

**The “Perfect Storm” That’s Swamping
Compensatory Split-Dollar Arrangements**

The Background That Set the Stage for this Storm

Split-dollar agreements were traditionally governed by a series of published I.R.S. rulings, dating back to the early 1960’s. There had been no change with respect to the underlying tax rules relating to split-dollar arrangements until the I.R.S. published a series of Notices in 2001 and 2002. The 2002 Notice, Notice 2002-8, now governs these split-dollar agreements, and, for the first time, the I.R.S. has taken the position that on termination of these agreements during the insured’s lifetime, any policy cash value in excess of company-advanced premiums will, with some limited potential exceptions, be taxable income to the employee.

In 2003, the I.R.S. adopted the Final Split-Dollar Regulations, which applies to all new arrangements, but which only apply to earlier arrangements if they were “materially modified” after the date of those Regulations (late 2003). Accordingly, any change to any older arrangement (or even to the policies subject to them) should be viewed as a potential material modification, which will cause the Regulations to apply to them. If those Regulations apply to any split-dollar arrangement, in order to continue to be able to measure the income tax consequences of them to the employee by the economic benefit of providing the death benefit (measured by term insurance costs, rather than interest on the premiums advanced), the employee would have to be willing to give up his or her present (and any future) interest in the policy cash values to the employer.

Finally, Congress passed Section 409A to apply to deferred compensation arrangements, generally effective January 1, 2005. In late 2007, the Service issued Notice 2007-43, applying the concepts of Section 409A to compensatory split-dollar arrangements. The provisions of that Notice

are similar to the provisions of Notice 2002-8, and state that any policy cash values in excess of employer provided premiums will be income to the employee on termination of the arrangement during the insured's lifetime, with no potential exceptions. There is some actual grandfathering from this provision of pre-1/1/05 agreements that provide vested benefits, and in any event, only the cash value created by post 1/1/05 premiums would be subject to this new rule. Finally, most compensatory split-dollar arrangements will need to be reviewed and amended to comply with these rules this year; changes to prior agreements required to comply with Section 409A will, in most cases, not be considered material modifications for purposes of the Final Split-Dollar Regulations.

It is the intersection of this series of relatively new changes in the law applicable to compensatory split-dollar arrangements, and the absence of any perfect "grandfathering" for prior arrangements, even for very old arrangements, which raises issues that now need to be addressed by all employers and employees who have entered into these arrangements in the past.

What is Compensatory Split Dollar?

A split-dollar insurance arrangement is a method of paying for insurance coverage. An economic benefit split dollar arrangement involves an employer paying all or a portion of the premium, where the payment is treated as an advance to the employee. When the arrangement is terminated, the employer receives back its advances (and sometimes the earnings on the advanced funds in the form of the cash value of the policy) and the employee (or his or her beneficiary) retains the balance of the policy and the death benefit. A split dollar loan involves an employer loaning the employee the amount to pay all or a portion of the premium, which loan either bears interest or not, with the repayment of the loan coming from the death benefit or cash value of the policy.

Since the repayment is usually made from the cash value of the policy, the arrangement involves permanent cash value insurance, such as whole life, universal life, variable universal life or a term/whole life blend. After the employer has received repayment for its premium payments at the employee's death, the beneficiaries designated by the employee will receive the remaining death benefit.

Since these agreements are not tax qualified benefit plans, they can be discriminatory in terms of employee selection; they do not require IRS qualification; however, the premium payments are not tax deductible. On the other hand, the refunded contributions to the employer and the death benefits to the insured's beneficiaries are received income tax-free.

The Income Tax Rules

The income tax treatment of these arrangements depends on when the arrangement was entered into. If the arrangement was entered into prior to September 17, 2003, and was not "materially modified" thereafter ("Pre-Final Regulation SDAs" arrangements), the tax treatment is set forth under Notice 2002-8. Any arrangement entered into (or "materially modified") after that date ("Final Regulation SDAs") are governed by these Regulations.

Tax Treatment of Pre-Final Regulation SDAs

For all arrangements that were entered into prior to September 17, 2003 and not "materially modified" thereafter, there are generally two methods of policy ownership.

The Collateral Assignment Method – in this method the insured purchases the life insurance directly and is considered the owner of the policy. The insured collaterally assigns

certain rights in the policy to the company which will be paying all or a portion of the premiums to secure it's right to be repaid for these advances.

The Endorsement Method – traditionally the entity which is paying all or a portion of the premiums is the purchaser and owner of the insurance policy and there is a separate agreement between that person and the insured defining the insured's rights in the death benefit of the policy. The premium payor typically names itself as the beneficiary of an amount of the proceeds equal to the amount it will be owed at the time of the insured's death, and, by policy endorsement, provides that the insured's beneficiaries have the right to the portion of the proceeds in excess of such amount.

Either method can be treated as a loan arrangement or an economic benefit method for income tax purposes.

Taxation of Loan Arrangements

The only tax consequences of a split-dollar loan arrangement are if interest at the applicable federal rate is not charged (or is forgiven) or if the loan amount itself is forgiven. If the loan bears no interest or interest at a rate that is below the applicable federal rate (the "AFR"), then the employee will have to report the interest as taxable income as though it had been paid; when that interest is reportable and how it is reported is determined by the nature of the loan. If the loan bears interest at at least the AFR, no interest is imputed as income to the employee.

Taxation of Economic Benefit Arrangements

In an economic benefit arrangement, each year, the cost of the current life insurance protection the employee receives (which is the cost of a term policy on someone the same age as the insured for each year) is taxable income to the owner, unless the employee pays that amount rather than having the employer advance it. The cost of current life insurance protection is determined either using the Government's Table 2001 or it can be determined using the insurance carrier's own "alternative" term rates, so long as such rates are generally available to the public. One reason parties decide to use an economic benefit arrangement rather than a loan arrangement to structure their split dollar arrangement is because the cost of current insurance costs may be much lower than the interest rate that is charged on a loan.

The second tax consequence of an economic benefit arrangement is less clear. When the employer is repaid its advance, which is defined in the agreement as just the premiums paid, is any cash value in the policy that remains after the payment (assuming the insured is still alive) taxable? This is called the "equity" in the policy. It is a matter of debate among practitioners as to whether or not the equity is taxable to the employee, if the arrangement is terminated during the insured's lifetime. Some economic benefit arrangements address this by avoiding the issue and provide that the greater of the cash value in the policy or the premiums advanced is what is repayable to the employer; these are called "non-equity" economic benefit arrangements. One reason some employers utilized the loan arrangement rather than the economic benefit arrangement, since it is clear that all that has to be prepaid to the lending party is the amount actually advanced, not the additional cash value, if any, in the policy.

If the arrangement is terminated upon the insured's death, the amounts payable back to the employer and to the employee's beneficiary of the policy are considered insurance proceeds and such proceeds are not taxable income, under most circumstances.

Tax Treatment of Final Regulation SDAs

For all arrangements that were entered into after September 17, 2003 or were entered before that date but were "materially modified" thereafter, there are the same two methods of policy ownership, but unlike Pre-Final Regulation SDAs, the method of policy ownership will control the income tax treatment of the arrangement to the employee.

The Collateral Assignment Method –the insured purchases the life insurance directly and is considered the owner of the policy, and collaterally assigns certain rights in the policy to the company which will be paying all or a portion of the premiums to secure its right to be repaid for these advances. This method is taxed as a loan arrangement, unless the parties are an employee and employer, in which case, if the arrangement is a "non-equity" arrangement, the arrangement will be taxed as an economic benefit arrangement.

The Endorsement Method –the entity which is paying all or a portion of the premiums is the purchaser and owner of the insurance policy and there is a separate agreement between that entity and the insured defining the insured's rights in the death benefit of the policy by endorsement. This method is taxed as an economic benefit arrangement.

Taxation of Loan Arrangements

The tax consequences of a Final Regulation split-dollar loan arrangement are the same as a Pre-Final Regulation Split Dollar Arrangement, with a few exceptions.

Taxation of Economic Benefit Arrangements

The tax consequences of an economic benefit arrangement are more onerous than for Pre-Final Regulation arrangements, and all uncertainty about the taxation of the equity has been resolved - it is taxable at any time the party who will receive the equity has “current access” to the equity.

Each year, just as in the Pre-Final Regulation Arrangement, the cost of the current life insurance protection the employee receives is taxable income to the employee, unless the employee pays that amount. The cost of current life insurance protection is determined either using the Table 2001 or it may be determined using the insurance carrier’s own “alternative” term rates, so long as such rates are generally available to the public and the carrier actually sells policies at those rates.

An additional article will be available in the next few weeks discussing the potential application of Section 457 to compensatory split-dollar arrangements for employees of tax-exempt employers.