

Exiting From Split-Dollar Plans

Of the many forms of life insurance ownership available, split dollar may be the most flexible and versatile. You can benefit by obtaining financially rewarding, tax-advantaged death benefits at a much lower cost. And you may possibly receive substantial retirement income under a split-dollar arrangement.

But before you institute a split-dollar plan, you must have an exit strategy. Otherwise, at some point, the plan may cost more than it's worth.

How Split-Dollar Works

A split-dollar life insurance plan splits the costs and benefits of an insurance policy between the employer and the employee. Basically, your employer pays part or all of your annual premium. It might, for example, pay that part of the premium attributable to the policy's cash value, while you pay the portion equal to the policy's term cost. If your employer pays the entire premium, those premiums are excluded from your income. Instead, your employer reports the economic benefit of the life insurance policy on your W-2 form. The economic benefit is based either on the insurance carrier's one-year term rates for standard risks or a government table. Under one approach, you assign the policy's cash value to your employer. When you die or surrender the policy, your employer recovers its out-of-pocket costs. Neither your employer nor your beneficiaries owe income tax on the policy's proceeds.

An advantage of using a split-dollar plan with an irrevocable life-insurance trust rather than giving the entire premium to an irrevocable life-insurance trust is that the gift in a split-dollar arrangement is typically a small fraction of the entire premium so the gift tax consequences are much more favorable.

Why You Need an Exit Plan

The economic benefit increases each year -- just as premiums for annually renewable term insurance increase each year. Eventually the cost of the term insurance portion of the premium that is used to measure the economic benefit will exceed the premium. This is called the "crossover point." After the crossover point is reached, you will owe income tax on the excess cost. (This is in addition to the tax on the actual premium amount if your employer pays the whole premium.)

The leverage you initially obtained through the split-dollar plan is reversed after the crossover point. (For a second-to-die policy, the crossover point usually won't occur until one insured dies.)

Exiting From Two Types Of Plans

Let's take a closer look at the two primary types of split-dollar plans and their possible exit strategies:

1. Endorsement agreements. An endorsement plan occurs when your employer owns the policy and you name the beneficiary only for your portion of the death benefit. Then after the split-dollar plan ends, the employer can retain control of the policy as owner and as one of the beneficiaries. It may choose to pay you a retirement benefit in the form of nonqualified deferred compensation payments of monthly income

after retirement. If instead the insurance policy is distributed to you after the split-dollar arrangement is terminated, the transfer results in taxable income to you unless you pay your employer for the transferred rights. The amount of income may be significant because you have no basis in the transferred property and the cash value transferred can be significant.

When an endorsement arrangement terminates, generally avoid transferring the policy directly to a revocable nongrantor trust or other third party because a transfer-for-value issue may arise. Termination of an endorsement plan with a deemed transfer of cash value to you, even when ownership is transferred to a trust, can cause inclusion of the death proceeds in your estate unless you survive for three years.

Here are some exit strategies:

- You repay your employer for the greater of the cash value or its premium payments.
- Your employer releases its rights in the policy, resulting in your having to recognize additional compensation as income.
- You make a taxable gift to a third party if a third party owns the insurance, who can then use the gift to repay the employer.

2. Collateral assignments. In a collateral-assignment plan, you own the policy and assign a portion of the cash value to your employer as security for the repayment of employer-paid premiums. Collateral-assignment plans are often used for equity split-dollar plans in which an employee is entitled to the cash value in excess of the employer's premium costs. But a recent controversial IRS ruling held that, in equity split-dollar plans, an employee is taxed each year on his or her rights to policy cash values in excess of the employer's interest.

Here are some of the ways to exit from a collateral assignment plan:

- Your employer releases its rights, possibly resulting in taxable income to you.
- Your employer receives repayment of its premiums by removing the cash value, resulting in adverse tax consequences if the policy is treated as a modified endowment contract. But the IRS has never officially taken a position on the income tax consequences of this repayment method.
- Instead of a lump-sum payment, repayment can be made gradually each year, and your employer may stop paying the premiums.

Plan for Your Exit

Although selecting among the available options may be difficult, you should consider an exit plan at the beginning of any split-dollar arrangement. We would glad to help you choose the right alternative to fit your needs.