

IRS Memo Attacks "Equity" Split-Dollar Life Insurance

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A recent IRS memorandum jeopardizes the use of "equity" split-dollar life insurance as a deferred compensation benefit. Although the dust has not yet settled, both taxable and tax-exempt employers should reassess the risks associated with these programs.

For years, taxable corporations have used equity split-dollar life insurance as a method of providing tax-deferred compensation to highly paid employees. Increasingly, tax-exempt employers have implemented these programs for executives and physicians.

A split-dollar life insurance arrangement is a financing tool that permits an employee to acquire life insurance. In an "equity" split-dollar arrangement, the employer pays the premiums due on a whole-life insurance policy that insures the life of the employee and names the employee as the owner.

The employee, in turn, agrees to eventually repay the employer for the premium payments, securing this obligation by collaterally assigning the death benefit and the cash value of the policy to the employer. When employment terminates, the employee repays the premiums and the employer releases the collateral assignment.

Assuming the policy has been in place long enough, its cash value will exceed the amount of premiums paid. The excess of the cash value over the premiums paid represents the employee's "equity" in the policy.

The appropriate income-tax treatment of the employee's equity in this type of policy has been debated over the years. The IRS finally addressed this issue in Technical Advice Memorandum 9604001, issued last January.

One theory states that the employee is at all times the owner of the policy.

Therefore, once the employer is repaid the premiums and releases the collateral assignment, nothing of value passes to the employee. Under this theory, no taxable event takes place until the employee surrenders the policy.

Under another theory, the employee receives a current taxable economic benefit as soon as the cash value of the policy exceeds the total premiums paid. Each year thereafter, the employee has additional taxable income equal to the increase in the policy equity.

In its memorandum, the IRS agreed with the second theory, concluding that the equity build-up in the policy each year was taxable income to the insured. This conclusion jeopardizes the use of equity split-dollar insurance as a deferred compensation benefit.

Certain considerations mitigate the impact of the IRS memorandum. First, a Technical Advice Memorandum generally does not receive a high level of review at the IRS. Second, it applies only to the case being reviewed. Third, and not surprisingly, the insurance industry has disagreed strongly with the memorandum.

Still, any employer considering an equity split-dollar program should proceed with caution. If the program does not effectively achieve its tax goals, the employer could face penalties and liability for failure to withhold adequate income and employment taxes. Employees, in turn, could face penalties for not reporting income.

An employer with an equity split-dollar program already in place should review the associated tax risks with its advisors.

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