Split Dollar Life Insurance Arrangements and IRS Notice 2001-10

Apr 01 2001

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On January 9th of this year, the Internal Revenue Service issued Notice 2001-10 to announce the Service's position involving split-dollar arrangements. The Notice is intended to clarify prior rulings issued by the Internal Revenue Service regarding the taxation of split-dollar arrangements and provide taxpayers with interim guidance pending further publication. The Notice primarily addresses split-dollar arrangements between employers and employees; however, the Internal Revenue Service believes the same principals generally govern the tax treatment of family split-dollar arrangements.

Traditional Split-Dollar Arrangements

A split-dollar arrangement is one in which a life insurance policy is owned by two parties, the employer and the employee. Each premium payment is divided into a portion allocable to the policy's increasing cash value and a portion allocable to the policy's death benefit. The death benefit is often referred to as the term insurance portion of the policy. Under the traditional split-dollar arrangement, the employee owns the death benefit and the employer owns either the cash value of the policy, or the lesser of the premiums paid by the employer and the cash value. If the employer pays the entire premium, the portion allocable to the death benefit and owned by the employee is treated as compensation to the employee.

How the Notice Affects Traditional Arrangements

Split-dollar arrangements are affected by this Notice in two ways. First, after 2001 the Internal Revenue Service will no longer accept the "PS-58" rates as a proper measure of the value of current life insurance protection for federal tax purposes and has introduced a new table. PS-58 refers to a schedule issued by the Service in 1958 which lists the percentage of each premium attributable to the term insurance element owned by the employee, based on employee age groups. In its place the IRS has issued an interim table and will continue to accept an insurer's published rates under certain circumstances. As a practical matter, the PS-58 rates tend to be significantly higher than the actual rates issued by insurance companies for term insurance. Consequently, because the PS-58 rates are not mandatory they are not currently used in most ordinary split-dollar arrangements. In most instances, therefore, the first action taken by the Internal Revenue Service regarding these rates, will not significantly affect split-dollar arrangements.

The Notice also affects the taxation of equity split-dollar arrangements. In an equity split-dollar arrangement, upon the "rollout" of a policy (transfer of the policy to the employee) or the death of the employee, the employer receives only the premium payments that the employer has paid towards the policy, but no other payments. The Internal Revenue Service now views this arrangement as a loan or a series of loans of the employer's portion of the premium payments. Where there is a below market interest rate on the loan, or no interest rate, the IRS believes that the employee is benefited and should be taxed on the employer's foregone interest as compensation income.

For future equity split-dollar arrangements, the employer and the employee can choose to treat the employer's premiums as interestfree loans with the inputed interest taxed to the employee annually if the following three conditions are met: 1) the characterization is not inconsistent with the substance of the agreement, 2) the parties' actions are consistent with the characterization and 3) all of the employee's economic benefits are accounted for in a manner consistent with the characterization. If they do not choose the loan characterization, then in addition to the compensation equal to the value of term insurance protection provided in each year paid by the employer, the employee will have compensation income to the extent that he or she has a vested interest in the cash surrender value of the policy, its "equity." The equity is measured as the difference, if any, between the premiums paid by the employer and the cash value of the policy. There is great uncertainty regarding the extent to which existing arrangements may be subject to the Notice, but if they are subject to the Notice, the Internal Revenue Service has stated that it does not intend to tax the equity until the split-dollar arrangement is terminated by the repayment of the employer's premiums.

Reverse Split-Dollar Arrangements

In a reverse split-dollar arrangement, the employer owns the death benefit and the employee owns the cash value. Typically, the PS-58 cost is used to value the death benefit to pass the greatest value to the employee at the least tax cost. The substitution of the new Table 2001 rates for the PS-58 rates may significantly impact the economics of these arrangements.

What Measures Should You Take

With regard to your existing split-dollar arrangements, we do not suggest that you terminate the split-dollar arrangements. The Internal Revenue Service has issued guidance only, and has indicated that further guidance may be forthcoming. Under these circumstances we believe it prudent to wait and determine what the Service's final position will be. When further guidance is published, we will advise you on any changes that might be necessary in order to continue the economic benefit of your split-dollar arrangements.
