ST. LOUIS BUSINESS JOURNAL

IN DEPTH: EMPLOYEE BENEFITS
From the December 19, 2003 print edition

Deadline looms to avoid tax on split-dollar policies

William Poe

Owners of split-dollar life insurance policies have until Dec. 31 to take action to avoid new tax liabilities, according to several area tax attorneys.

"We are really swamped with calls from people asking us to take a look at their policies and make a recommendation," said Carolyn Ohlsen, an attorney with the private client group of Bryan Cave LLP.

The Dec. 31 deadline is part of new U.S. Internal Revenue Service regulations governing the tax treatment of split-dollar life insurance arrangements. Under the new IRS rules, companies can no longer use split-dollar life insurance as a means to provide tax-free compensation to executives.

"The important message is that if someone has a split-dollar life policy in place, get it reviewed by the end of the year," said Troy Kendrick, the managing attorney of the employee benefits practice group of Blumenfeld, Kaplan & Sandweiss PC. "The last thing that someone with high equity in such a policy wants to do is to do nothing."

Most split-dollar life insurance owners, Kendrick said, are choosing to convert the insurance into a loan. Other options before Dec. 31 include terminating the insurance or doing nothing if the policy has little or no cash value, Kendrick said.

Split-dollar life insurance has often been a perk granted by an employer to a key executive. Under the arrangement, a company buys an insurance policy on the life of an executive and pays the premiums. At some point, usually at retirement, the employee reimburses the company for the premiums and takes sole ownership of the policy. Besides a death benefit, the policy builds cash value that the executive may withdraw or borrow. It is the cash value, which historically has been tax-free to the employee, that now faces taxation, said Ohlsen and Kendrick.

For most policy holders, the race is on to take advantage of IRS transition rules that make it possible for executives to avoid paying personal income taxes on the cash value of the policies.

The new IRS regulations provide for the tax treatment of split-dollar life insurance arrangements to be determined under one of two sets of rules, depending on who owns the policy, the attorneys said. If the executive owns the policy, the employer's premium payments are treated as loans to the executive. Unless the executive is required to pay the employer market-rate interest on the loan, the executive will be taxed on the difference between the market rate interest and the actual interest. If the employer is the owner, the employer's premiums are treated as providing a taxable economic benefit to the executive.

"Anyone needs to look at how much in premiums have been paid by the company and then compare that to the cash value of the policy and see if they have a question at all," Ohlsen said.

Larry Brody, with Bryan Cave, said, "It is the excess cash value over premium payments that we are worried about."

Policy holders have three basic options, according to Kendrick: 1. Take no action. If a policy has little or no cash value, new taxation of the cash value at the individual's tax rate would not be burdensome. 2. Terminate the insurance to, as Kendrick said, "get rid of the problem." 3. Convert the arrangement into a loan.

Few executives are choosing to terminate their policies, Kendrick and Brody said.

"In our practice, we are suggesting terminating the insurance only for people who have substantial equity and think they are going to have to keep paying premiums," Brody said. "The other choice is to convert the whole arrangement into a loan and treat all prior premium payments as a loan on which you either have to pay interest or be taxed on the interest."

The number of split-dollar life insurance arrangements in place is not known. The Association for Advanced Life Underwriting estimates that 1,600 public companies have split-dollar plans, representing billions of dollars in life insurance. But, according to Ohlsen, the association's numbers do not include the thousands of private and closely-held companies that have used such arrangements as incentives to attract and retain executives.

The new tax rules may lead to a decline in new split-dollar arrangements, Kendrick said. "A lot of companies are basically saying that we'll pay a bonus to our people instead," Kendrick said.

William Poe is a St. Louis free-lance writer.