SPLIT DOLLAR LIFE INSURANCE ARRANGEMENTS

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By

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I. Introduction

Split-dollar life insurance is not a type of life insurance policy; instead, it is an arrangement under which two (or more) parties agree to share obligations and rights with respect to a permanent life insurance policy.[1] Premiums, death benefits, policy cash value and dividends may be allocated or "split" under a split-dollar life insurance arrangement ("SDA"). Typically, the employer will pay most (and often all) of the policy premiums, and the employee will be able to name a beneficiary who will receive policy death proceeds less the amount of the premiums that were paid by the employer. SDAs have often been used as a form of employee compensation, and this outline solely addresses the use of SDAs in the employer-employee context.[2] SDAs typically involve the filing of a security interest with the insurer reflecting the relative rights of the parties. If the employee owns the policy subject to an SDA, a so-called "collateral assignment" will be filed with the insurer to reflect the employer's policy rights. This collateral assignment provides the employer certain rights to policy cash surrender value upon certain events, such as termination of the SDA. If the employer is the policy owner subject to an SDA, a form of "endorsement" will be filed with the insurer to reflect the employee's policy rights.

II. Common Types of Split-Dollar Life Insurance

An SDA may split policy obligations and benefits in a variety of ways regardless of who owns the policy. The three most common types of SDAs that have been used for compensation planning are Non-Equity SDAs, Equity SDAs, and Reverse SDAs.

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[1] Split-dollar final regulations (discussed below in Part IV of this outline) define a "split-dollar life insurance arrangement" as one between an owner and a non-owner of a life insurance contract wherein (1) either party pays, directly or indirectly, all or a portion of the premiums on a life insurance contract, including a payment by means of a loan to the other party that is secured by the life insurance contract; (2) one of the parties paying premiums is entitled to recover (either conditionally or unconditionally) all or a portion of the premiums, and the recovery is to be made from or secured by the proceeds of the life insurance, and (3) the arrangement is not part of a group term life insurance plan described in Section 79. Treas. Reg. §1.61-22(b).

[2] SDAs may also be used in other contexts, such as between a corporation and a shareholder, a partnership and a partner or a donor and a donee.

A. Non-Equity SDA

A Non-Equity SDA allocates all policy cash value to the employer. The employer will typically pay all the policy premiums. In return, the employer retains a right to receive an amount that is not less than the policy's cash surrender value upon termination of the arrangement for any reason. Sometimes the employee will be responsible to reimburse the employer for a portion of the premium cost, which will be limited to the amount necessary to avoid imputed compensation income to the employee due to death benefit coverage under the Non-Equity SDA. Alternatively, the employer provides a tax gross-up payment for any imputed compensation income resulting from the death benefit coverage provided at no cost to the employee.

B. Equity SDA

In contrast to a Non-Equity SDA, an Equity SDA allocates a portion of the policy cash value and/or policy dividends to the employee. The classic form of Equity SDA limits the employer's right to policy cash surrender value to its premium payments. Any policy cash value in excess of the employer's right to recover its premium payments is allocated to the employee, and is often referred to as the "equity" under the SDA. Often, policy death benefits are allocated in the same manner as policy cash value; however, that is not required and sometimes an employer will provide for its recovery right on termination to include both premiums and an interest factor for the use of its funds for premium payments. It is not uncommon for cash values, particularly with modern variable life insurance policies, to exceed premiums in a relatively short period of time, thereby providing a valuable benefit to the employee. Employers have frequently used Equity SDAs to provide a source of funds that can be accessed by the employee for retirement benefits.

C. Reverse SDA

Reverse SDA, as its name implies, reverses the roles of the employer and the employee in a Non-Equity SDA. The employee retains rights to all of the policy's cash value, and the employer pays for the policy's death benefit coverage under a predetermined IRS valuation table, with the employee paying the remaining portion of the policy premiums. In effect, the employer is "renting" death benefit coverage from the employee. The amount paid by the employer annually for the current life insurance protection often was based on so-called "P.S. 58 rates" that were significantly higher than the actual cost of providing such protection within the policy. The intended result from having the employer acquire the current life insurance protection at a high rate from the employee was to accumulate policy cash value without immediate income tax consequences to the employee. In Notice 2002-59, the IRS announced that it would review the facts and circumstances on a case-by-case basis consistent with tax principles to determine if policy benefits are being provided or transferred without proper reporting of tax liability.[3]

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[3] Previously, the IRS stated in Notice 2001-10 that using a P.S. 58 rate for a Reverse SDA "significantly overstates the value of the policy benefits allocated to the employer, such that the employee's share of the premiums is significantly lower than the employee's actual share of the policy benefits." This Notice further warns that "[n]o published guidance has authorized reliance on the P.S. 58 rates for this purpose."

II. Prior Law: Revenue Ruling 64-328, TAM 9604001 and Notice 2001-10

Revenue Ruling 64-328 sets forth the tax rules governing SDAs that were regularly relied upon by practitioners prior to the issuance of the split-dollar final regulations (which are discussed below in Part IV). This ruling held that an employer funded SDA provided the employee with an "economic benefit" of having his or her life insured, and that this benefit was taxable unless it was paid for by the employee. Revenue Ruling 64-328 identified the "economic benefit" as the one-year term insurance cost for the policy death benefits allocated to the employee under the SDA. Revenue Ruling 64-328 specifically rejected that an SDA resulted in an interest-free loan,[4] and provided that the identity of the policy's owner did not matter in determining the tax consequences to the employee (i.e., the same tax consequences resulted regardless of whether the collateral assignment method or endorsement method was used to establish the SDA).

Revenue Ruling 64-328 provided for the one-year term insurance cost to be measured by using so-called "P.S. 58 rates." These rates were based on mortality experience in the 1940s, and tended to inflate the amount of compensation income attributable to death benefit coverage. In Revenue Ruling 66-110, the IRS allowed taxpayers to elect to use the insurer's generally available, published non-renewable one year term rate in lieu of the applicable P.S. 58 rate. These alternative term rates represent a percentage of the total premium cost for permanent life insurance, and will be a relatively small percentage for younger employees. By using SDAs with the alternative term rates, the employer could pay all or a substantial part of the premium cost at little or no tax cost to the employee while recovering its entire capital outlay upon termination of the SDA.

Revenue Ruling 64-328 did not indicate that an SDA resulted in any other taxable benefits for the employee, and arguably did not distinguish between different type of SDAs (i.e., Equity SDAs vs. Non-Equity SDAs). One sentence in Revenue Ruling 64-328 indicates that the results in this rule apply when an employer is entitled to receive "out of the proceeds of the policy" an amount equal to the cash surrender value "or at least a sufficient part thereof to equal the funds it has provided for the premium payments." An important question not expressly addressed by Revenue Ruling 64-328 is whether the reference to "proceeds" is intended to include policy cash surrender value. Two years later, the IRS ruled in Revenue Ruling 66-10 that dividends and "other benefits" constituted economic benefits subject to taxation under Revenue Ruling 64-328.

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[4] In Revenue Ruling 55-713, the IRS had initially determined that SDAs were in all respects the same as if the employer had made annual loans without interest to the employee in an amount equal to the annual increases in policy cash surrender value, and that merely making available funds without interest did not result in taxable income to the employee. The IRS subsequently reconsidered this area and revoked Revenue Ruling 55-713. Subsequently, in Dean vs. Commissioner (35 T.C. 1083 (1961)), the Tax Court held that an interest free loan did not result in taxable income to an employee. Congress subsequently directed that the IRS develop a method for valuing the economic benefit that resulted from SDAs, which resulted in Revenue Ruling 64-328. Several years later, in Dickman vs. Commissioner, 465 U.S. 330 (1984), the U.S. Supreme Court ruled that interest-free demand loans provided to a family member and a closely held family corporation constituted taxable gifts. Shortly after the Dickman decision in 1984, Congress enacted Section 7872 of the Code, which sets forth rules for determining the amount of imputed compensation to the employee resulting from an employment-related loan that does not bear an adequate amount of interest.

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Arguably, “other benefits” could have been interpreted to apply to the policy cash surrender values that exceeded cumulative employer premiums in an Equity SDA.

Many practitioners relied on the “in sufficient part” language in Revenue Ruling 64-328 in developing Equity SDAs as a tax efficient deferral technique. Policy cash value inside a permanent life insurance policy grows on a tax deferred basis. As noted above, only the value of the current death benefit protection - and not cash values - was treated as an economic benefit under the Revenue Ruling 64-328. Relying on this ruling, Equity SDAs were used to accumulate policy cash value from which the employee could withdraw or borrow amounts against to supplement retirement income.

In 1996, the IRS issued a Technical Advice Memorandum 9604001 (“TAM”), which provided for immediate taxation of the employee’s “equity” in the policy as soon as the cash surrender value exceeded the employer’s premium recovery amount. The TAM, while applicable to only one taxpayer not precedent in other cases, caused considerable concern that the IRS was changing its historical view of SDAs. Industry groups submitted extensive legal briefs arguing that the TAM was wrong under current law and that any change should be made only on a prospective basis by formal statute or published ruling.

In January 2001, the IRS issued Notice 2001-10, in which the IRS narrowed the scope of Revenue Ruling 64-328 to apply only to Non-Equity SDAs. This interpretation represents the IRS’ position that an employee receives a taxable economic benefits from Equity SDAs in addition to current term life insurance coverage. Notice 2001-10 states that “it is necessary to account for the employee’s rights in cash surrender value under an equity split-dollar arrangement in a manner consistent with the substance of the parties’ contractual positions.” Notice 2001-10 suggested alternative approaches for taxing equity based on transfers of policy cash value under Section 83 or imputed compensation under Section 7872.[5]

III. IRS Transition Rules under Notice 2002-8

On January 3, 2002, the IRS revoked Notice 2001-10 and issued further guidance regarding SDAs. Notice 2002-8 provides a series of rules as “interim” guidance.[6] Among other things, these rules allow taxpayers to chose either the “economic benefit” regime or the “loan regime” for taxing Equity SDAs entered into before the effective date of the split-dollar final regulations (September 18, 2003). In addition, Notice 2002-8 provided significant relief for Equity SDAs entered into before January 28, 2002.

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[5] See Liazos, IRS Review of Split-Dollar Life Insurance, McDermott, Will & Emery (January 2001) for a summary and analysis of Notice 2001-10.

[6] Notice 2002-8 has substantially the same effect as a revenue ruling and may be relied upon by taxpayers. *See* Revenue Ruling 90-91 (holding that all Notices are considered authorities for purposes of determining substantial authority under section 6662(d)(2)(B) of the Code).

A. "Economic Benefit" Regime: No Income Tax on Increases in Policy Cash Value During the Term of an Equity SDA Entered into Before September 18, 2003

Employers can continue to report current life insurance protection provided under Equity SDAs entered into before September 18, 2003 as the employee's primary taxable economic benefit during the term of the arrangement.[7] Notice 2002-8 provides that increases in policy cash value in excess of the employer's premium recovery right during the term of an SDA entered into before September 18, 2003 will not be treated as a deemed transfer of property under Section 83.[8] Notice 2002-8 further provides that the "Service will not treat the arrangement as having been terminated" for purposes of this rule "so long as the parties to the arrangement continue to treat and report the value of the life insurance protection as an economic benefit provided to the benefited person." It appears that this rule applies during any period of time that the employer has a premium recovery right under the SDA.[9] The inference from these provisions is that a termination of an Equity SDA would be treated by the IRS as a transfer of the entire policy, and a withdrawal by the employee of policy equity would be treated as a transfer of that amount.

B. "Economic Benefit" Regime: Standards for Imputed Compensation from Current Life Insurance Protection

Notice 2002-8 provides that SDAs entered into on or before January 28, 2002 may continue to use indefinitely either P.S. 58 rates[10] or "the insurer's lower published premium rates that are available to all standard risks for initial issue "one-year term insurance" to measure the value of current life insurance protection." In contrast, SDAs entered into after January 28, 2002 are not allowed to use P.S. 58 rates. Taxpayers entering into SDAs after January 28, 2002 can only use insurer one-year term rates for standard risks with respect to periods after 2003 subject to special distribution and sales requirements.[11] All SDAs entered into before the effective date of "future guidance" (which has yet to be issued) may use the Table 2001 rates.[12] Notice 2002-8 also

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[7] Notice 2002-8, Part I. Most of the transition rules depend upon when the taxpayer "entered into" the split-dollar life insurance "arrangement," and Notice 2002-8 does not address what is required in order to "enter into" an SDA. Split-dollar final regulations, however, did address this matter, which is discussed below in Part IV. A. below.

[8] In effect, this provision of Notice 2002-8 reverses the IRS' position in TAM 9604001. It also foreclosed the ability of a taxpayer to file a Section 83(b) election to avoid taxation on future increases in policy cash value.

[9] The author is aware that some employers have recovered most (but not all) of their premium payments under Equity SDAs while continuing to rely on this transition rule (and avoid potential taxation on termination of these arrangements).

[10] The P.S. 58 rates are one-year term rates that were provided by the IRS in Revenue Ruling 55-747 to measure the taxable economic benefit received by an employee from the current life insurance protections provided by SDAs and tax qualified retirement plans.

[11] Specifically, Notice 2002-8 requires that "(1) 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."

[12] The Table 2001 rates were issued in Notice 2001-10 as a replacement for the P.S. 58 rates. The Table 2001 rates are based on the rates used under Section 79 for group term life insurance, and are significantly lower than the P.S. 58 rates, thereby resulting in a lower taxable economic benefit.

permits “appropriate adjustments” to the Table 2001 rates when reporting economic benefits under “second to die” survivorship policies.

C. “Loan Regime”: Below-Market Loan Treatment Available as an Alternative to Report Taxable Income from Equity SDAs

Notice 2002-8 allowed parties to elect to treat premium payments under Equity SDAs entered into before the effective date of final regulations (September 18, 2003) as below-market loans regardless of actual ownership or the method used to establish the Equity SDA. The IRS further provided that it would “not challenge reasonable efforts to comply with the requirements of sections 1271-1275 and section 7872.” Using this transition rule requires that all premium payments made prior to the conversion be treated as a loan as of the first day of the year in which the election is made. Notice 2002-8 does not appear to restrict when an Equity SDA entered into before September 18, 2003 may elect loan treatment under this transition rule.

In effect, treatment under this “loan regime” means that the employee is deemed to be the economic owner of the policy, and the employer is treated as extending credit with each premium payment. Interest not charged by the employer at the applicable federal rate or AFR on each premium payment appropriate to the type of loan is treated as compensation income to the employee.[13] As discussed in Part IV D. below, Section 7872 allows taxpayers to plan when the interest free element will result in taxable income by varying the loan’s repayment terms. The employee, as policy owner, is not taxed on current life insurance protection provided under the arrangement as is the case with SDAs that are not treated as loans. The imputed compensation amount for the employee under the loan regime may be less than the cost of current one-year term life insurance depending upon the age of the employee and the prevailing interest rate conditions.

A significant advantage of using the loan regime for all employees is that there is no income tax upon termination of the Equity SDA (i.e., when the employer receives a return of its premium payments). Increases in property value owned by the employee are not treated as employer provided benefits. In addition, premium payments will be treated as paid by the employee, thereby resulting in basis for purposes of future policy withdrawals. In contrast, termination of an Equity SDA (other than a termination qualifying for special tax treatment as described below) reported under the economic benefit regime may be challenged by the IRS to result in taxable income equal to the employee’s policy cash value on termination. In addition, it is unclear whether amounts paid by the employee toward current life insurance protection under such Equity SDAs will be treated as creating policy basis by the IRS.

D. No Income Tax on Termination of Pre-January 28, 2002 Equity SDAs Before 2004

Notice 2002-8 provides that an “arrangement entered into” before January 28, 2002 may be terminated at any time before January 1, 2004 without resulting in a taxable transfer of the life insurance policy’s cash surrender value to the employee, provided that the employer “is entitled

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[13] Of course, there is no imputed compensation cost if interest is charged at the required AFR level for the type of loan under Section 7872.

to receive full repayment of all of its premiums."[14] This rule effectively allowed "equity" (i.e., cash surrender value in excess of the employer's premium payments) accrued under a pre-January 28, 2002 Equity SDAs to be transferred before January 1, 2004 without any income taxation. Similarly, Notice 2002-8 allowed taxpayers to convert to pre-January 28, 2002 Equity SDAs to the loan regime without any taxation of policy equity so long as all premium payments were treated as loans beginning on January 1, 2004. Taxpayers who took advantage of this transition rule were able to continue owning the policy and policy equity with no income tax.

E. "No Inference" Rule

Notice 2002-8 states that "no inference should be drawn from this notice" regarding the appropriate tax treatment for SDAs entered into before the effective date of split-dollar final regulations. Instead, taxpayers may rely on the principles described in Notices 2002-8 and 2001-10 for SDAs entered into before that date. As a result, taxpayers may either rely on rules provided in the Notices as safe harbors (e.g., policy equity under the economic benefit regime is taxable on termination of an Equity SDA) or take an alternative position based on an interpretation of law prior to January 28, 2002 (such as Revenue Ruling 64-328). For taxpayers seeking to take the position that there is no tax on termination of an Equity SDA, the IRS may not use Notice 2001-10, Notice 2002-8 or the split-dollar final regulations as authority for the position that the policy equity is taxable. In addition, a taxpayer cannot cite the Notices and the split-dollar final regulations for the proposition that they represent a change in the law.

IV Split-Dollar Final Regulations

On September 12, 2003, the IRS issued final regulations governing SDAs under Treas. Reg. §§1.61-22, 1.83(e), 1.83-6(a)(5) and 1.7872-15). These regulations provide detailed rules regarding SDAs that are either "entered into" after September 17, 2003 or "materially modified" thereafter. The IRS simultaneously issued Revenue Ruling 2003-105, which declared that Revenue Ruling 64-328 and Revenue Ruling 66-110 (except to the extent incorporated into Section III, paragraph 3 of Notice 2002-8) were obsolete for SDAs subject to the split-dollar final regulations. As discussed below, the split-dollar final regulations provide for the identity of the policy owner to determine whether the economic benefit regime or the loan regime will apply to an Equity SDA.

A. When is an Arrangement "Entered Into"

The split-dollar final regulations provide that an SDA is "entered into" on the latest of (i) the date the policy subject to the arrangement is issued, (ii) the effective date of the policy subject to the arrangement, (iii) the date the first policy premium is paid, (iv) the date the parties enter into the agreement and (v) the date the arrangement satisfied the definition of split-dollar

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[14] Typically SDAs are non-recourse in that the employer is not entitled to recover its premium payments from the employee under the terms of the arrangement. Initially some practitioners were concerned that the employer would not be entitled to full repayment of its premiums within the meaning of Notice 2002-8 due to the non-recourse nature of most Equity SDAs. Informal conversations with IRS officials suggested that the "entitled to" requirement in Notice 2002-8 was not intended to disqualify non-recourse Equity SDAs from this transition relief, and the author is not aware of any situation in which the IRS has pursued this position in an audit.

arrangement. As a result, an arrangement is not "entered into" until the policy is issued, paid for and entered into before September 18, 2003. It is the author's experience that arrangements considered to be covered by the transition rules in Notice 2002-8 are in fact subject to the final regulations because of the failure to timely complete the policy issuance. Whether or not an arrangement is "entered into" before there is a signed written agreement between the parties presumably will depend upon whether there is a binding contract under state law. It also appears that the failure to file a security interest for the SDA (i.e., a collateral assignment or endorsement) does not impact when an arrangement is "entered into" for purposes of the split-dollar final regulations.

B. Material Modifications

The final regulations will also apply to an SDA that is "materially modified" after September 17, 2003. The final regulations provide a "non-exclusive list" of modifications that are not considered material, which includes the following events: (i) change solely in the mode of premium payment (for example, a change from monthly to quarterly premiums); (ii) a change solely in the beneficiary of the life insurance contract, unless the beneficiary is a party to the arrangement; (iii) change solely in the interest rate payable under the life insurance contract on a policy loan; (iv) a change solely necessary to preserve the status of the life insurance contract under Section 7702 of the Code, (v) change solely to the ministerial provisions of the life insurance contract (for example, a change in the address to send payment); (vi) a change made solely under the terms of any agreement (other than the life insurance contract) that is a part of the split-dollar life insurance arrangement if the change is non-discretionary by the parties and is made pursuant to a binding commitment (whether set forth in the agreement or otherwise) in effect on or before September 17, 2003; (vii) a change solely in the owner of the life insurance contract as a result of a transaction to which Section 381(a) applies and in which substantially all of the former owner's assets are transferred to the new owner of the policy. To date, the IRS has not expanded the examples of modifications that will not be considered material. It appears from this non-exclusive list and comment letters submitted to the IRS that only ministerial changes will be considered by the IRS not to be "material modifications."[15] Care must be exercised in identifying events regarding Equity SDAs entered into prior to September 18, 2003 to avoid inadvertently becoming subject to the split-dollar final regulations.

C. Mutually Exclusive Regimes

The split-dollar final regulations provide two mutually exclusive regimes for taxing Equity SDAs that are entered into or materially modified on or after September 18, 2003 based on policy ownership. The economic benefit regime under Treas. Reg. §1.61-22 applies to an Equity SDA if the employer is the owner of the policy. The loan regime under Treas. Reg. §1,7872-15 applies to an Equity SDA if the employee is the owner of the policy. In general, the

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[15] Several groups, including the American Bar Association's Section of Taxation, submitted comments on several additional changes that should not be considered a "material modification." In addition, split-dollar proposed regulations has specifically requested comments on whether a policy exchange under Section 1035 should be considered a "material modification," which was not addressed in the final regulations. It is the author's understanding that the omission of policy exchanges was intentional due to concern that replacement policies could be designed in a manner that could materially enhance the growth of grandfathered policy cash value.

person named as owner in the policy subject to an Equity SDA is treated as the "owner" for this purpose.[16] Non-Equity SDAs will be taxable as providing an economic benefit equal to the cost of current life insurance protection under Treas. Reg. §1.61-22(d) regardless of whether the policy is owned by the employer or the employee.

D. Economic Benefit Regime

The split-dollar final regulations treat the employer as providing the "value of the economic benefits" to the employee, reduced by the consideration paid by the employee.[17] The economic benefits provided under an Equity SDA in which the employer is the policy owner are the cost of current life insurance protection, the amount of policy cash value to which employee as "current access" and any other "economic benefits" that are provided to the non-owner."[18]

1. Current Life Insurance Protection

The amount of current life insurance protection is the total policy death benefit, reduced by the amount payable to the employer and the value of any policy cash value taxable to, or paid by, the employee.[19] The cost of this protection is then determined by multiplying it by "the life insurance premium factor designated or permitted in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter)."[20] To date, no such guidance has been published by the IRS, and it appears unlikely that it will be forthcoming due to difficulties in establishing standardized tables that take into account individual policy holder differences (such as sex and health status). As a result, taxpayers continue to rely on the interim guidance set forth in Notice 2002-8 for measuring the cost of current life insurance protection. The cost of the current life insurance protection is to be determined on the last day of the employer's taxable year, unless the parties agree to use the policy anniversary date as the valuation date.[21]

2. Current Access to Policy Cash Value

Any policy cash value to which the employee has "current access" will be treated as paid by the employer to the employee. Split-dollar final regulations broadly define "current access" as a situation in which (a) the employee has a "current or future right" to cash value that is (b) either (i) accessible by the employee, (ii) inaccessible to the employer or (iii) inaccessible to the employer's general creditors.[22] The preamble to the final regulation explains that "access" is to be broadly interpreted, and includes the right to take withdrawals, borrow against the policy or surrender the policy. Access also exists if policy cash value is available to the employee's

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[16] The split-dollar final regulations provide a special rule in the event that there are bona fide co-owners of a policy; each co-owner is treated as owning a separate policy if each co-owner holds all of the rights in its respective undivided interest in a policy.

[17] Treas. Reg. §1.61-22(d)(1).

[18] Treas. Reg. §1.61-22(d)(2).

[19] Treas. Reg. §1.61-22(d)(3)(i).

[20] Treas. Reg. §1.61-22(d)(3)(ii).

[21] Treas. Reg. §1.61-22(d)(5)(i). The date on which the SDA terminates is used to determine the amount of current life insurance protection for the year of the SDA's termination.

[22] Treas. Reg. §1.61-22(d)(4)(ii).

creditors or the employee can pledge policy cash value. The preamble also provides that state creditor protection laws (which may protect policy cash value from the employer's creditors) will cause policy cash value to be currently accessible if the employee has a current or future right to policy cash value.[23] In determining policy cash value, the final regulations require taxpayers to disregard surrender charges[24] and any "artifice or device"[25] used to understate policy cash value. Given this broad definition of "current access," few, if any, Equity SDAs have been structured after September 17, 2003 under the economic benefit regime using endorsement split-dollar.

3. Amounts Received under the Policy

The split-dollar final regulations provide that any amount provided under a policy subject to the economic benefit regime is to be treated as though paid by the insurer to the employer, and then by the employer to the employee.[26] Amounts distributed from the policy are taxable to the employer under the rules set forth in Section 72 of the Code.[27] As such, a policy loan taken by the employer is not a taxable distribution (except in the case of a modified endowment contract). However, loan proceeds will be taxable to the employee if (i) the proceeds are distributed directly to the employee, (ii) the employee would not expected to repay or (iii) the "the non-owner's [employee's] obligation to repay the loan to the owner is satisfied or is capable of being satisfied upon repayment by either party to the insurance company."[28]

4. Investment in the Contract and Employer Deductions

The split-dollar final regulations provide that only the employer has an "investment in the contract" with respect to a policy subject to an SDA covered under the economic benefit regime.[29] As a result, the employee does not have any basis in the policy for purposes of any subsequent distribution, and the employer will have taxable income equal to any amount paid by the employee for current life insurance protection.[30] No premium payment or current life insurance protection benefit that is taxable to the employee is deductible by the owner during the term of the SDA.[31]

5. Taxation of Policy Death Benefits

Policy death benefits under the economic benefit regime are excludible from income under Section 101 of the Code to the employee's beneficiary only to the extent that the employee has

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[23] *See also* Treas. Reg. §1.61-22(d)(6) (Example 2) (illustrating taxation when policy cash value is inaccessible to the employer's creditors).

[24] Treas. Reg. §1.61-22(d)(4)(i).

[25] Treas. Reg. §1.61-22(d)(5)(iii).

[26] Treas. Reg. §1.61-22(d)(e).

[27] Treas. Reg. §1.61-22(d)(e)(i).

[28] Treas. Reg. §1.61-22(d)(e)(ii).

[29] Treas. Reg. §1.61-22(f)(2).

[30] Treas. Reg. §1.61-22(f)(2)(ii).

[31] Id.

paid for or taken into account current life insurance protection in prior years.[32] As a result, the employee's failure to report current life insurance protection as income in prior years would result in the policy proceeds being treated as taxable compensation income to the beneficiary.

6. Policy Transfers

In general, a transfer of a life insurance policy (or an undivided interest therein) under economic benefit regime results in compensation income equal to the fair market value of the policy less (i) the amount paid by the employee to obtain the policy and (ii) the economic benefits of the SDA previously reported as taxable income (other than current life insurance protection).[33] The policy's fair market value for this purpose is the policy cash value and "the value of all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than the value of current life insurance protection."[34] Taxation on policy transfer to the employee under the economic benefit regime will be delayed until the lapse of any substantial risk of forfeiture under Section 83.[35]

E. Loan Regime

The loan regime under the split-dollar final regulations applies if the employee is the owner of the policy. A payment is treated as a "split-dollar loan" under the loan regime if (i) a payment is made directly or indirectly by the employer to the employee (including a payment by the employer to a life insurance company), (ii) the payment is a loan under general federal tax law principles or alternatively, a "reasonable person" nevertheless would expect the payment to be repaid in full to the employer, and (iii) repayment is to be made from or secured by either the policy's death benefit or its cash value.[36] The "reasonable person" standard allows for non-recourse Equity SDAs to be treated as "split-dollar" loans even if the policy cash surrender value is less than the cumulative premiums that the employer is entitled to recover upon termination. A split-dollar loan will result in imputed compensation income to the employee if it is a "below-market loan" under Section 7872 of the Code.

1. Below-Market Loans

A "below-market loan" is a loan with an interest rate below the AFR that applies to the split-dollar loan. If a split-dollar loan is a below-market loan, Section 7872 will generally treat the below-market loan as consisting of three transactions:[37] (i) a loan issued to the employee with an interest rate equal to the AFR appropriate to the loan, (ii) a payment of compensation to the

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[32] Treas. Reg. §1.61-22(f)(3)(i).

[33] Treas. Reg. §1.61-22(g). Previously reported taxable amounts cannot be used to offset gain on transfer of a policy if applied previously to a policy distribution to the employee. Id.

[34] Treas. Reg. §1.61-22(g)(2).

[35] Treas. Reg. §1.61-22(g)(3).

[36] Treas. Reg. §1.7872-15(a)(2).

[37] Sometimes a policy subject to an Equity SDA will be owned by an irrevocable life insurance trust established by the employee. In that case, the split-dollar loan will be recharacterized as two back-to-back loans: a loan by the employer to the employee, and then a loan by the employee to the irrevocable life insurance trust. Treas. Reg. §1.7872-15(e)(2).

employee to the extent that adequate interest (based on the appropriate AFR) is not charged to the employee, and (iii) an interest payment by the employee that is income to the employer.[38] Usually there is no net tax consequence for the employer, as the employer may deduct the imputed interest income that was deemed paid to the employee as compensation income. However, the employee will not be entitled to an offsetting interest deduction under the split-dollar final regulations. While Section 7872 generally provides an exception for de minimis loans,[39] this exception does not apply to split-dollar loans.[40] Whether a split-dollar loan will result in a below-market loan, and the timing and amount of any imputed compensation income, will depend on whether the split-dollar loan is a "term loan," a "demand loan," or a "hybrid loan."

2. Demand Loan

The split-dollar final regulations defines a demand loan as one that is payable in full at any time on the demand of the lender (or within a reasonable time after demand).[41] A "demand loan" is tested for sufficiency by comparing the loan interest rate to the blended AFR published each July during the term of the Equity SDA.[42] If the stated interest rate is less than the blended AFR, then the split-dollar loan is a below-market loan subject to taxation under Section 7872. The imputed compensation to the employee is equal to the amount of the split-dollar loan amount multiplied by the AFR less the stated interest rate, if any. Consistent with Notice 2002-8, each premium payment is treated as a separate "split-dollar loan."

3. Term Loan

A "term loan" includes any loan that is not a demand loan or a hybrid loan (as discussed below). In general, a loan that is repayable after a fixed period of time (such as a stated number of years) without any restrictions (such as continued employment with the employer) will be a term loan. A "term loan" is tested for sufficiency by comparing the AFR that's applicable to the Equity SDA to the loan's stated interest rate.[43] The short-term AFR is used for a loan with a term of three years or less, the mid-term AFR is used for a loan with a term between three and nine years, and the long-term AFR is used for a loan with a term greater than nine years.[44] If the present value of a split-dollar loan discounted at the applicable AFR is less than the amount of the initial loan, the arrangement is a below-market loan subject to Section 7872, and the difference is compensation income to the employee.

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[38] Section 7872(a)(1) of the Code. The split-dollar final regulations also provide that any payment to the employer from the death benefit proceeds of a loan is not excludable from income under Section 101(a). However, the employer will not have any taxable income to the extent that its recovery is limited to its premium payments under general income tax principles (i.e., recovery of its basis).

[39] Section 7872(c)(3) of the Code.

[40] Treas. Reg. 1.7872-15(a)(3).

[41] Treas. Reg. 1.7872-15(b)(2).

[42] Treas. Reg. §1.7872-15(e)(3).

[43] Treas. Reg. §1.7872-15 (e)(4)(i). *See* Treas. Reg. §1.7872-15(3)(4)(iii) for rules used to determine the "term" of a split-dollar loan which is a "term loan."

[44] Section 7872(f)(2) of the Code. These AFRs are published monthly under Section 1274(d) of the Code.

4. Hybrid Loan

The split-dollar final regulations provide hybrid loan treatment in the compensation context for loans payable at the employee's death, loans payable at the earlier of death or a stated term and loans payable at the earlier of a lapse of a substantial risk of forfeiture or a stated term. A "hybrid loan" is treated as a split-dollar term loan for purposes of determining whether the loan provides for sufficient interest to avoid being treated as a below-market loan. If a hybrid loan is determined to be a below-market loan, the foregone interest is treated as compensation income paid to the employee and re-transferred as an interest payment to the employer annually (as opposed to being reported all in the year of the split-dollar loan).[45]

5. Non-Recourse Split-Dollar Loans and the Contingent Payment Rule

As noted above, most Equity SDAs are non-recourse (i.e., the employer does not have a right to collect principal and interest from the employee's personal assets). All other things being equal, a greater risk of nonpayment exists with a non-recourse obligation as compared to a recourse obligation. The final split-dollar regulations reflect this reality by providing a special "contingent payment" rule (as discussed below) with respect to non-recourse obligations unless the parties to the Equity SDA have each timely filed a written representation to the IRS that a reasonable person would expect the loan to be repayable in full to the employer.[46] It is advisable for taxpayers to obtain life insurance projections to support this representation in light of any planned policy withdrawals or loans. Both parties must sign this representation with respect to the initial split-dollar loan under an Equity SDA so that they can each file it with their respective tax returns covering the taxable year in which this loan is made.[47] A copy of this representation should also be included each year that there are subsequent split-dollar loans under an Equity SDA (assuming that this representation remains accurate).[48]

The contingent payment rule provides a complicated set of requirements to determine the tax consequences under a so-called contingent split-dollar loan. In general, the employer is required to establish a "projected payment" schedule for each contingent payment, which will typically result in a significant discount of the anticipated payments when testing for a below-market loan.[49] Applying the below-market rules to a smaller number of projected payments will ordinarily result in a much larger up front tax obligation to the employee as compared to the situation in which it is assumed that the employee will make all scheduled payments of principal and interest. If payments under the split-dollar loan are actually made in advance of the projected payment schedule, a deduction will be available to the employee that is intended to put

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[45] Treas. Reg. §1.7872-15(e)(5).

[46] Treas. Reg. §1.7872-15(d)(2)(i).

[47] Treas. Reg. §1.7872-15(d)(2)(ii). The representation must include the names, addresses, and taxpayer identification numbers of the borrower, lender, and any indirect participants. Id.

[48] Id.

[49] Treas. Reg. §1.7872-15(j)(3). Specifically, the split-dollar final regulations provide that "[t]he projected payment for a contingent payment is the lowest possible value of the payment. . . that produce[s] a yield that is not less than zero. If the projected payment schedule produces a negative yield, the schedule must be reasonably adjusted to produce a yield of zero." Id.

the employee in approximately the same position as if there had been no initial taxation under the contingent payment rule.[50]

6. Employer Subsidy for Interest Payments

The split-dollar final regulations include an anti-abuse rule designed to penalize an employee when the parties to an Equity SDA seek to avoid below-market loan status by providing a stated interest rate that will effectively be paid by the employer. The stated rate of interest in a split-dollar loan will be disregarded if "all or a portion of the interest is to be paid directly or indirectly by the lender (or a person related to the lender)." Disregarding stated interest may result in the split-dollar loan becoming a below-market loan, thereby resulting in imputed compensation income under Section 7872. In addition, the employee will also be subject to tax on the actual income from the other payment that is linked to the split-dollar loan.

Whether a split-dollar loan is "sufficiently independent" from other payments being made by the employer to the employee is determined based on all the facts and circumstances.[51] For example, stated interest must be disregarded if the employer establishes a nonqualified deferred compensation plan in connection with an Equity SDA, and the payment date under the this plan coincides with the date when the employee must pay interest to the employer.[52] On the other hand, a fully vested nonqualified deferred compensation plan established a few years before the employer makes a split-dollar loan should not result in the employer being treated as if it paid interest on the split-dollar loan.[53] It is unclear whether a discretionary decision by the employer after establishing an Equity SDA to pay a bonus in an amount equal to the stated interest or to increase the employee's compensation from time to time will trigger this rule.

The split-dollar final regulations also provide a disincentive for the employer to waive or forgive interest payments at a later time. As one would expect, waived or forgiven interest payments are treated as compensation paid to the employee that is then transferred back to the employer as an interest payment.[54] This amount is then increased by a so-called deferral charge, which is equal to the underpayment of tax interest penalty and is treated as transferred to the employee as compensation income and then received by the employer as interest income.[55]

7. Reporting and Withholding

An employer is not required to withhold income taxes with respect to any imputed compensation to an employee under a split-dollar loan. However, imputed compensation to an employee under Section 7872 with respect to a split-dollar loan is treated as taxable wages for FICA purposes. With respect to a demand loan, the imputed compensation is deemed to be transferred by the employer to the employee on the last day of the calendar year. With respect

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[50] Treas. Reg. §1.7872-15(j) (4).

[51] Id.

[52] Treas. Reg. §1.7872-15(a)(4)(ii) (Example 1).

[53] Treas. Reg. §1.7872-15(a)(4)(ii) (Example 2).

[54] Treas. Reg. §1.7872-15(h).

[55] Treas. Reg. §1.7872-15(h)(4).

to a term loan, the imputed compensation is deemed to be transferred at the time the loan is made.

The proposed regulations to Section 7872 applicable to all below-market loans provide that an employer is required to attach a statement to its income tax return for any year in which the employer either has interest imputed under Section 7872 or claims a deduction for compensation deemed to be transferred to an employee under Section 7872. The statement must: (i) explain that it relates to an amount includible in income or deductible because of Section 7872; (ii) provide the name, address and taxpayer identification number of the employee; (iii) specify the amount of imputed interest income and the amount and character of any item deductible because of Section 7872 (i.e. wages for a compensation loan); and (iv) describe how the imputed amounts under Section 7872 were computed.

Similarly, the employee is required to attach a statement to his or her income tax return in any year in which he or she had income from an imputed transfer under Section 7872. The statement requires the same information as the employer statement noted above, except that the employee reports his or her deemed compensation in lieu of the employer information under item (iii) above. The imputed compensation income should be reported on Form W-2 for employees and on Form 1099-MISC for an independent contractor.

V. Section 409A and Split-Dollar Life Insurance Arrangements

In October 2004, Congress amended the Code by adding a new Section 409A. Section 409A provides that unless a "nonqualified deferred compensation plan" complies with various rules regarding the timing of distributions, all amounts deferred under the plan for the current year and all previous years become immediately taxable, plus a 20% addition to tax and premium interest tax, to the extent the compensation is not subject to a "substantial risk of forfeiture" and has not previously been included in gross income.[56] The result of these restrictions is that most of the details under a nonqualified deferred compensation arrangement must be in writing and set forth in the plan from the beginning unless there is an available exception.[57] Subsequent changes to the time or form of payment can be made only under limited and tightly restricted circumstances.

A. General Rules

In general, distributions under a nonqualified deferred compensation plan can only be payable upon one of six circumstances:

(1) the service provider's (e.g. the employee's) separation from service;

(2) the service provider's becoming disabled;

(3) the service provider's death;

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[56] A full discussion of Section 409A is outside the scope of this outline.

[57] See Treas. Reg. §1.409A-1(c) (setting forth the requirements that must be set forth in a nonqualified deferred compensation plan).

(4) a fixed time or schedule specified under the plan;

(5) a change in ownership or effective control of the corporation, or a change in the ownership of a substantial portion of the assets of the corporation; or

(6) the occurrence of an unforeseeable emergency.

Section 409A prohibits the acceleration of the time or schedule of benefits under a nonqualified deferred compensation plan except for certain limited exceptions.

The scope of Section 409A is far reaching due to the broad definition of what is a "deferral of compensation." A deferral of compensation will occur when an employee "has a legally binding right during a taxable year to compensation that … is or may be payable to (or on behalf of) the service provider in a later taxable year unless an exemption is available."[58] There are exemptions for certain types of compensation that would otherwise fall within this definition, including: qualified plans (e.g. 401(k), 403(b), and 457(b) plans), "bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan," and welfare benefits excluded from gross income. In addition, payments that are made within two and one-half months of the year in which the deferred compensation is no longer subject to a substantial risk of forfeiture are exempt from Section 409A under the so-called "short-term deferral" rule.[59]

A significant exemption to Section 409A is also available for so-called grandfathered benefits.[60] Amounts of deferred compensation that are both "earned and vested" as of December 31, 2004 as well as earnings on those amounts will not be subject to Section 409A unless there is a subsequent "material modification" of the nonqualified deferred compensation plan. A material modification exists if a benefit or right existing as of October 3, 2004 is "materially enhanced or a new material benefit or right is added, and such material enhancement or addition affects amounts earned and vested before January 1, 2005."[61] Such material benefit enhancement or addition is a material modification whether it occurs pursuant to an amendment or to the service recipient's exercise of discretion that is inconsistent with the terms of the plan.[62]

Notice 2007-86 provides employers a one time opportunity to change the time and form of payments under nonqualified deferred compensation plans in order to comply with Section 409A or, in some instances, become exempt from Section 409A. The deadline for making these changes is December 31, 2008. In addition, plan documents providing a deferral of compensation *must be* amended by December 31, 2008 in order to avoid a violation of Section 409A. Final regulations interpreting Section 409A become effective on January 1, 2009, and taxpayers will not be able to rely on a "reasonable, good faith interpretation" of Section 409A after December 31, 2008.

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[58] Treas. Reg. §1.409A-1(b)..

[59] Treas. Reg. §1.409A-1(b)(4).

[60] Treas. Reg. §1.409A-6.

[61] Treas. Reg. §1.409A-6(a)(4).

[62] Id.

B. Notice 2007-34

In April 2007, the IRS issued Notice 2007-34, which provides guidance regarding the application of Section 409A to split-dollar life insurance arrangements.[63] In general, a split-dollar life insurance arrangement provides a "deferral of compensation" if "under the terms of the arrangement and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year . . . to *compensation* that . . . *is or may be included* in the income of the service provider [the employee] in a later year." . . (emphasis added).[64] Notice 2007-34, identifies what types of SDAs are subject to Section 409A, provides standards for determining the portion of an Equity SDA that is grandfathered from Section 409A, and permits certain modifications to comply with Section 409A without losing favorable tax treatment under Notice 2002-8.

C. Split-Dollar Life Insurance Arrangements Exempt from Section 409A

SDAs that only provide for "death benefits" to or for the benefit of the service provider are excluded from Section 409A. As a result, Non-Equity SDAs in which the employee does not have any "current access" to policy cash value should be exempt from Section 409A. The employer's obligation to pay premiums paid under an SDA that are allocable to the cost of one-year term life insurance protection under IRS guidance should also be exempt from Section 409A as a death benefit. An unaddressed question is whether an Equity SDA can be converted into a Non-Equity SDA prior to 2009 in order to avoid Section 409A. Notice 2007-86 generally grants an extension of time to amend agreements to either comply with, or become exempt from, Section 409A. However, the split-dollar final regulations provide that an Equity SDA cannot qualify for the death benefit by eliminating rights to policy cash value.

Notice 2007-34 also identifies two potential exemptions for SDAs in which the service provider has a policy equity interest. An Equity SDA that either qualifies under the "short-term deferral rule" (i.e., payment of compensation within two and one-half months after the taxable year in which a substantial risk of forfeiture lapses) or as a "split-dollar loan" will not be subject to Section 409A. Most (if not all) equity split-dollar life insurance arrangements are not subject to a substantial risk of forfeiture and therefore will not qualify as a short-term deferral. As a result, Equity SDAs established before September 18, 2003 that are not structured as split-dollar loans will be treated as a deferral of compensation subject to Section 409A.

Part III.C. of Notice 2007-34 does warn that "*in certain situations*" . . . split-dollar loans may give rise to deferrals of compensation for purposes of section 409A "if amounts on a split-dollar loan are waived, cancelled or forgiven." No further explanation is provided in Notice 2007-100 regarding this type of situation, although it appears that the IRS is reserving the right to take the position that the termination of a split-dollar loan without full repayment may be tantamount to deferral of compensation.

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[63] Notice 2007-34 was issued on the same day as the Section 409A final regulations.

[64] Notice 2007-34, Part III.B.

D. Loss of the "No Inference" Rule for Compensation Subject to Section 409A

Section III.D of Notice 2007-34 states that an Equity SDA grandfathered under Notice 2002-8 "provides for deferred compensation for purposes of Section 409A if, under the terms of the arrangement and the relevant facts and circumstances the Employee has a legally binding right during the taxable year to compensation that pursuant to the terms of the arrangement is payable to (or on behalf of) the Employee in a later year *(for example upon termination of the split-dollar arrangement)*." This statement implies that the IRS will consider policy equity in a Equity SDA that is not grandfathered from Section 409A to be taxable on termination as a form of nonqualified deferred compensation. The "no inference" language in Notice 2002-8 that allows practitioners to take the position that there is no tax on policy equity upon termination of an Equity SDA is not repeated in Notice 2007-34. The author understands that the IRS will take the position that policy equity that is not grandfathered from Section 409A will be taxable upon termination (or earlier in the event of noncompliance with Section 409A).

E. Grandfathered Amounts under an Equity SDA

The loss of the "no inference" language makes it important to determine whether all or a portion of the Equity SDA will be treated as grandfathered from Section 409A. Consistent with the rules applicable to all nonqualified deferred compensation plans, Notice 2007-34 provides for policy equity (and future increases in that equity) to be treated as grandfathered from Section 409A if the employee had a legally binding right to be paid that amount before January 1, 2005, and the right to the amount was earned and vested as of that date. In addition, policy cash value attributable to premiums paid after December 31, 2004 will also be grandfathered if the employee had a legally binding right to be paid those premiums and this right was earned and vested by December 31, 2004. A common example in the compensation context in which this may occur is in the context of a so-called SERP swap, in which the employee exchanged a right to receive nonqualified deferred compensation for an Equity SDA that provided for continued premium payments and retention of policy cash value regardless of when the employee terminates employment with the employer. On the other hand, premium payments on and after January 1, 2005 (and all related policy cash value) will not be grandfathered if the employer was required to make these payments only if the employee continued to provide services. If an Equity SDA is only partially grandfathered from Section 409A, Notice 2007-34 permits the employer to use any "reasonable method" to allocate policy cash value to grandfathered amounts, so long as the method does not allocate "a disproportionate amount of policy costs and expenses to the non-grandfathered benefit."

F. Equity SDA Compliance with Section 409A

It is the author's experience that very few non-grandfathered Equity SDAs that are not reported under the loan regime will comply with Section 409A. Common provisions in Equity SDAs that are problematic under Section 409A include (i) allowing either the employer or the employee to terminate the Equity SDA at any time (which can be particularly difficult to address with respect to a majority stockholder situation); (ii) terminating the Equity SDA if the employee did not make required premium payments; and (iii) permitting the employee to make policy withdrawals or policy loans at any time subject to not impairing the employer's collateral

assignment. All of these type of powers and rights must be removed or modified consistent with the permissible distribution requirements before January 1, 2009 in order to comply with Section 409A.

G. Modifications to Comply with Notice 2007-34 without Losing Grandfathered Status under Notice 2002-8

Notice 2007-34 provides rules that allow parties to an Equity SDA to make changes that are necessary to bring the arrangement into compliance with Section 409A (or to become exempt from Section 409A) without becoming subject to the split-dollar final regulations. This relief is available only if all of the following requirements are satisfied:

1. One of the parties to the Equity SDA has determined based on a reasonable application of Section 409A, the regulations and other guidance that Section 409A is applicable to the Equity SDA; and that the SDA does not comply with the requirements of Section 409A.

2. One of the parties to the Equity SDA has determined based on a reasonable application of Section 409A, the regulations and other guidance that the modification, either by itself or as part of a number of other related actions, causes the Equity SDA to either comply with Section 409A or to qualify for an exemption from Section 409A.

3. The modification consists solely of one or more of the following changes to either comply with Section 409A or that result in Section 409A no longer being applicable to the Equity SDA: (a) changes to the applicable definitions; (b) changes to the payment timing requirements; and (c) changes to the conditions under which all or part of the benefit under the SDA will be forfeited.

4. The modification establishes a time and form of payment, or potential times and forms of payment that are consistent with times and forms of payment under which the benefits could have been paid under the terms of the Equity SDA before the modification.

5. The modification cannot materially enhance the value of the benefits to the employee under the Equity SDA.

If an amendment to comply with Section 409A is not made in compliance with this transitional guidance, the Equity SDA established using the collateral assignment method will immediately be treated as a split-dollar loan, with any policy equity becoming immediately taxable upon conversion to the loan regime.