Tax Law Changes Affecting Equity Split Dollar Life Insurance Arrangements

Nov 01 2003

Practice Area: Compensation and Benefits/ERISA

Introduction
The federal tax landscape governing split dollar life insurance arrangements has changed dramatically since the vast majority of those arrangements were designed and implemented. The Internal Revenue Service recently issued final regulations that apply to split dollar arrangements entered into or materially modified after September 17, 2003. Safe harbors are available to those who entered into split dollar arrangements prior to that date. One important safe harbor that is available for arrangements entered into before January 28, 2002 will expire on December 31, 2003. If you entered into a split dollar arrangement before September 17, 2003, we suggest that you review the arrangement with your insurance, legal and tax professionals in light of the new rules and the safe harbors. Split dollar arrangements take many forms. This Legal Update focuses on equity split dollar arrangements established by employers and employees as part of the employees' compensation.

How are equity split dollar arrangements structured?
Under one common arrangement, the employer pays most or all of the premiums on a life insurance policy and acquires an interest in the cash value and/or death benefit under the policy equal to the premiums paid. The employee or his beneficiary is entitled to the cash value or the death benefit in excess of the premiums paid by the employer. The cash value of the policy in excess of the employer's interest is the employee's "equity" in the policy.

The employer acquires its interest in the cash value or death benefit by either the "*endorsement*" method or the "*collateral assignment*" method. Under the *endorsement* method, the employer owns the policy on the employee's life and files an endorsement with the insurance company allowing payment of a stated dollar amount of death proceeds to be paid to the employee's designated beneficiary. Under the collateral assignment method, the employee owns the policy and executes an assignment giving the employer a security lien against the policy for the premiums paid. If the arrangement is terminated during the employee's life, the employee repays the employer the premiums that the employer paid over the years (usually from the cash value of the policy itself) and the collateral assignment is released. The employee ends up owning the residual cash surrender value of the policy, *i.e.*, the equity in the policy, free and clear. If the employee dies while the arrangement is in effect, the employer is reimbursed for its share of the premiums out of the death proceeds and the employee's designated beneficiary receives the balance.

How do the new regulations change the income tax treatment of split dollar arrangements?

Old Rules. Under the old rules, which still apply to policies issued on or before September 17, 2003, the tax treatment of premiums paid by an employer under a split dollar life insurance arrangement is the same whether the arrangement is structured under the *collateral* assignment model or the *endorsement* model. In either case, the employee either pays none of the premium, and is then taxed on the value of the current life insurance protection he receives each year, or the employee pays the portion of the premium equal to the value of the current life insurance protection provided to him and incurs no current tax liability. The employee pays no tax on the portion of the premiums paid by the employer that exceed the value of the employee's current life insurance protection under the policy.

There were two tax risks under the old rules: 1) the risk that when a collateral assignment arrangement is terminated and the employer releases its interest in the employee's life insurance policy the employee is taxed on the entire amount of his equity in the policy; or, alternatively, 2) the risk that annual increases in an employee's equity in the cash value of the policy is taxable every year. Neither the new regulations nor the safe harbors described below entirely remove either of these risks with respect to split dollar arrangements entered into before September 17, 2003 that continue after December 31, 2003.

New Regulations: Two Regimes. Under the new regulations, a split dollar arrangement entered into or materially modified after September 17, 2003 must be taxed under one of two mutually exclusive regimes: a loan regime or an economic benefit regime.

Loan Regime. The loan regime generally governs the taxation of new equity *collateral assignment* split dollar arrangements. The premiums paid by the employer (the non-owner of the policy) are treated as a series of loans made by the employer to the employee (the owner of the policy). If the employee is not required to pay the market rate of interest on the loans, he is taxed on the difference between the interest he pays (if any) and the interest that would be payable at the market rate. The employee is not taxed on the value of the life insurance protection he receives each year.

Economic Benefit Regime. The economic benefit regime generally governs the taxation of new *endorsement* arrangements. The employer (the owner of the policy) is treated as providing economic benefits to the employee (the non-owner of the policy). The employee is taxed on the value of the economic benefits received under the policy, reduced by any consideration paid by the employee to the employer. The value of the economic benefits for a year equals the value of the current life insurance protection provided to the employee, the amount of the policy cash value to which the employee has current access (or which is inaccessible to the employer or the employer's general creditors) that was not taxed in a prior year, and the value of any other economic benefits provided to the employee that were not taxed in a prior year.

What safe harbors are available for split dollar arrangements entered into before September 17, 2003?

Safe Harbor Regarding Taxation of Accrued Equity for Arrangements Entered into before January 28, 2002. In private letter rulings issued in the 1980s, the Internal Revenue Service held that a taxable event occurs when an *endorsement* split dollar arrangement is terminated and the employer transfers ownership of the life insurance policy to the employee. The employee is taxed on the net cash value of the policy, *i.e.* the cash surrender value less the amount of any premiums paid by the employee. In contrast, the IRS has never ruled on whether a taxable event occurs when a *collateral assignment* split dollararrangement is terminated and the employer releases its collateral assignment interest in the policy owned by the employee. The IRS has not ruled on this issue, but it has offered a safe harbor for split dollar arrangements entered into before January 28, 2002.

Under the safe harbor, if the employer has made premium payments and has received or is entitled to receive full repayment of all of its payments, the IRS will not assert that there has been a taxable transfer of property, *i.e.*, the accrued equity in the policy, to the employee upon termination of the arrangement if either:

- The arrangement is terminated before January 1, 2004, or
- For all periods beginning on or after January 1, 2004, all payments by the employer from the beginning of the arrangement (reduced by any repayments to the employer) are treated as loans for federal tax purposes.

The safe harbor has little or no value to an employee who has little or no accrued equity in the cash value of the insurance policy. Furthermore, it is difficult to gauge the value of the safe harbor to employees who do have accrued equity in their policies. By its terms, the safe harbor appears to apply to either an *endorsement* arrangement or a *collateral assignment* arrangement that meets the above criteria. If the safe harbor applies to *endorsement* arrangements, the employer could transfer the life insurance policy to the employee without tax. In that case, the employee under the *endorsement* arrangement would be able to avoid a tax that he would otherwise certainly incur. Yet, apparently under the theory that it sounds too good to be true, some believe that the safe harbor is not available to an employee in an endorsement arrangement.

The potential advantages of the safe harbor to an employee in a *collateral* assignment arrangement are even less clear. If the employee terminates the split dollar arrangement (not necessarily the policy) by December 31, 2003, he definitely will not be taxed on his accrued equity in the policy at the time that the arrangement terminates. But it is not clear that the employee *would* betaxed on his accrued equity upon termination of the arrangement without the safe harbor. It is possible that he would not be. That is, it is possible that the IRS or a court would hold that no taxable event occurs upon the termination of a collateral split dollar arrangement (irrespective of the safe harbor) because no transfer of property occurs when the employer releases its interest in the policy. The employee owns the policy throughout the duration of the arrangement. Logically, there can be no taxable transfer if there is no transfer. Nevertheless, the fact that the IRS has issued this safe harbor may be an indication that it intends to attempt taxation of equity in *collateral* assignment split dollararrangements, either as the equity accrues year by year or when the arrangement is terminated.

An employee in a split dollar arrangement should assess his own facts and circumstances, including his tolerance for tax risk, when deciding whether or not to take advantage of this safe harbor.

Safe Harbor for Continued Reporting of Economic Benefit. For split dollar arrangements entered into on or before September 17, 2003, and not materially modified after that date, the IRS will not assert that there has been a transfer of property to the employee because of the termination of the arrangement as long as the parties continue to treat and report the value of the life insurance protection as an economic benefit to the employee. The safe harbor applies without regard to the remaining level of the employer's interest in the policy. If this safe harbor applies to endorsement arrangements (which is not clear), it presents an opportunity for the employee to avoid a tax that would otherwise apply when the life insurance policy is transferred from the employer to the employee. The usefulness of this safe harbor to an employee under a *collateral assignment* arrangement depends on whether, without the safe harbor, the termination of the arrangement results in a taxable transfer of property when the employer releases its collateral assignment interest in the life insurance policy. It might be argued that no such taxable transfer occurs and that the safe harbor is therefore unnecessary.

Safe Harbor Relating to Annual Increases in Accrued Equity. It has never been clear whether an employee under a split dollar arrangement is taxed on annual increases in his accrued equity in the cash value of the life insurance policy. Under a safe harbor for split dollar arrangements entered into on or before September 17, 2003 and not materially modified after that date, such annual increases in the employee's equity in the policy will not be taxed under section 83 of the Internal Revenue Code (the "Code"), dealing with the taxation of property transferred for the performance of services. This is a limited safe harbor, however, because the IRS has left the door open to taxing such increases in the employee's accrued equity under other provisions of the Code, such as section 61, the general definition of taxable income.

Election of Loan Treatment. The parties to a split-dollar arrangement entered into on or before September 17, 2003, and not materially modified after that date, may elect to treat the employer's premium payments as loans to the employee. If this election is made, all premium payments from the start of the arrangement to the first year in which the payments are treated as loans would be treated as loans entered into at the beginning of that year.

What other issues might affect decisions regarding split dollar arrangements?
Whether an Equity Split Dollar Arrangement Constitutes Deferred Compensation for Tax Exempt and Government Entities. Under Code section 457(f), employees of tax exempt organizations and governments are taxed on nonqualified deferred compensation when there is no substantial risk of forfeiture of the rights to the compensation. It has never been clear whether equity split dollar arrangements constitute deferred compensation governed by Code section 457. In the preamble to the new regulations, however, the IRS states that an equity split-dollar life insurance arrangement governed by the economic benefit regime constitutes a deferred compensation arrangement for purposes of Code section 457. The preamble has no legal force, but it indicates how the IRS would probably rule on this issue.

Whether a Collateral Assignment Split Dollar Arrangement Is Treated as a Loan under the Sarbanes-Oxley Act. The Sarbanes-Oxley Act prohibits certain loans from a public company to or for any director or executive officer. It is not clear whether employer paid premium payments under a *collateral* assignment split dollar arrangement are considered loans for purposes of the Sarbanes-Oxley Act. Many public companies are taking the conservative approach, however, and have suspended employer premium payments under *collateral assignment*arrangements until the SEC issues further guidance. A conservative approach is warranted because violations of Sarbanes-Oxley subject the parties to criminal and civil penalties.

What should we do with split dollar arrangements entered into before September 17, 2003?
Employers. An employer that sponsorsa split dollar program for employees should review the program in light of the new regulations and the safe harbors. For example, an employer may want to close the program to new participants, but let each employee with an arrangement established before September 17, 2003 decide whether he wants to continue the arrangement and, if he does, whether he wants to take advantage of the safe harbors discussed above. In many cases, the employer would want to explore alternative death benefit or deferred compensation programs for the affected employees. Of course, like any other management decision, the employer's decision regarding the future of its split dollar program must be made in the context of the employer's general circumstances, e.g., budget considerations, whether the employer has Sarbanes-Oxley or section 457 concerns and employee relations issues.

Employees. Essentially, the options available to an employee are to terminate, freeze or continue the split dollar arrangement. If the arrangement is terminated, the employee must decide whether he also wants to terminate (cash in) the policy. If a collateral assignment arrangement is frozen, all future premium payments would be made by the employee but the employer would continue to have a collateral assignment interest in the policy for past premiums. If a collateral assignment arrangement is continued, the employee must decide whether he wants to treat future premium payments made by the employer as loans.

As noted above, the IRS left open the possibility that an employee could be taxed on his equity in a split dollar life insurance policy – either annually as the equity grows, or all at once when the arrangement is terminated. This is not a current risk for an employee who does not yet have any equity in his policy, *i.e.*, the cash value of the policy is less than the premiums paid by the employer. In that case, the employee may want to continue the split dollar arrangement. If, in the future, the IRS or a court holds that an employee may be taxed on the equity that an employee accrues under a split dollar arrangement, the employee may decide to terminate the arrangement or elect the loan treatment at that time. In contrast, an employee who has a substantial amount of equity in his split dollar arrangement may want to terminate the arrangement by December 31, 2003 to avoid the risk that the accrued equity will be taxed if the arrangement is terminated at a later date.

Certain changes to a life insurance policy in the first 15 contract years may have other ramifications under the insurance tax laws. Consequently, we suggest that employees consult with their insurance carrier before making any withdrawals or other changes under the contract within the first 15 years.
