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White Paper

Reverse Split Dollar Life Insurance

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Reverse Split Dollar Life Insurance

What is reverse split dollar life insurance?

Caution: In Notice 2002-59, the IRS said "under certain split dollar life insurance arrangements (some of which are referred to as 'reverse' split dollar), one party holding a right to current life insurance protection uses inappropriately high current term insurance rates, prepayment of premiums, or other techniques to confer policy benefits other than current life insurance protection on another party. The use of such techniques by any party to understate the value of these other policy benefits distorts the income, employment, or gift tax consequences of the arrangement and does not conform to, and is not permitted by, any published guidance." In view of Notice 2002-59, the concept of reverse split dollar is no longer a viable planning technique.

Reverse split dollar plans are a split property arrangement between an individual and a corporation. Under a reverse split dollar arrangement, the individual owns the life insurance policy, and the corporation pays the IRS Table 2001 costs. Generally, the corporation receives the right to name itself beneficiary for all or part of the death benefit. The employee is allowed to name a beneficiary who receives any death benefit in excess of the corporation's portion. The employee has access to the cash values over the life of the policy. At the death of the insured, typically, the corporation receives an amount equal to the pure death benefit.

When is the reverse split dollar method used?

Reverse split dollar plans are used primarily by sole or majority shareholders of closely held C corporations. Reverse split dollar arrangements may be used to fund stock redemption agreements, to provide insurance protection for a corporate loan, and as a way for an owner employee to move retained earnings out of the corporation, over time, on a tax-favored basis. Such a plan can be used to provide insurance coverage on a key employee or as part of a death benefit only plan.

Benefits of reverse split dollar life insurance to the corporation

- Provides for insurance coverage on a key employee
- Can provide funding for a death benefit only plan
- May help solve an accumulated earnings problem by transferring corporate dollars to the reverse split dollar plan
- Corporation can target plan to select employees
- Death proceeds payable to the corporation are received income tax free
- Corporation holds rights to portion of cash value up to the balance in the unearned premium account (more information on this later)

Benefits of reverse split dollar life insurance to the employee

- Employee owns the life insurance policy
- Employee may take a policy loan against cash value
- May be an effective method of transferring corporate dollars to an owner-employee
- Can be used to supplement the employee's group life insurance
- At termination of the reverse split dollar plan, the employee has access to the cash value and typically still owns the life insurance policy

Tradeoffs of reverse split dollar life insurance for the corporation

- Employee owns the life insurance policy and has access to the cash value
- Premiums are not tax deductible
- There are costs and legal fees involved in drafting an agreement

Tradeoffs of reverse split dollar life insurance for the employee

- Death benefit must be included in value of employee's estate (deduction allowed for portion paid to company)

Establishing a reverse split dollar life insurance plan

To establish a reverse split dollar plan, the following legal and technical documentation is required:

- Policy application--The life insurance application must be approved through the life insurance company underwriting procedures.
- Corporate resolution to authorize reverse split dollar--The resolution must be authorized and placed in the minutes of the corporation.
- Reverse split dollar agreement--The reverse split dollar agreement should be drafted by a legal professional and must be signed by an authorized corporate officer and the employee. The agreement should include the rights and restrictions of each party, as well as the exact death benefit that the corporation will receive, the premium it will pay, whether or not a prepaid account will be used, and the length of the agreement.

How the reverse split dollar plan works

Agreement put into place

An agreement between the corporation and the policyowner/insured is put in place. The corporation receives the right to name itself as beneficiary for all or part of the death benefit. The employee is allowed to name a beneficiary who receives any death benefit in excess of the corporation's portion.

Premium payment account set up

Traditionally, the corporation pays a premium payment at least equal to the IRS's costs under the Table 2001. To provide a level expense amount for the corporation, a popular method is to establish two accounts on the company's books--a prepaid premium account and a related unearned premium account (UPA). The UPA is carried on the balance sheet of the corporation as an asset. A level payment amount larger than the actual term premium is posted on the books to result in an accumulation in the early years. This overpayment is credited to a UPA. The UPA account balance is an allocated account and is not included in the calculation of the accumulated earnings tax

In the later years when the increasing premium exceeds the level payment amount, the corporation debits the UPA to make its term premium payment. Each year the actual amount of the scheduled yearly increasing term premium due is entered in the income/expense statement of the corporation as a nondeductible premium for the death benefit the corporation received. At the death of the employee, the death benefit payable to the corporation will be the agreement amount plus the balance of the UPA. This affects the design of the policy for reverse split dollar to have a death benefit that will at least equal this total. Any balance of proceeds will be paid to the employees designated beneficiaries.

Tax consequences

Caution: The following is not a comprehensive discussion on the tax consequences of reverse split dollar life insurance. You should consult additional resources.

Premiums are not deductible

Policy premiums are not deductible to the corporation.

Death benefit included in estate

The amount of the death benefit must be included in the estate of the insured. A deduction is allowed for the portion of the death benefit that is paid to the corporation. If the insured is the owner of the corporation, the value of the business may increase, impacting the estate value.

Employee may be responsible for tax on an economic benefit or imputed interest

According to the IRS, any split dollar arrangement is a sharing of the costs and benefits of a life insurance policy between the employer and employee. Depending on how the split dollar arrangement is structured, the employee must pay income taxes each year on either the current cost (less any premiums paid by the employee) of life insurance protection under the plan or imputed interest under the below-market loan rules. Additionally, the premium paid by the employer to the employee for its share of the death benefit may be income taxable to the employee.

Beneficiary generally receives proceeds free of income tax

Generally, death benefit proceeds are received income tax free by the beneficiaries. Proceeds received by a C corporation may subject the corporation to, or increase an existing exposure to, the alternative minimum tax (AMT).

Policy cash values accumulate tax deferred

Policy cash values accumulate tax deferred within the life insurance policy. Withdrawals of cash value may result in a tax liability to the employee. There may never be any taxation if the employee borrows the cash value.

Questions & Answers

Are there transfer-for-value issues with reverse split dollar life insurance plans?

If the key employee is not a stockholder or officer of the corporation, the endorsement method may create a problem. The endorsement of the death benefit by the key employee to the corporation does not fall within exceptions to the transfer-for-value rule (Code 101(a)(2)(B)). The split ownership method may be the best solution where the key employee makes an anticipatory assignment to the corporation upon acceptance of the policy by the insurance company.

Does a reverse split dollar plan impact the alternative minimum tax?

In corporations that don't qualify as small corporations (average gross receipts up to \$5 million), proceeds received by the corporation from a reverse split dollar plan may be subject to the corporate alternative minimum tax.

Caution: You may have questions specific to your situation. You should consult additional resources.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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