

Split-Dollar Life Insurance – Past, Present, and Future

-January 1, 2004-

Here is our report about the current status of split-dollar as we enter the New Year.

Past: December 31, 2003, the magic date for terminating an old pre-January 28, 2002 split-dollar plan or switching the plan to a loan without adverse tax consequences, is now history. This safe harbor grandfather date under IRS Notice 2002-8 was especially important for policies having employee or trust cash value in excess of employer premium payments, i.e., “equity,” as of December 31, 2003.

That said, we suspect there are a number of clients out there who have old split-dollar plans with equity but who neglected to do anything by December 31st. These clients and their advisers must now figure out the most expeditious way to minimize the tax damage. Furthermore, for those clients who did switch their plans to a loan by December 31st, it is important to analyze and model just how the plan will work in the future, for example, what are the interest costs and the tax effects thereof, will there be an exit strategy for repaying the employer during life as well as at death, and will the loan be a demand or term loan and interest-free or interest-bearing?

Present: For old split-dollar plans entered into before January 28, 2002 that did not have equity as of December 31, 2003, advisers frequently recommended intentionally delaying a switch to a loan. This “switch-dollar” technique contemplates continuing in split-dollar after December 31, 2003 to preserve low split-dollar term cost taxation and then switching to a loan before policy equity accrues to avoid taxation of the equity. Similar reasoning applies to interim split-dollar plans entered into after January 28, 2002 and on or before September 17, 2003, the effective date of the final split-dollar regulations, although the December 31st safe harbor rules applicable to old plans do not apply to interim plans.

In these situations, a number of issues are presented. First, the same questions posed above for old plans that switched to a loan by December 31st are also pertinent to old and interim plans that delay the switch until after that date. Second, analysis and modeling is equally important for these plans to determine how they will operate in the future. Third, important additional questions are raised for such plans. Will the switch to a loan be considered a “material modification” of the plan under the final regs. and what is the impact if it is? For example, will policy equity, and the resulting time to make the loan switch, be measured by cash value before surrender charges or by cash surrender value after surrender charges? To what extent will the new split-dollar loan rules apply, such as the effect of interest bonuses on stated interest and the application of the non-recourse rules?

Future: We believe the future is bright for the next generation of split-dollar plans, those adopted after September 17, 2003, though admittedly not as favorable as under the old rules. A solid virtue of the final regs. is that they specify the types of plans

that are available and clarify their tax treatment, including both corporate and private split-dollar plans. We expect to see a new generation of non-equity endorsement and split-dollar loan plans.

We are especially impressed with the results of a new technique, “Collateral Endorsement Switch-Dollar™,” that we’ve been developing, modeling, and testing. This technique combines non-equity split-dollar with split-dollar loans. With Collateral Endorsement Switch-Dollar™, the plan starts as non-equity endorsement split-dollar (in the collateral assignment format) in order to capture low term cost taxation for as long as possible. Just before policy equity appears, the plan switches to a loan to avoid equity taxation. In this connection, we understand that the insurance industry proposed to the IRS revised individual split-dollar term rates that are appreciably lower than the Table 2001 rates. Survivorship term rates derived from the Table 2001 individual rates are already remarkably low and they will be even lower assuming the Table 2001 rates are reduced.

In summary: 1) for those old split-dollar plans that should have terminated or switched to a loan by December 31, 2003, but neglected to do so, control the tax damage as carefully and expeditiously as possible; 2) for those old and interim plans that intentionally delayed the loan switch until after December 31st, analyze and model the results and consider the additional tax issues raised; and, 3) for new plans adopted after September 17, 2003, take advantage of the opportunities and techniques sanctioned by the split-dollar regulations, notably Collateral Endorsement Switch-Dollar™.

We have dealt with these and other split-dollar issues and problems in a number of cases in which we’ve been engaged, both as a consultant and an expert witness. If we can be of assistance to you and your clients, please contact us for specific details.

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