

Working Within the Final Split-Dollar Life Insurance Regulations

Equity split-dollar life insurance arrangements have been utilized by employers for nearly 40 years to provide current life insurance protection and tax-favored deferred compensation to key employees. In the wake of the much-anticipated final regulations governing split-dollar life insurance arrangements issued on September 12, 2003,¹ most equity split-dollar arrangements will not fully achieve the tax benefits they were originally designed to achieve and employers must act prior to December 31, 2003 to save a portion of these originally intended benefits. This article examines (i) the traditional taxation of split-dollar arrangements in the employer-employee context, (ii) the taxation of split-dollar arrangements under the final regulations, (iii) the treatment of existing split-dollar arrangements under the grandfather and safe harbor provisions of Notice 2002-8,² and (iv) steps employers should take with respect to existing split-dollar arrangements.

I. Traditional Taxation of Split-Dollar Arrangements

In the employer-employee context, equity split-dollar life insurance arrangements are a method to finance the cost of current life insurance protection and provide deferred compensation to an employee in the form of the built-up cash value in excess of the employer's premium payments with little or no tax cost to the employee. There are two types of split-dollar arrangements utilized by employers: (i) collateral assignment split-dollar; and (ii) endorsement method split-dollar.

In collateral assignment arrangements, (i) the employee owns the insurance policy, (ii) the employer pays all or most of the premiums, and (iii) the employee assigns the policy to the employer as collateral for repayment of the premiums paid by the employer. Collateral assignment arrangements are almost always equity arrangements, meaning the employee has a right to the built-up cash value of the policy in excess of the employer's premium payments. Practitioners generally believed that the employee was not subject to income tax on the built-up cash value of the policy in equity split-dollar arrangements until the employee cancelled the

policy or withdrew cash value in excess of the employee's basis in the policy, thereby offering a deferred compensation arrangement at no tax cost. The employee only recognized the cost of current term life insurance protection (i.e, the P.S. 58 cost³) as taxable income each year.

In endorsement arrangements, the employer (i) owns the policy, (ii) pays the premiums on the policy, and (iii) endorses a portion of the death benefit to the employee. The employee generally has no interest in the policy other than the ability to designate a beneficiary. As a result, endorsement split-dollar arrangements are typically non-equity, meaning that the employer is entitled to receive all of the cash value of the policy if the arrangement is terminated during the employee's lifetime or upon the employee's death. As with collateral assignment arrangements, the employee only included the cost of current term life insurance protection as income each year.

Generally, both types of arrangements are designed to terminate upon the earlier of the employee's termination of employment or death. Upon termination of employment, a collateral assignment arrangement is usually "rolled-out" by (i) the employee taking a loan against the policy to repay the employer for premiums paid and the employer releasing its security interest in the policy, or (ii) the employer releasing its security interest in the policy without repayment. The employee is only subject to income tax to the extent the employer released its security interest without repayment. In contrast, an endorsement arrangement is usually terminated upon an employee's termination of employment by the employer either (i) retaining control of the policy as sole owner and beneficiary and using the cash value and death benefit to provide the employee monthly income pursuant to a separate nonqualified deferred compensation plan, or (ii) transferring the policy to the employee and subjecting the employee to income tax on the cash value in excess of the employee's basis. In both types of arrangements, upon the employee's death, the employer is repaid from the death benefit the amount of its premium

payments (in equity arrangements) or the entire cash value (in non-equity arrangements) and the remainder is paid to the employee's designated beneficiary income tax-free.

II. Taxation of Split-Dollar Arrangement Under the Final Regulations

The final regulations provide that split-dollar arrangements entered into after September 17, 2003 will generally be taxed under two mutually exclusive regimes: (i) an "economic benefit" regime; and (ii) a "loan" regime. Which regime applies depends solely on whether the employer or the employee owns the policy.⁴ The economic benefit regime applies to endorsement arrangements where the employer owns the policy. The loan regime applies to collateral assignment arrangements where the employee owns the policy. Generally, the owner named on the insurance policy will be considered the owner for split-dollar purposes.⁵ The only exception is that the employer is treated as the policy owner if, at all times, the only economic benefit provided to the employee is current life insurance protection (i.e., non-equity split-dollar arrangements).⁶

A. Economic Benefit Regime

If the employer owns the policy (or in any non-equity arrangement), the arrangement will be taxed under the economic benefit regime. Non-equity endorsement arrangements will continue to be taxed in a manner similar to before—the employee will be taxed each year only on the cost of current term life insurance protection.⁷ Split-dollar arrangements entered into before January 28, 2002 may continue to value the current life insurance protection using either the P.S. 58 rates set forth in Revenue Ruling 55-747 or the insurer's lower published one-year term insurance rates. Split-dollar arrangements entered into after January 28, 2002, but on or before September 17, 2003, may use the insurer's lower published rates through December 31, 2003. Thereafter, the value of current life insurance protection may be based on the insurer's rates only if the insurer regularly sells term insurance at such rates to individuals applying for

term insurance through the insurer's normal distribution channels. Otherwise, the rates originally published in Notice 2001-10 as Table 2001 must be used.⁸

In the less common equity endorsement arrangement, in addition to taxation of the cost of current term life insurance protection, the employee will also be subject to tax each year on (i) any increased amount of cash value to which the employee has "current access" and (ii) the value of any other economic benefits provided to the employee during the year (i.e., policy dividends, withdrawals, or policy loans⁹), reduced by any amount contributed by the employee.¹⁰ An employee is considered to have current access to any portion of a policy's cash value that he or she has a current or future right to and that is currently directly or indirectly accessible to the employee, inaccessible to the employer, or inaccessible to the employer's general creditors.¹¹

In addition, under the economic benefit regime, since the employer is treated as the owner of the entire policy, the employee has no investment in the policy.¹² As a result, the employee does not obtain basis in the policy for either (i) any premium actually paid by the employee, or (ii) the cost of current life insurance protection included in the employee's income. Any premium paid by the employee is income to the employer,¹³ but the employer cannot deduct (i) any premium payment made by either the employer or the employee or (ii) the cost of current life insurance protection included in the employee's income.¹⁴

Under the economic benefit regime, all economic benefits provided by the employer to the employee are fully taxed each year. Going forward, no equity can be transferred to an employee without immediate taxation using an endorsement arrangement. As a result, very few equity split-dollar arrangements will be structured as endorsement arrangements in the future. Endorsement arrangements will only be useful as a planning tool if an employer's sole objective

is to provide current life insurance protection to an employee and perhaps fund a separate non-qualified deferred compensation plan at retirement through the insurance investment.

B. Loan Regime

If the employee owns the policy, the arrangement will be taxed under the loan regime.¹⁵ Most split-dollar arrangements in the employer-employee context use the collateral assignment method and, as such, will fall within the loan regime. Under the loan regime, each premium payment by the employer is treated as a separate loan from the employer to the employee. Each loan is subject to Section 7872 if below-market interest rates are used, and the original issue discount rules of Sections 1271–1275 if the loan is a term loan. Since the policy is purchased by the employee via a loan, the employee is not subject to tax on the cost of current life insurance protection.

For purposes of determining whether a split-dollar loan provides adequate interest, the loan is characterized as either (i) a demand loan, (ii) a term loan, or (iii) a hybrid term/demand loan. A split-dollar demand loan is any split-dollar loan that is payable in full at any time on the demand of the employer.¹⁶ Most existing collateral assignment arrangements will be considered demand loans unless modified, since employers generally reserve the right to terminate a split-dollar arrangement. A demand loan is tested each calendar year for adequate interest by comparing the interest rate on the loan to the blended applicable federal rate (“AFR”) published in July of each year.¹⁷ If the interest rate is less than the AFR, the loan is a below-market loan subject to Section 7872. The employer is deemed to have paid the foregone interest to the employee as compensation on the last day of the calendar year and the employee is treated as having paid the interest to the employer.¹⁸ The employer can deduct the imputed interest paid to the employee, but must recognize income on any interest actually or deemed paid by the

employee. Because the indebtedness is personal in nature, the employee cannot deduct any interest that is actually or deemed paid.¹⁹

The advantage of a demand loan is that it is easy to determine whether it provides sufficient interest. The disadvantage is that the determination is subject to changes in the annual blended AFR.

Split-dollar term loans are tested for adequate interest on the day the loan is made by comparing the present value of the repayment amount using the appropriate AFR for the term of the loan to the amount of the initial loan.²⁰ If the present value of all repayments is less than the amount of the initial loan, the loan is a below-market loan subject to Section 7872 and the present value of the entire foregone interest is imputed to the employee as compensation income in the year the loan is entered into—all up-front.²¹ There is no offsetting interest expense available to the employee. The employer is generally able to deduct the imputed interest as compensation expense in the year the loan is made. The original issue discount rules then require the employer to include deemed interest payments in the employer's income over the term of the loan arrangement.²² For these reasons, a split-dollar arrangement should not be structured as a term loan unless it provides for adequate interest.

The final regulations also provide hybrid term/demand loan treatment in the employer-employee context for (i) term loans conditioned on the performance of substantial future services, (ii) loans payable at an employee's death, or (iii) loans payable at the earlier of an employee's death or a stated term.²³ Hybrid loans are term loans for purposes of testing for adequate interest (using the AFR related to the term of the loan and tested on the date on which the arrangement is entered into).²⁴ However, if the loan does not provide sufficient interest when the loan is made, foregone interest is determined and taxed annually similar to a demand loan, except that the appropriate AFR for the term of the loan as of the date of the loan is used

to determine the amount of forgone interest each year.²⁵ The term of a loan payable on the death of an employee is based on the employee's life expectancy calculated under the appropriate table in Treasury Regulation Section 1.72-9 on the date the loan is made.²⁶ The term of a loan conditioned on the performance of substantial future services is presumed to be seven years unless the loan states a maturity date.²⁷ In either case, the loan is treated as retired and reissued as a split-dollar demand loan if the loan remains outstanding longer than the term.²⁸

Under the loan regime, the employee receives basis for all premiums paid by the employer since each premium payment is deemed to be loaned to the employee and used by the employee to purchase the policy.²⁹ This compares favorably to the economic benefit regime where, as discussed above, the employee can obtain no basis in the policy.

Finally, if a split-dollar loan is non-recourse, the final regulations treat the loan as providing for "contingent" payments, which will result in the imposition of unfavorable assumptions when testing the loan for adequate stated interest.³⁰ The typical collateral assignment arrangement is non-recourse to the employee since repayment is only made from the insurance policy and the employee is generally not personally obligated to repay the employer. To avoid contingent payment treatment, the employer and employee must represent in writing that a "reasonable person" would expect that all payments under the loan will be made.³¹ The written statement must be attached to the income tax returns of both the employer and the employee for each year the loan is outstanding.³²

The end result of the loan regime is that, going forward, equity can only be transferred to an employee using a collateral assignment arrangement if the insurance investment yields a higher return than the interest rate charged on the loan. Under this regime, higher premiums will generate higher interest, which must be paid by the employee or imputed as income. In

addition, the amount of interest will increase each year as the cumulative premiums paid by the employer increases. In order for an arrangement under the loan regime to emulate old equity split-dollar arrangements, the policy must minimize premiums and yet build enough equity to maintain the death benefit following roll-out and repayment of the employer's premiums. Premium efficiency will be critical.

III. The Grandfather and Safe Harbor Provisions

The final regulations apply only to split-dollar arrangements "entered into"³³ or "materially modified"³⁴ after September 17, 2003. Split-dollar arrangements entered into on or before September 17, 2003 (and not materially modified thereafter) will be governed by the grandfather and safe harbor provisions of Notice 2002-8 issued on January 3, 2002.

A. Grandfathering

Split-dollar arrangements entered into on or before September 17, 2003 (and not materially modified thereafter) are "grandfathered" pursuant to Notice 2002-8. Under the grandfather provision, an employee's built-up equity in the cash value of a policy in excess of the employee's basis will not be taxed to the employee until the split-dollar arrangement is rolled-out if the parties to the arrangement continue to report the value of current life insurance protection as an economic benefit provided to the employee.³⁵

Under this grandfather provision, an employer may continue an existing equity split-dollar arrangement after January 1, 2004 without subjecting the employee to income tax each year on the built-up equity in the cash value. However, when the arrangement is later rolled-out upon an employee's termination of employment, the entire built-up cash value beyond the employee's basis in the policy will be taxable to the employee, whether or not the employee continues the policy. As discussed above, practitioners previously believed that an employee was not subject to income tax on the built-up cash value in excess of the employee's basis upon

roll-out of the arrangement. Thus, even under the grandfather provision, equity split-dollar arrangements will not achieve the tax benefits they were originally designed to achieve.

B. Safe Harbor Options

Notice 2002-8 also offers two safe harbor options for split-dollar arrangements entered into before January 28, 2002, each of which allow an employer to roll-out a split-dollar arrangement without the employee being subject to tax on the built-up equity in the cash value.

First, an employer may roll-out a split-dollar arrangements prior to January 1, 2004. Rolling-out a split-dollar arrangement involves ending the relationship between the employer and the employee with respect to the policy. Two steps are required to roll-out an arrangement and qualify for this first safe harbor: (i) the employee repays the employer for all premiums previously paid by the employer (usually by taking a loan against the policy cash value); and (ii) the employer releases its security interest in the cash value of the policy. Alternatively, the employer can release its security interest in the cash value without repayment. This method of roll-out will subject the employee to income tax on the amount released by the employer.

Following roll-out of the arrangement, the employee remains the owner of the policy and the employer has no rights in the policy and no obligation to pay future premiums. So long as the policy remains in effect after the arrangement is rolled-out, the employee is not taxed on the built-up equity in the cash value. Going forward, the employee can either pay premiums out-of-pocket or, if the policy has sufficient equity, the premiums can be charged against the cash value as loans. Interest will be charged by the insurance company on any loans taken against the policy by the employee.

The second safe harbor option requires the parties to treat an arrangement as a split-dollar loan for all periods beginning on or after January 1, 2004 and subjecting it to tax under the loan regime.³⁶ To comply with this safe harbor option, all past premiums paid by the employer

from the inception of the arrangement must be treated as a loan made on January 1, 2004. If the arrangement is treated as a loan, the employee will not be subject to income tax on the built-up equity in the cash value when the arrangement is subsequently roll-out upon the employee's termination from employment.

Treating an arrangement as a split-dollar loan for purposes of this safe harbor option does not require the parties to modify the existing arrangement prior to January 1, 2004. Instead, the parties only need to report the arrangement in a manner consistent with the loan regime, including the below-market interest rate and original issue discount rules. However, because these rules are so complicated, an employee should execute a promissory note effective January 1, 2004 providing adequate interest to (i) avoid the below-market interest rate and original issue discount rules, and (ii) structure the loan in a manner most advantageous to the parties (i.e., as a demand loan, term loan, or hybrid term/demand loan and with interest being paid annually or accrued and paid when the principal becomes due). Nonetheless, if the parties fail to roll-out an arrangement prior to January 1, 2004 under the first safe harbor, the parties can still roll-out the arrangement after January 1, 2004 without subjecting the employee to income tax on the built-up equity under the second safe harbor if the employer and the employee report the arrangement as a split-dollar loan for the period beginning January 1, 2004 through the date of subsequent roll-out. This should help alleviate the negative tax consequences in situations where parties desire to roll-out now, but fail to do so prior to the end of the year.

Some commentators have suggested that Notice 2002-8 permits a third safe harbor option described as "switch-dollar." The idea is that an arrangement entered into before January 28, 2002 may continue to be taxed only on the cost of current life insurance protection pursuant to the grandfather provision and later switch to the loan regime in some future tax year

when the cost of current life insurance protection equals or exceeds the interest cost. However, attempting this switch-dollar approach seems very risky, since Notice 2002-8 states that the loan regime safe harbor is only available where the arrangement is treated as a loan “for all periods beginning on or after January 1, 2004.” As a result, it seems that an employee will be subject to tax on the built-up equity in the cash value once the arrangement is later rolled-out.

IV. Steps Employers Should Take With Respect to Existing Policies

Policies with substantial built-up equity in the cash value should generally be rolled-out prior to January 1, 2004. If the policy equity is sufficient, the policy can maintain itself without the payment of future premiums by the employee and the employee will not be taxed on the built-up equity unless and until the employee either cancels the policy or withdraws cash value in excess of the employee’s tax basis in the policy.

Policies with some built-up equity but still requiring the payment of additional premiums to sustain them should generally be treated as loan arrangements during the first period beginning on or after January 1, 2004. Otherwise, the employee will be required to pay future premiums out-of-pocket (if the arrangement is rolled-out prior to January 1, 2004) or subject to tax on the built-up equity upon subsequent roll-out. Once the built-up equity is sufficient to sustain the policy, it can be rolled-out at any time and the employee will not be subject to tax on the built-up equity. In the current low interest rate environment, the best course of action in many circumstances may be to convert the arrangement to a term loan that states adequate interest unless roll-out is likely to occur in the near future, in which case the arrangement should be converted to a demand loan to take advantage of the lower annual blended AFR.

¹ Treas. Reg. Sects. 1.61-2(d)(2)(ii)(A), 1.61-22, 1.83-3(e), 1.83-6(a)(5), 1.301-1(q) and 1.7872-15 (2003).

² I.R.S. Notice 2002-8, 2002-1 C.B. 398.

³ Rev. Rul. 55-747, 1955-2 C.B. 228.

⁴ Treas. Reg. Sec. 1.61-22(b)(3)(ii)(A).

⁵ Treas. Reg. Sec. 1.61-22(c)(1)(i).

⁶ Treas. Reg. Sec. 1.61-22(c)(1)(ii)(A)(1). In such non-equity split-dollar arrangements, the employer will be deemed the policy owner even if the employee is named as the owner on the policy.

⁷ Treas. Reg. Sec. 1.62-22(d)(2).

⁸ I.R.S. Notice 2002-8, 2001-1 C.B. 398.

⁹ A policy loan provided to an employee is treated as a loan taken by the employer against the policy and paid to the employee as compensation. See Treas. Reg. Sec. 1.61-22(e)(1).

¹⁰ Treas. Reg. Sec. 1.61-22(d)(2).

¹¹ Treas. Reg. Sec. 1.61-22(d)(4)(ii). The explanation to the final regulations states that “access” is to be construed broadly and discusses in greater detail when these conditions are met. The right to withdraw from a policy, borrow against a policy, or affect a total or partial surrender of a policy is considered access.

¹² Treas. Reg. Sec. 1.61-22(f)(2)(i).

¹³ Treas. Reg. Sec. 1.61-22(f)(2)(ii). The theory for subjecting the employer to tax on premiums paid by the employee is that the employee is renting the death benefit from the employer.

¹⁴ *Id.*

¹⁵ The one exception is that if the employer and employee enter into a separate agreement providing that the employer will make a transfer to the employee in an amount sufficient to repay the purported split-dollar loan, the employee will be subject to income tax on each premium payment to the extent that the employee’s rights in the policy are substantially vested. See Treas. Reg. Sects. 1.61-2(d)(2)(ii)(A) and 1.61-22(b)(5).

¹⁶ Treas. Reg. Sec. 1.7872-15(b)(2).

¹⁷ Treas. Reg. Sec. 1.7872-15(e)(3)(ii).

¹⁸ Treas. Reg. Sec. 1.7872-15(e)(3)(iii)(B).

¹⁹ Treas. Reg. Sec. 1.7872-15(c).

²⁰ Treas. Reg. Sec. 1.7872-15(e)(4)(ii).

²¹ Treas. Reg. Sec. 1.7872-15(e)(4)(iv).

²² Treas. Reg. Sec. 1.1272-1 (as amended in 1996).

²³ Treas. Reg. Sec. 1.7872-15(e)(5)(i).

²⁴ *Id.*

²⁵ *Id.*

²⁶ Treas. Reg. Sec. 1.7872-15(e)(5)(ii)(C).

²⁷ Treas. Reg. Sec. 1.7872-15(e)(5)(iii)(C).

²⁸ Treas. Reg. Sects. 1.7872-15(e)(5)(ii)(D) and 1.7872-15(e)(5)(iii)(D).

²⁹ Treas. Reg. Sec. 1.61-22(f)(2)(ii).

³⁰ Treas. Reg. Sec. 1.7872(d).

³¹ Treas. Reg. Sec. 1.7872-15(d)(2)(i).

³² Treas. Reg. Sec. 1.7872-15(d)(2)(ii).

³³ A split-dollar arrangement is entered into on the later of the date that (i) the policy is issued, (ii) the policy is effective, (iii) the first premium is paid, (iv) the parties enter into an agreement with respect to the policy, or (v) the arrangement satisfies the definition of a split-dollar life insurance arrangement. See Treas. Reg. Sec. 1.61-11(j)(1)(ii).

³⁴ The final regulations provide a non-exclusive list of non-material modifications. For the most part, the list contains only changes that are clearly not material, such as a change in the mode of premium payments, a change of the designated beneficiary, or a change of address. See Treas. Reg. Sec. 1.61-22(j)(2)(ii). As a result, any proposed modification to a policy or split-dollar arrangement should be closely reviewed before implementation.

³⁵ I.R.S. Notice 2002-8, 2002-1 C.B. 398.

³⁶ The explanation to the final regulations provides that arrangements modified to comply with the loan regime will not be considered materially modified.

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