i.e., economic benefit method (employee exchanges services), or the loan method (employee borrows the funds). Under each method, there is a tax treatment. Be sure to understand the taxation of each method.***

## More About the Loan Method and Taxes

A split-dollar arrangement is taxed under the Loan Method if the arrangement meets one of the following three criteria:

1. The yearly premium payment is made either directly or indirectly by the non-owner to the owner.

2. The yearly premium payment is a loan under the general principles of federal tax law, or, if not a loan under the general principles of federal tax law then, would *a reasonable person expect the payment to be repaid in full by the non-owner?*

3. The repayment of the premium to the owner is to be made from, or is secured by, either the policy's death benefit proceeds or its cash surrender value, which is usually the case in a split-dollar relationship.

The parties to a split-dollar arrangement need to be careful to provide for sufficient interest under the loan method, or the IRS will treat the arrangement as a below-market loan and it will be subject to variable rates of interest, contingent interest payments, and the tax treatment of the arrangement will be subject to additional, more complex terms. It is important to provide for an adequate interest rate when creating a split-dollar arrangement.

## More About Valuing the Current Life Insurance Protection

Earlier in this article, we mentioned the "value" of the policy. Let's see what the IRS says about how to determine the value of a split-dollar policy. It is important to understand the current method the IRS will allow in determining the value of a split-dollar life insurance policy that is taxable to the non-owner. The IRS and the Treasury Department issued a Notice in 2002 to provide us with temporary guidance on the tax treatment of split-dollar arrangements. The proposed regulations that have recently been issued have reserved the issue of valuation until the future. Thus, we must rely on the current notice issued this year.

The IRS states that the rates used in determining the value of the life insurance policy to the employee are out of date. The "P.S. 58" rates as they have been referred to, are no longer valid if the arrangement was entered into after January 28, 2002. If this is the case, then the taxpayer may use the premium rate table set forth by the IRS labeled "table 2001."

There is an alternative a taxpayer can consider. A taxpayer may use the insurer's lower published premium rate that is available to a standard risk individual for an initial cost of a one-year term insurance. This is, however, limited to arrangements entered into before January 28, 2002. If the arrangement is entered into after January 28, 2002, a taxpayer can utilize an insurer's published premium rates only if the insurer generally makes the availability of the rates known to those who apply for insurance coverage, and the insurer regularly sells insurance at those rates.

## Conclusion

Small business owners can now take a step forward in competing with larger companies in terms of employee benefits. A split-dollar life insurance arrangement provides a cost effective way for an employer to provide benefits to his/her employees that is not complicated to set up and carries few restrictions. However, it must be remembered that the regulations that have been published are just proposed regulations. Therefore, it is important to understand the current as well as the proposed treatment of split-dollar arrangements, and to stay abreast of any changes that the IRS may levy upon the existing standards. These arrangements, if utilized properly, can be a tool in retaining quality employees. Good help is hard to find, but can be a little easier with a split-dollar life insurance arrangement.

Remember, a split-dollar arrangement falls under one of two methods, i.e., economic benefit method (employee exchanges services), or the loan method (employee borrows the funds). Under each method, there is a tax treatment. Be sure to understand the taxation of each method.

If you have any questions regarding a split-dollar life insurance arrangement and the tax aspects, contact Bart at The Center for Financial, Legal, and Tax Planning, Inc. or visit our website at www.taxplanning.com.