Split-Dollar Life Insurance Arrangements: Critical Planning Decisions

By Thomas S. Flickinger

Introduction

A split-dollar life insurance arrangement (SDA) is an agreement between an owner and a non-owner of a life insurance policy where one party pays part or all of the life insurance premiums for the other party and, in return, is entitled to a share of the proceeds of the life insurance contract. These proceeds may come from the cash surrender value of the contract or from the death benefits. The Internal Revenue Service (IRS) remained silent about the tax effects of SDAs for many years, with its position remaining virtually unchanged. Since 1996, however, the IRS has modified the income tax treatment of SDAs multiple times. The effect that these changes have on income tax planning when dealing with SDAs depends largely on the date that the SDA was entered into in relation to key dates given in the latest IRS notice and the final IRS regulations.

An SDA may be used in various contexts, including employer-employee, corporation-shareholder, and donor-donee, to provide a benefit for the respective employee, shareholder, or donee. The most common plan, and the one discussed in this article, involves the employer-employee relationship. However, this situation is analogous to other SDAs. Typically, the employer will pay all or part of the life insurance premiums for the employee in exchange for repayment from the life insurance proceeds.

SDAs provide an effective means to give additional benefits to key executives in both large and small businesses.[1] Large companies use SDAs to provide certain employees with deferred compensation that will avoid estate taxes. Smaller businesses may use SDAs both to provide for the business owners' heirs and to cover estate taxes that may be incurred on death.

Historically, SDAs have been viewed as either non-equity or equity plans. A non-equity plan gives the employer an interest in the policy's entire cash value—through either a collateral assignment (where the employee owns the policy but assigns a portion to the employer) or an endorsement (where the employer owns the policy but allows the employee to name the beneficiary of any life insurance protection exceeding the employer's interest).[2] An equity plan, however, only gives the employer an interest in the cash value to the extent that the employer paid premiums toward the policy. Accordingly, the employee may have equity in the policy to the extent that the cash value exceeds the amount owed to the employer.

History of Income Tax Treatment of SDAs

Phase I—Revenue Rulings

For over 30 years, the IRS paid little attention to SDAs. During this time, the benefits to parties entering into such plans were maximized. The primary source of guidance by the IRS was Revenue Ruling 64-328, which dealt exclusively with non-equity plans.[3] This revenue ruling held that SDAs should not be considered interest-free loans from an employer to an employee.[4] However, the employee still had to recognize some income because the employer provided "an economic benefit to the employee represented by the amount of the annual premium cost that he should bear and of which he is relieved."[5] The value of this economic benefit was measured by the P.S. 58 cost tables.[6] These annual economic benefits were considered "accessions to wealth"[7] and income to the employee. All proceeds received by the employee and the employer were free of income tax.[8] This revenue ruling was amplified by Revenue Ruling 66-110, which allowed the benefit to the employee to be valued by the lower of the amount in the P.S. 58 table or the insurer's term rates.[9]

Even though these revenue rulings dealt only with non-equity SDAs, there was no

indication from the IRS that it would treat equity SDAs any differently. An employee could have had life insurance entirely paid for by his employer with a cash surrender value that exceeded the amount owed to repay the employer. This equity, though only available because of the employer's premium payments, belonged to the employee. Regardless, it grew tax free until withdrawn from the policy.

Phase II—Technical Advice Memorandum 9604001

The IRS grew dissatisfied with this state of affairs. In 1996, it gave its first indication of its changing perspective in Technical Advice Memorandum (TAM) 9604001.[10] This TAM held that income must be recognized by the employee "under [IRC] 83 to the extent that the cash surrender values of the policies exceed the premiums paid by" the employer.[11] Thus, income was to be recognized each year in the amount of the employee's increase in equity. However, since TAMs are private determinations and case specific, this TAM left practitioners uncertain about the proper income tax treatment of equity SDAs.[12]

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Phase III—IRS Notice 2001-10

The first public guidance regarding equity SDAs came in 2001 with the publication of IRS Notice 2001-10.[13] While this notice retained the taxation of the annual economic benefit, it changed the income tax treatment of SDAs in multiple ways.

First, the employee did not automatically recognize income each year in the amount of the increase in equity. Instead, if the employer was the owner of the life insurance contract, the employee did not recognize the increase in equity as income until the SDA was terminated. This left the employee facing a potentially large tax bill in the year the SDA was terminated.

Second, an option was available to treat the SDA as a series of interest-free loans, the income tax consequences of which were to be determined under IRC 7872. Participants in such SDAs were allowed to choose the best method available to them under the two alternatives.

Finally, the valuation of the annual economic benefit to the employee was altered: P.S. 58 was replaced by Table 2001. The alternate method of using the insurer's term rates was still available under the notice. However, significant restrictions were to be imposed beginning after December 31, 2003.

Phase IV—IRS Notice 2002-8

IRS Notice 2001-10 was revoked in January 2002 by IRS Notice 2002-8.[14] In addition to revoking IRS Notice 2001-10, the 2002 notice announced and summarized forthcoming proposed regulations that would give comprehensive guidance regarding the tax treatment of SDAs and provide guidance for the valuation of current life insurance protection under SDAs. IRS Notice 2002-8 has different rules for SDAs entered into before January 28, 2002; SDAs entered into after January 28, 2002 but before the publication of final regulations; and SDAs entered into after publication of the final regulations.

IRS Notice 2002-8 provides that SDAs entered into before January 28, 2002, receive the most beneficial treatment—especially when they are terminated or converted into loans before January 1, 2004. The first effect of such an SDA is that the employee will only be taxed on the value of life insurance protection received from the employer for the current year. For valuation, the employee is able to use the lower of the Table 2001 rates or the generally available, published rates of the insurer. The P.S. 58 rates may be used only if "a contractual arrangement between an employer and employee provides that the P.S. 58 rates will be used to determine the value of current life insurance protection provided to the employee."[15] However, agreements with such specific terms regarding valuation are rare and this safe harbor is not as beneficial as it appears at first glance.[16] Second, the annual increase in equity will never be taxed. Finally, "there will be no tax to the employee upon the rollout of the policy, so that if an agreement entered into before January 28, 2002, is terminated (or converted to a loan) [before January 1, 2004], there will never be any tax on the equity."[17] If a pre-January 28, 2002 plan is not terminated or converted to a loan before January 1, 2004, the employee will be taxed on the equity in the cash surrender value of the life insurance policy at the time of rollout. This crucial date is imminent; clients with pre–January 28, 2002, SDAs should be advised of their options immediately.

If an SDA was set up after January 28, 2002, but before the publication of the final

regulations, IRS Notice 2002-8 gives two options: (1) the employee may report income based on the economic benefit determined by the lower of the Table 2001 rate or the insurer's generally available rate[18] and be taxed on the equity of the policy when the SDA is terminated, or (2) the SDA may be treated as a series of loans from the employer to the employee and be taxed in accordance with IRC 7872.[19] In addition, commentators have offered a third option that was not explicitly mentioned in the notice: the parties may elect to treat the payment of the insurance premiums as bonuses under IRC 162.[20] In this final scenario, the employee would recognize compensation income for the full amount of the premium paid by the employer.

Although IRS Notice 2002-8 also gave some insight into what guidance the proposed regulations would provide, we need not dwell on that issue here, since both the proposed and the final regulations are now available.

Phase V—The Proposed Regulations Regarding SDAs

In July 2002, the IRS published proposed regulations regarding SDAs.[21] Additional proposed regulations regarding the valuation of the economic benefits of equity SDAs were published in May 2003.[22] The proposed regulations were only to be relied on before publication of the final regulations "provided that all taxpayers who are parties to the arrangement treat the arrangement consistently under this section."[23] In addition, for an equity SDA, this early reliance was available only "if the value of all economic benefits taken into account by the parties exceeds the value of the economic benefits the parties would have taken into account" if the SDA were treated as a non-equity SDA.[24] It is not necessary to discuss the details of the proposed regulations because they have been finalized, with minor changes, in September 2003.[25]

The Final Regulations Regarding SDAs

The final IRS regulations were issued on September 11, 2003 with an effective date of September 17, 2003.[26] As under the proposed regulations, the final regulations create two mutually exclusive regimes that determine the impact an SDA has on the employee's income tax: the economic benefit regime and the loan regime. The applicable regime depends on whether the employer or the employee is the owner of the life insurance policy. The economic benefit regime applies if the life insurance policy names the employer as the owner of the contract.[27] If the employee is the owner of the policy, the loan regime applies.[28] One important caveat should be noted: non-equity SDAs are deemed to be owned by the employer even if the employee technically owns the life insurance contract.[29] Thus, a non-equity SDA is always treated under the economic benefit regime.

When the employer owns the life insurance, it is considered to be providing economic benefits to the employee and the economic benefit regime applies.[30] The non-owner "must take into account the full value of all economic benefits . . . , reduced by the consideration paid directly or indirectly . . . to the owner for those economic benefits."[31] The valuation is to occur on the last day of the non-owner's taxable year.[32] The final regulations specify that the valuation of economic benefits includes:

> (1) The cost of current life insurance protection provided to the non-owner . . . ;
>
> (2) The amount of policy cash value to which the non-owner has current access . . . (to the extent that such amount was not actually taken into account for a prior taxable year); and
>
> (3) The value of any [other] economic benefits . . . provided to the non-owner (to the extent not actually taken into account for a prior taxable year).[33]

The income to the employee from the "cost of current life insurance protection provided" is the amount of the employee's current life insurance protection multiplied by a life insurance premium factor that is to be given in the Internal Revenue Bulletin.[34] The policy cash value is only included in the economic benefits if the non-owner has "current access" to it. Current access exists not only when the non-owner has actual (direct or indirect) access to the cash value of the policy, but also if the owner or the owner's creditors do not have access to it.[35] Death

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proceeds paid to anyone other than the owner are excluded from the beneficiary's gross income under IRC 101(a).[36]

Alternately, when the employee is the owner of an equity SDA, the employer is considered to be loaning the premiums to the employee.[37] If inadequate interest is charged, the transaction will result in imputed interest income to the employee under IRC 7872.[38] When interest on the loan equals or exceeds market rate, "the loan is governed by the general rules for debt instruments."[39] The loan regime modifies IRC 7872 slightly to eliminate its *de minimis* exception.[40] Thus, all employee-owned equity SDAs with below-market interest rates fall under IRC 7872, regardless of the dollar value of the loan.

Practitioners must take immediate action by reviewing their clients' SDAs and advising them of their choices in light of the imminent deadline.

Final Thoughts

Careful consideration must be given when advising clients regarding SDAs. For existing SDAs, the most important fact is whether the SDA was entered into before January 28, 2002. If so, IRS Notice 2002-8 results in beneficial treatment if the plan is terminated or converted into a loan before January 1, 2004. It is not mandatory that clients take advantage of this safe harbor; however, if they continue the plan as is into 2004, there may be tax on the equity. Thus, the best plan for mature equity SDAs entered into before January 28, 2002, is to terminate the SDA or convert it into a loan by the end of 2003.[41] This pivotal date is looming and clients with SDAs should be consulted immediately.

Clients with plans entered into after January 28, 2002, but before September 17, 2003 (the date the final regulations became effective) may choose to (1) report the economic benefit as income and be taxed on the equity when the SDA is terminated, (2) treat the premium payments as a series of loans, or (3) treat the payments as bonuses from the employer to be taxed under IRC 162. The best plan depends on individual circumstances; the facts of each client's situation should be closely scrutinized.

For all other plans, the final regulations give some much-needed guidance to practitioners about how the IRS views (and plans to tax) SDAs. The income tax treatment of these SDAs depends on who owns the life insurance contract and whether it is a non-equity or equity SDA. Non-equity SDAs and employer-owned equity SDAs will always be taxed under the economic benefits regime. Employee-owned equity SDAs are taxed under the loan regime. The publication of the final regulations gives attorneys more certainty than they have had in the seven years since TAM 9604001 was issued.

Time is of the essence. Practitioners must take immediate action by reviewing their clients' SDAs and advising them of their choices in light of the imminent deadline. Failure to do so could result in unexpected, and undesired, income tax bills.

NOTES

1. Mike McNamee, *The IRS Gives Executives a Break*, 3767 Bus Wk 112 (2002).
2. Sherwin P. Simons & David C. Howell, *Split Dollar Insurance Arrangements*, ALI-ABA Course of Study Materials, Advanced Est. Plan. Techniques (1995).
3. Rev Rul 64-328, 1964-2 CB 11.
4. *Id.* at 12.
5. *Id.* at 13.
6. These tables give one-year premiums per $1,000 of life insurance and are contained in Rev Rul 55-747, 1955-2 CB 228.
7. *Commissioner v Glenshaw Glass Co*, 348 US 426, 431 (1955).
8. 1964-2 CB 11, 15.
9. Rev Rul 66-110, 1966-1 CB 12, 14.
10. Tech Adv Mem 9604001 (Jan 26, 1996).
11. *Id.* at 15.
12. "In most instances, a TAM does not receive high level review within the service, and in all cases is only applicable to the taxpayer on whose return it was issued." Edward F. Koren, *Estate and Personal Financial Planning* § 2:23 (2003).
13. IRS Notice 2001-10, 2001-1 CB 459.
14. IRS Notice 2002-8, 2002-1 CB 398.
15. IRS Notice 2002-8.
16. Lawrence Brody et al., *Notice 2002-8: A Major Change for Split-Dollar Life Insurance*, 29 Est Plan 211, 216 (2002).
17. *Id.*
18. "[F]or arrangements entered into after January 28, 2002, and before the effective date of future guidance, for periods after December 31, 2003, the Service will not consider an insurer's published premium rates to be available to all standard risks who apply for term insurance unless (i) the insurer generally makes the availability of such rates known to persons who apply for term insurance coverage from the insurer, and (ii) the insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels." IRS Notice 2002-8.
19. *Id.* at *3.
20. *Brody, supra* note 16, at 224.
21. 67 Fed Reg 45,414 (2002).
22. 68 Fed Reg 24,898 (2003).
23. Prop Treas Reg 1.61-22(j), 67 Fed Reg 45,427 (July 9, 2002).
24. *Id.* (to be codified at Treas Reg 1.61-22(j)(2)(ii)).
25. 68 Fed Reg 54,336 (2003).
26. *Id.* The final regulations apply not only to SDAs entered into after September 17, 2003, but also to any SDA that is "materially modified" after September 17th. Treas Reg 1.61-22(j) (2003). It is not clear what constitutes a material modification; the regulations do, however, provide a nonexclusive list of modifications that are deemed to be nonmaterial. Treas Reg 1.61-22(j)(2)(ii) (2003).

27. Treas Reg 1.61-22(b)(3)(ii)(A) (2003).

28. Treas Reg 1.7872-15(a)(2)(i) (2003); Treas Reg 1.61-22(b)(3) (2003).

29. Treas Reg 1.61-22(c)(1)(ii)(A)(1) (2003).

30. The economic benefit regime is generally dealt with in Treas Reg 1.61-22(d)-(g) (2003).

31. Treas Reg 1.61-22(d)(1) (2003).

32. Treas Reg 1.61-22(d)(5)(i) (2003).

33. Treas Reg 1.61-22(d)(2)(i)-(iii) (2003).

34. Treas Reg 1.61-22(d)(3)(ii) (2003). The amount of current life insurance protection afforded to the employee is "the excess of the death benefit of the life insurance contract . . . over the total amount payable to the owner under the split-dollar life insurance arrangement, less the portion of the policy cash value actually . . . paid for by the non-owner." Treas Reg 1.61-22(d)(3)(i) (2003).

35. Treas Reg 1.61-22(d)(4)(ii) (2003).

36. Treas Reg 1.61-22(f)(3)(i) (2003).

37. Treas Reg 1.7872-15(2)(i) (2003). Section 402 of the Sarbanes-Oxley Act of 2002, Pub L No 107-204, 116 Stat 745 (2002), enhances certain conflict-of-interest laws. These changes include a change to 15 USC 78m(k) to provide that it is "unlawful for any issuer (as defined in section 2 of the Sarbanes-Oxley Act of 2002 [15 USCS 7201]), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer." This prohibition of loans to directors and officers may drastically affect the treatment of SDAs for publicly held companies. It is unclear to what extent section 402 applies to SDAs. The final regulations "do not address this issue, as interpretation and administration of Sarbanes-Oxley fall within the jurisdiction of the Securities and Exchange Commission." 68 Fed Reg 54,338 (2003). This Act should be carefully analyzed when advising publicly held companies.

38. Treas Reg 1.7872-15(a)(1) (2003).

39. *Id.*

40. Treas Reg 1.7872-15(a)(3) (2003).

41. *Brody, supra* note 16, at 220.

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