

# legal & tax trends

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## MetLife®

### Split Dollar Life Insurance

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#### I. Introduction

In September 2003 the Service published the final regulations governing the taxation of split dollar life insurance arrangements, providing much needed clarity to an area that had been in flux. The purpose of this issue of *Legal & Tax Trends* is to present a general overview of split dollar, discussing its current tax treatment and the opportunities in using split dollar today. We felt the best way to present this material would be in a question and answer format. In Appendix we review the tax treatment of “grandfathered” split dollar policies. Appendix II we examines equity endorsement arrangements, a little known type of split dollar which is seldom seen today. Appendix III discusses the impact of Section 409A and how the rules regarding deferred compensation plans apply to split dollar life insurance. Appendix IV addresses the provision in Sarbanes Oxley Act that raised the issue as to whether the payment of a premium on a split dollar arrangement is a prohibited extension of credit to certain executives of publicly held companies. Appendix V focuses on how the COLI Best Practices Act and more specifically, Section 101(j) affects split dollar. Lastly Appendix VI summarizes how the Financial Accounting Standards Board changed the manner in which employers must account for split dollar life insurance arrangements that provide a “post retirement benefit”.

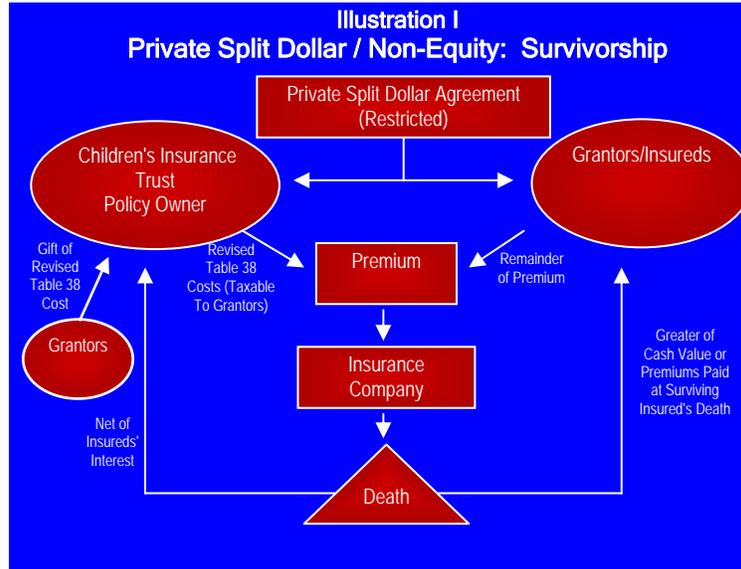
**1. What is split dollar?** Split dollar is simply a means by which two parties share the costs and benefits of a life insurance policy. Split dollar typically involves a business and a key employee. Split dollar, however, is more than an executive benefit as it can be used in many situations that do not involve an employer/employee relationship. Split dollar is generally most appropriate when one party (usually the business) has the cash to pay the premiums for life insurance and the other party (usually the key employee) has the need for life insurance. Depending upon the method of split dollar used, the policy owner may be the employer, the insured/employee or a third party.

Split dollar is not a type of life insurance nor is it a reason for buying life insurance; rather, it is a method of financing the purchase of life insurance. Although the 2003 Final Regulations on Split Dollar Life Insurance substantially changed the landscape, split dollar arrangements remain a viable and important planning tool for both the executive compensation and estate planning markets.

**2. Where are the opportunities for split dollar arrangements today?**

Split dollar is still attractive as an employee benefit where it is structured as non-equity, non-contributory endorsement split dollar. If the employer owns all of the cash values and pays the entire premium, then the taxation of the split dollar arrangement remains essentially unchanged. This type of endorsement split dollar arrangement can be used in conjunction with a supplemental executive retirement plan (SERP). These two benefits - the endorsement split dollar and the SERP - can be financed with a single life insurance policy. The life insurance policy is an attractive vehicle to informally fund for the employer's obligation under the SERP. Based upon the executive's personal performance and the company's profitability, the employer could credit the executive's "memorandum" account an amount equal to all (or a portion) of the policy's cash value. While the agreement could provide for vesting, the executive would not have any interest in the policy itself and consequently, would not be taxed until receipt. In combination, these two non-qualified benefits can be excellent tools to recruit, motivate and retain key executives.

Non-equity collateral assignment split dollar will also be used in the estate planning marketplace where it is often important to minimize the gift tax consequences from paying the premiums on a trust-owned policy. The value of the gift is the low economic benefit cost and not the premium itself. Survivorship split dollar is especially attractive as the Table 38 costs have been lowered to incorporate the lower Table 2001 rates. (See Illustration I) For these types of non-equity split dollar arrangements, it will be important to design an exit strategy in order to avoid any unpleasant tax consequences at rollout. That is, it will be critical to create a tax-efficient gifting strategy so that the irrevocable trust holding the life insurance policy has sufficient funds to repay the split dollar obligation from sources other than the policy itself.



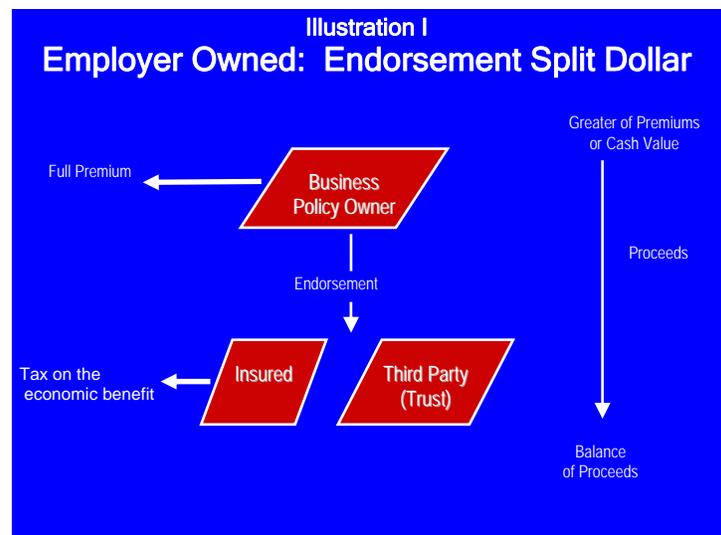
Lastly, split dollar may still be effective where there is a “C” corporation in a low (e.g., 15%) tax bracket to pay the premiums. In this situation, it will generally be advisable to treat the arrangement initially as non-equity collateral assignment split dollar, converting to a loan at the crossover point. In this way, the parties can enjoy the low economic benefit costs in the early years and then, after switching to a loan, all the employee equity can be insulated from taxation at rollout.

## II. Non-Equity Endorsement & Non-Equity Collateral Assignment Arrangements

### 1. What is a non-equity endorsement split dollar arrangement and when is it attractive?

Under a non-equity endorsement split dollar arrangement, the employer owns the policy and endorses a portion of the death benefit to the employee. The amount of the death benefit endorsed to the employee can be a fixed amount, a multiple of the employee's earnings or may simply be defined as the death benefit in excess of the cash values. Typically, the employer pays the full premium and the employee reports the value of the life insurance protection as income – the so-called "economic benefit" amount. This amount is measured by the IRS Table 2001 or the insurer's alternative term rates. At the employee's death, the employee's beneficiary receives the employee's portion of the death proceeds income tax-free and the employer receives the balance of the death benefit. (See Illustration I).

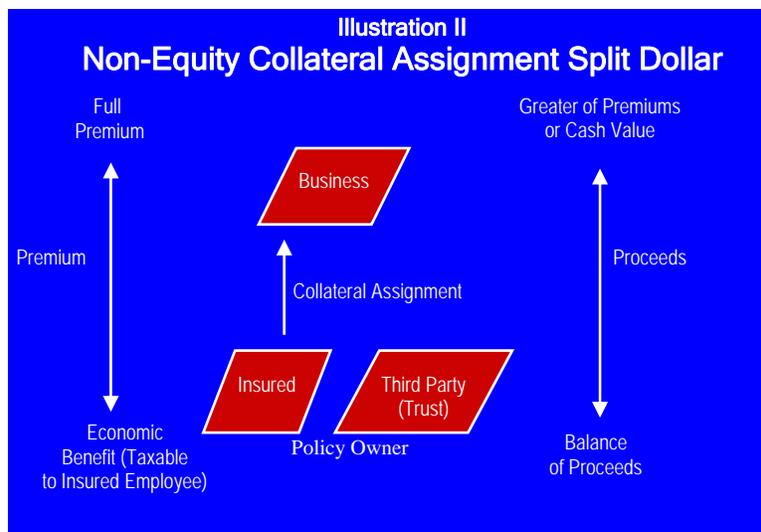
The endorsement split dollar arrangement is often used as a tool to recruit, retain and reward key employees. In addition, the cash values can be used to informally fund a supplemental executive retirement plan (SERP) for the key employee. At retirement, the employer can access the cash values in the policy to help pay the living benefit. A SERP agreement meeting the requirements of section 409A will need to be executed. This double benefit is a very attractive and cost effective way to retain a key employee.



**2. What is a non-equity collateral assignment split dollar arrangement, and when is it attractive?**

Under the non-equity collateral assignment method, the employee or third party owns the policy and collaterally assigns all of the cash value of the contract to the employer as security for the employer’s premium payments. In the event of the termination of the agreement, the employer is entitled to receive either (i) the policy’s cash value or (ii) the greater of the policy’s cash value or its premiums paid. (See *Illustration II*)

This method is often used when the policy is owned by a third party such as the employee’s irrevocable life insurance trust. The advantage of this approach is that upon termination of the split dollar arrangement, the release of the collateral assignment is not considered a transfer for purposes of the transfer for value rule. Another benefit is that it is possible through use of a restricted collateral assignment to remove the pure death proceeds from a majority shareholder’s estate for federal estate tax purposes.



Since non-equity endorsement and non-equity collateral assignment split dollar arrangements are both taxed under the economic benefit regime, questions regarding either method will be simultaneously addressed in this section

**3. Ownership of a split dollar arrangement is a defined term for tax purposes and may be different than what the contract says. Please explain.**

The final regulations will tax split dollar differently depending upon how the arrangement is structured. Generally, the ownership of the policy will determine which tax treatment applies. Employer or donor owned arrangements (i.e., endorsement) are governed by the economic benefit regime. Under the

endorsement method, the employee (donee) is taxed on the current life insurance protection and any other economic benefit provided to the employee (or donee). Employee or donee owned arrangements (i.e., collateral assignment) are taxed as a loan. The employer-paid premiums are treated as a series of loans by the employer to the employee. If the employee or donee does not pay adequate interest, interest will be imputed under section 7872 of the Code.

The regulations take the position that the taxpayers can, in essence, elect which regime will apply to the split dollar arrangement by their selection of one party or the other as the contract owner, i.e., the owner of record. The final regulations, however, provide two important exceptions to the general rule that the owner of record is the owner for tax purposes. First, under a non-equity collateral assignment split dollar arrangement that is entered in connection with the performance of services, the employer is treated as the owner of the contract. That is, if the only benefit available to the employee under the collateral assignment arrangement would be the value of the current life insurance protection, the Service will treat it like an endorsement split dollar arrangement. A similar exception applies to private split dollar arrangements. That is, the donor is treated as the owner of the life insurance contract under a non-equity collateral assignment split dollar arrangement if the only economic benefit available to the donee (e.g., irrevocable trust) would be the value of the life insurance protection.

#### ***4. How is the tax basis apportioned between the parties to a split dollar arrangement?***

Under the final regulations, the entire basis accrues in the hands of the owner of the contract. In the past, many taxpayers took the position that basis accrued between both parties, based upon their actual or deemed contributions to premium. Under the final regulations, the IRS treats the economic benefit portion of the arrangement as a kind of rent. That is to say, the non-owner (e.g., the donee) is renting the net death benefit from the owner (e.g., the employer or donor), and therefore basis accrues only in the hands of the owner.

For endorsement and non-equity collateral assignment arrangements, this means the employer will receive the entire basis in the contract. The cost of the arrangement will increase at termination to the extent the non-owner is bonused the policy. Historically, a bonus of the policy to a non-owner resulted in income tax on the cash surrender value of the contract less the non-owner's basis in the contract. Under final regulations, a bonus would result in income tax on the full cash value since the non-owner has no basis in the contract. Note that under the final regulations the value of a transferred policy is now the full cash value, not reduced by any surrender charges.

## **5. What is the tax impact of premium contributions by non-owners?**

Under the final regulations, the payment of the economic benefit by the non-owner (e.g., the employee) will result in income to the owner (e.g., the employer). Historically, the non-owner would often pay a portion of the premium equal to the economic benefit (called the premium offset amount). Most advisors took the position that this resulted in the employee having basis in the contract equal to the premium offset amount and the employer having basis in the contract equal to the balance of the premium. In keeping with the rent analogy, a payment by the non-owner is effectively a taxable rent payment to the owner. This lends a kind of symmetry to the regulations since under the final regulations the entire basis accrues in the hands of the owner. Parties to a split dollar arrangement should now consider using a non-contributory split dollar arrangement in lieu of a contributory arrangement whenever possible.

***6. An endorsement split dollar arrangement might provide for the owner (e.g., the employer) to have all rights in the cash value during the non-owner's (e.g. the employee's) life, but reduces the owner's interest to only the sum of the premiums paid if the arrangement is terminated by death. Is this an equity arrangement?***

While the final regulations do not specifically address this situation, it would appear that it is not an equity arrangement. An equity endorsement arrangement gives the non-owner an economic interest in the policy in addition to the pure death benefit. Here, the employee only has a right to the death benefit. The key is to avoid giving the non-owner any direct benefit in the policy (e.g. an interest in the cash value) during the non-owner's life. It would also appear that so long as the non-owner is reporting income equal to the economic cost of the net death benefit (even if the net death benefit is equal to the difference between the sum of the premiums paid and the death benefit) no part of the death benefit should be taxable to the beneficiary at the insured's death. The unknown is whether the Service would disagree with this position and attempt to tax the beneficiary on this equity.

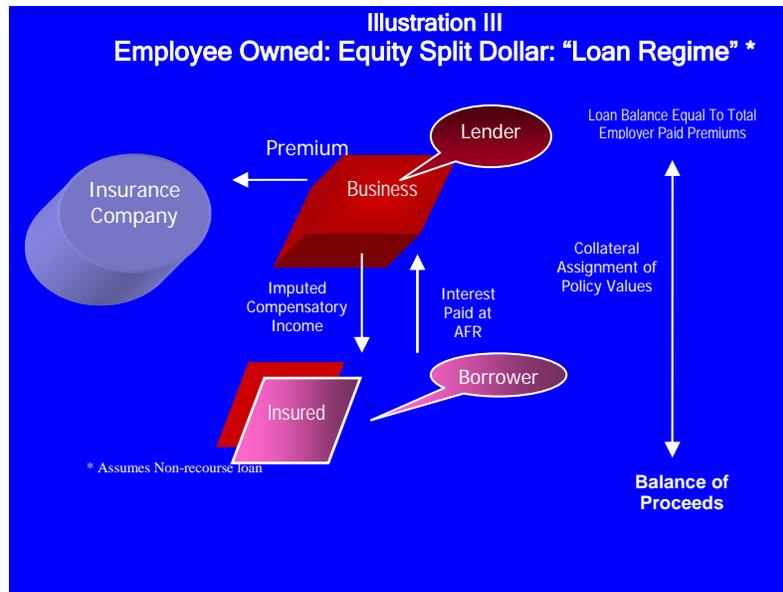
## **III. Loan Regime**

### ***1. What is the loan regime and when it is attractive?***

Under the loan regime, the employer (donor) pays the policy's premium and the premium payment is treated as a loan to the employee (donee) If the employee (donee) is not charged at least the government established interest rate for the type of loan (i.e., the applicable federal rate (AFR)), then taxable income equal to the difference between the AFR and the rate the employee is charged is imputed to the employee. Upon termination of the loan arrangement, if the employee does

not repay the outstanding loan balance, he or she is taxed on the amount of the loan balance forgiven.

Under the loan regime, the employee or third party owns the policy and collaterally assigns the cash value (not to exceed the outstanding loan balance) of the policy to the business. The employee retains the cash values over and above the outstanding loan balance. (See Illustration III)



## ***2. When are the parties to a split dollar arrangement required to treat the arrangement as a loan?***

For any equity collateral assignment split dollar arrangements entered into after 9/17/03 the parties will be required to use the loan regime. That is, when the employee (donee) owns the policy and the employer's (donor's) interest is limited to the premiums paid, the loan approach must be used. The parties are free to structure the arrangement as a term or a demand loan. However, the loan must have an adequate rate of interest (a rate at least equal to the applicable federal rate (AFR)), or the imputed interest rules of section 7872 of the Code and the original issue discount rules of sections 1271-1275 of the Code will apply. If the loan regime applies, the payment of premiums by the employer (or donor) will be treated as a series of loans from the employer to the employee.

**3. Is it possible to switch to a loan at the crossover point (i.e., when the cash values exceed the cumulative premiums paid)?**

Yes, even after 9/17/03 the parties will still be able to use the “switch at crossover” technique. Under this planning technique the parties would initially elect the economic benefit regime by entering into a non-equity collateral assignment arrangement with the employee picking up the economic benefit until the crossover year (i.e., the year in which the cash values equals the employer’s interest). At that time, the parties can elect loan treatment by terminating the economic benefit arrangement and then entering into a split dollar loan, treating all prior employer payments as loans. This approach would permit the parties to take advantage of the low economic benefit cost during the initial years of the arrangement while still avoiding a tax on any equity (accruing after the switch) at rollout.

The result of the switch is that any equity transferred to the employee at the time of the switch would be taxable to the employee (and deductible to the employer if considered reasonable compensation). In addition, upon transfer of the policy any gain in the contract will be taxable to the employer. But if the switch occurs before any equity appears, then there would be no transferred equity to tax.

The switch to a loan may also be appropriate if the interest under the loan regime is less than the economic benefit amount. This would likely be the case at the death of the first insured to die under a survivorship split dollar arrangement. The death of the first insured to die will cause the arrangement to be taxed using the much higher Table 2001 rates (or the insurer’s alternative term rates, if available) rather than the much lower revised Table 38 rates, the rates the parties had been previously enjoying.

**4. What are the benefits of converting to a loan at the crossover?**

If the arrangement is treated as a loan then there will be no additional income charged for the term insurance protection and the equity cash value accruing after the conversion will not be taxable to the employee at rollout (i.e., a lifetime termination of the split dollar arrangement). In addition, if a third party (e.g., an irrevocable trust) owns the policy, then this equity will not be considered a taxable gift from the employee to his or her trust. Furthermore, under the economic benefit regime the term insurance costs increase with age. Therefore, even if the premiums are paid with policy values (i.e., premium offset) or contractually cease, the employee will still have escalating economic benefit charges under the economic benefit regime.

On the other hand, under the loan regime when premiums are offset or cease, the amount of the loan balance remains constant and the imputed interest is effectively capped (although the interest itself may fluctuate with changes in the interest rate). Another benefit of this approach is that the “equity” in the policy is

not considered a deferred benefit subject to 409A. Finally, under the loan arrangement the owner (e.g., employee/donee) builds equity in the arrangement over time and this equity helps to facilitate a tax-free rollout.

**5. *What is a demand loan, how is it taxed and when is it attractive?***

A split dollar demand loan is any split dollar loan that is callable in full at any time on the demand of the lender – which is typical of most split dollar arrangements. If a split dollar demand loan is a below market loan (i.e., the interest on the loan is less than the short-term blended rate), the foregone interest is deemed to be transferred annually from the lender to the borrower.

A demand loan is attractive because it is easy to administer. The blended short-term rate (an average of the January and July short term rates) is simply multiplied times the outstanding loan balance to determine the amount of foregone interest and this income is then imputed to the borrower annually. The demand loan may also be appealing because the interest rate (at least in the short-run) is often much lower than the mid-term or long-term AFRs that are used with term loans. The primary disadvantage of the demand loan is the inability to lock-in the interest rate and the resulting uncertainty of future interest costs.

**6. *What is a term loan, how is it taxed and when is it attractive?***

A split dollar term loan is any split dollar loan other than a split dollar demand loan. For example, a loan due at the end of a certain term of years or upon the death of an individual is a term loan. The split dollar term loan is tested on the day the loan is made to determine if it has adequate stated interest. The applicable federal rate applied to determine if the split dollar term loan is a below market loan is the rate appropriate for the fixed term: short-term (not over 3 years), mid-term (over 3 years but not over 9 years), or long-term (over 9 years). A loan's term is the period from the date the loan is made to its stated maturity date.

For a private split dollar term loan where the term will end at the date of the donor's death, the regulations permit the parties to use the AFR appropriate for a term equal to the life expectancy of the donor. If a split dollar term loan is considered a below market loan, the entire amount of the foregone interest over the term of the loan is considered transferred in the year the loan is made for both income and gift tax purposes unless one of the recognized exceptions applies. (See Question 9 below). Thus, it will be important to fall within one of these recognized exceptions in order to avoid this adverse tax consequences under the below market term loans. Term loans can also be cumbersome to administer since each premium payment is considered a new term loan with a new interest rate.

Generally, if term loans are desired, it may be best to enter into a loan arrangement with a stated interest rate at least equal to the applicable federal rate. In this way, the parties can avoid the complexities of section 7872 of the Code including the possible acceleration of the foregone interest over the term of the loan into the year that the loan is made. Term loans are desired where the insured is a majority shareholder or a party to a private split dollar arrangement. Where it is important to keep the proceeds out of the insured's estate, care must be exercised not to give the corporation (or the insured) any incident of ownership. The right to demand payment could be considered an incident of ownership and such incident of ownership held by the corporation would be attributed to the majority shareholder/insured, causing inclusion of the proceeds in the insured's estate. Term loans are also attractive in a low interest rate environment where you want to lock in the interest rate for a set period of time.

***7. Is it possible to refinance an existing split dollar loan in the event that the current AFR is lower than the existing loan's stated rate?***

The parties to the split dollar loan arrangement can agree to refinance the outstanding indebtedness by substituting a new note with a lower interest rate for the existing note. Since the legal fees or expenses to refinance the loan would generally be minimal, the parties should consider refinancing whenever interest rates have declined.

While there should not be any income or gift tax consequence to refinance, some commentators believe that the new note with the lower interest rate should alter one or more terms of the loan to help justify the lower rate. For example, to compensate the lender for the lower rate, the term of the note could be shortened by several years. Refinancing may also simplify the future administration of the loan arrangement where a single note can be exchanged for a number of individual term loans with varying interest rates.

***8. Is it possible to lock in the interest rate for future premiums using a term loan?***

Unfortunately, it will not be possible to lock in today's AFR for future premium payments by using a term loan. The employer (or donor) can, however, loan a sufficiently large amount to the employee (or trust) so that future premiums can be paid with the loan proceeds. In this way, the interest rate on the lump sum amount can be locked in at today's rate.

***9. Are there any exceptions to the general rule that the foregone interest over the term is taxable in the year that the loan was made?***

Certain types of split dollar term loans are exempted from this general rule requiring acceleration of income. Split dollar loans payable on the death of an individual, those that are conditioned on the performance of future services, as

well as private split dollar term loans are treated as split dollar term loans for purposes of determining the appropriate AFR, but as demand loans for determining when the interest is taxed for income tax purposes. That is, if an adequate rate of interest is not provided for, then the foregone interest for these special types of term loans is determined on the loan annually (i.e., the income recognition is not accelerated). It does not appear that these exceptions will apply for gift tax purposes. That is the gift which is equal to the foregone interest over the term of the loan would be considered a gift in the year that the loan was made.

***10. Is it advisable to use both a term loan and a demand loan for the same split dollar arrangement?***

Yes, this combination could be used for existing split dollar arrangements that are being converted to a loan. In order to simplify the administration of the loan treatment, a term loan with a stated interest rate equal to the AFR could be used to lock in the interest rate for all premiums paid to the date of conversion and a demand loan could be used to account for all future premiums. In this way, the parties to the arrangement could avoid the complexity of having each future premium payment treated as a separate loan with a new interest rate. Here, there are only two split dollar loans and the administration of the split dollar loan arrangement would be greatly simplified.

***11. Is it possible to use a term loan for existing premiums and then pay all future premiums either personally or through a bonus plan?***

Yes, consideration should also be given to utilizing a term loan to lock in the interest rate on all premiums paid to date for the length of the term and to have future premiums paid by the employee (donee) either personally or by bonus. This strategy would provide for easy administration of the loan, as there would only be one loan. It would also facilitate an earlier rollout, as the buildup of the employee (donee) equity would under this type of arrangement occur significantly faster.

***12. Can the loan be structured as a non-recourse loan?***

Yes, a non-recourse note is a note in which the borrower is not personally liable for the obligation and the lender's only remedy or recourse in the event of default is to execute against the security interest given by the borrower. The final regulations specifically provide that the non-owner's payment of premium is a split dollar loan even if in the early years the cash value of the policy is less than the cumulative loans, so long as a reasonable person would expect the loan to be repaid in full. If a payment under a split dollar loan is non-recourse, then the final regulations will treat the loan as a loan that provides for contingent payments. A contingent payment is generally treated unfavorably as the final

regulations require that a contingent payment use unfavorable assumptions when testing the loan for adequate interest. To avoid contingent payment treatment, the parties to the arrangement will need to include with the parties' tax returns a written representation that indicates that a reasonable person would expect all payments under the loan will be made. Both parties must sign the representation letter not later than the last day (including extensions) for filing the tax return of the borrower or lender, whichever is earlier, for the taxable year in which the first split dollar loan is made.

***13. Can the interest on the loan be accrued and paid at some later time?***

By structuring the loan so that a rate of interest equal to or greater than the AFR is stated so that the loan falls outside of section 7872 of the Code, the interest can be accrued until the end of the term, instead of being treated as transferred annually or upon the creation of the loan. Even if the stated interest in the note were not paid, the lender would be taxed annually on the interest earnings. In addition, the interest paid by the borrower would generally be considered personal interest and thus, not deductible. Lastly, if adequate interest is paid, there should be no imputed gift tax consequences to the parties.

***14. Can the employer bonus or pay the interest directly or indirectly on the loan?***

Under a special rule for loans with interest, if the employer (i.e., lender) pays the interest to the borrower, either directly or indirectly, the interest paid will be ignored and the loan will be treated as an interest-free loan. This is troublesome, as it now appears that there cannot be any connection between additional compensation paid to the employee and the interest due on the note or the interest paid will be ignored.

***15. What are the tax consequences of a loan involving a third party such as a trust?***

The final regulations provide that split dollar loans involving third parties, such as a life insurance trust, will be structured as a series of successive below market loans for income and gift tax purposes. For example, assume that under the terms of the split dollar loan arrangement, an employer is treated as the lender and the irrevocable trust is treated as the borrower. Each premium payment is treated as part of series of back-to-back loans for federal income and gift tax purposes. To the extent that the arrangement does not provide for an adequate interest rate to be paid by the trust, the foregone interest will be computed as if the employer made a below market loan to the employee (likely generating income recognition) and the employee took the loan proceeds and made a second below market loan to the trust (likely generating a taxable gift).

## **IV. Private Split Dollar Arrangements**

### ***1. What are “Private” Split Dollar arrangements?***

Private split dollar arrangements are split dollar arrangements that do not involve an employer-employee relationship. As with employment-related plans, a private split-dollar plan involves a contractual arrangement, typically between two related parties, to split the premiums and benefits of the life insurance policy. In private split dollar any benefit derived by the donee (e.g., irrevocable trust) is potentially taxable as a gift, rather than as income.

Private split dollar comes in many variations – endorsement type private split dollar (e.g., where the insured owns his/her own policy and endorses the death benefit to a co-owner to fund a cross-purchase buy-sell arrangement) or collateral assignment type arrangements where the parties are typically an irrevocable life insurance trust created by the insured(s), and the insured(s) themselves or the insured’s spouse. The final regulations make it clear that the economic benefit and loan regimes also apply to private split dollar. Essentially all of the planning decisions and elections discussed above in the context of employer-employee split dollar plans apply in the same manner to private split dollar plans.

### ***2. How are collateral assignment private split dollar arrangements treated?***

The final regulations provide that the non-equity collateral assignment forms of private split dollar will be treated under the economic benefit regime and not the loan regime. If the only benefit to the donee (e.g., the irrevocable trust) is the pure life insurance protection and all of the cash values are assigned to the donor, the plan can be treated under the economic benefit regime. Thus, it will be possible after the final regulations to obtain the low cost economic benefit treatment and the estate tax savings associated with removing the proceeds from the insured’s estate. Contributions made by the trust for the economic benefit, however, will now be taxable to the donor. It is suggested the arrangement be structured as non-contributory when appropriate or alternatively, that the trust be structured as an intentionally defective grantor trust. In this way, any tax consequences between the trust and the grantor/insured will be ignored for federal income tax purposes.

## **Appendix I “Grandfathered” Split Dollar**

### ***1. A prospective client has an existing split dollar arrangement that is grandfathered. What are the opportunities?***

By assisting the client and his tax advisors in taking appropriate action, the agent can provide a value-added service that can help build a strong rapport with the client. For example, the agent may be able to assist the client and his or her advisors in switching from the economic benefit regime to a loan in order to protect the equity from income and/or gift tax. There may also be an opportunity to reduce premium outlay and/or the tax impact upon the parties by implementing a 1035 exchange.

Advanced Markets can assist in reviewing and analyzing each split dollar arrangement on a case-by-case basis. In order to provide this service, Advanced Markets will need a copy of the existing split dollar agreement, an in-force ledger policy illustration, a summary of the total premiums paid under the split dollar arrangement and a summary of the current policy values.

### ***2. Do the final regulations control all split dollar arrangements?***

The final regulations only apply to split dollar arrangements entered into after 9/17/03. The final regulations do not apply to a split dollar arrangement entered into before 9/18/03 unless the arrangement is materially modified after that date. For arrangements entered into prior to 9/18/03, Notice 2002-8 controls and the rules announced in that Notice will continue to apply to those plans so long as those arrangements are not materially modified after 9/17/03.

### ***3. What is a material modification that would cause a grandfathered split dollar arrangement to lose the benefits of the safe harbors under Notice 2002-8 and/or become subject to the final regulations?***

The answer is not entirely clear. The regulations contain a non-exclusive list of nine types of changes that will not be deemed a material modification. Unfortunately, this list is rather ministerial and not very helpful. For example, the final regulations provide that a change solely in the mode of premium payment or solely in the interest rate payable on a policy loan will not be treated as a material modification. While the final regulations do not address whether a significant increase in the amount of coverage or substantial expansion of the rights of the benefited party in the split dollar arrangement would be considered a material modification, common sense would indicate that such changes would most likely be a material modification. Unfortunately, the final regulations are also silent as to whether a section 1035 exchange is a material modification. Therefore, there is a serious risk that the safe harbors and benefits under the Notice would be lost if the underlying policy is exchanged.

***4. What action, if any, should be taken with non-equity endorsement/collateral assignment split dollar arrangements entered into prior to 1/28/02?***

For the most part, no action needs to be taken. Non-equity endorsement and non-equity collateral assignment split dollar arrangements entered into prior to 1/28/02 and not materially modified after 9/17/03 are essentially grandfathered under Notice 2002-8 and the final regulations. The only exception to the foregoing is with respect to P.S. 58 rates. P.S. 58 rates can no longer be used as a valid measure of economic benefit to the employee under pre-1/28/02 split dollar arrangements unless the split dollar agreement specifically requires its use.

While these arrangements can continue unchanged for the life of the arrangement and are not subject to the final regulations, it will be important, however, to have a well-designed exit strategy in place. As the insured ages his or her economic benefit costs will increase, often quite dramatically at older ages. For example, the economic benefit costs for \$1 million of life insurance protection, using Table 2001 are \$6,510 at age 60, increasing to \$33,050 at age 75 and a whopping \$144,300 at age 90. Only by terminating the split dollar agreement and repaying the employer's (donor's) interest can the escalating tax costs be stopped.

***5. What action, if any, should be taken with non-equity endorsement/collateral assignment split dollar arrangements entered into after 1/28/02, but before 9/18/03?***

Very little needs to change. Non-equity endorsement and non-equity collateral assignment split dollar arrangements entered into after 1/28/02 but before 9/18/03 also have favorable grandfathering under Notice 2002-8 and the final regulations. With a well-designed exit strategy, those arrangements can continue unchanged and are not subject to the final regulations, unless the arrangement is materially modified. However, after 2003 these types of arrangements must use the Table 2001 rates as the measure of the economic benefit unless the insurer's rate is both generally available and regularly sold.

It was anticipated that the IRS would, within a relatively short period of time following the publication of the final regulations, create a new measure of economic benefit, called the premium rate factor. This new rate, which has yet to be issued, was anticipated to be lower than the Table 2001 rates. Presumably, one may substitute the new rate table for Table 2001 when and if it becomes available.

**6. Does the basis issue effect grandfathered split dollar arrangements?**

No, grandfathered split dollar arrangements are not affected by the basis rules set forth in the final regulations, unless materially modified.

**7. Does the contribution issue effect grandfathered split dollar arrangements?**

No, grandfathered contributory split dollar arrangements are unaffected by the final regulations and can continue indefinitely without generating tax to the employer/donor, unless the arrangement is materially modified.

**8. Are the parties to a pre-9/18/03 equity collateral assignment split dollar arrangement required to convert to a loan?**

No, the parties to an existing equity split dollar arrangements are not required to treat the arrangement as a loan so long as the arrangement is not materially modified. While the Service will, in all likelihood, assert that the equity is taxable upon rollout, the employee (or third party owner) can rely upon the “no inference” rule and take the position that the portion of the equity which is grandfathered under 409A is not taxable, relying upon Notice 2007-34, Revenue Ruling 64-328 and the other rulings in existence prior to Notice 2002-8. The taxpayer will be taking his/her chances in court, as there is no certainty that this course of action will end in a favorable result for the taxpayer. The portion of the equity which is not grandfathered under 409A will be subject to income tax and if the policy is owned by a third party, this same amount will be considered a gift from the employee to the third party.

## **Appendix II. Equity Endorsement Arrangements**

### ***1. What is an equity endorsement split dollar arrangement?***

Unlike non-equity endorsement arrangements, the employee or donee is given some right or interest in the policy cash value. An example of an equity endorsement split dollar arrangement might be where the employer owns the policy and the employee is given an unrestricted right to borrow against the gain in the contract.

### ***2. Are equity endorsement arrangements taxed under the loan regime?***

No, final regulations carve out special tax treatment for equity endorsement arrangements. Despite the fact that the employee/donee may have access to a portion of the cash value of the contract, equity endorsement arrangements are treated as employer/donor owned and subject to the economic benefit rules. Each year the non-owner (e.g., employee/donee) must take into income an amount equal to the sum of the cost of the term insurance protection, any increase in the cash value of a life insurance contract to which he or she has “current access” to the extent such amount was not actually taken into account for a prior taxable year and any other economic benefit conferred upon the non-owner.

### ***3. When does the employee (donee) have “current access”?***

The concept of current access to policy cash value is based on the income tax doctrine of constructive receipt. Under that doctrine, income is taxed at the time that it is either credited to the taxpayer’s account, set apart for him/her or otherwise made available to the taxpayer so that he/she may draw upon it at any time. Under the regulations, a non-owner (e.g., the employee) is deemed to have current access to any portion of the cash value that is directly or indirectly accessible by the non-owner, inaccessible to the owner (e.g., the employer), or inaccessible to the owner’s creditors. The term access includes any direct or indirect right of the owner to obtain, use, or realize potential economic value from the policy cash value. The right to withdraw from the policy, borrow from the policy or affect a total or partial surrender of the policy is considered access.

While the final regulations appear to be harsh, the reality is that few equity split dollar arrangements in the past were structured using the endorsement method. Furthermore, equity arrangements entered into or materially modified after 9/17/03 will be taxed under the regulations as a loan and not subject to this troublesome treatment (See Section IV titled “Loan Regime”). Finally, it appears that the parties to a split dollar arrangement could rather easily avoid this

adverse tax treatment by arranging for the equity to be paid through an informally funded deferred compensation agreement. The employer avoids “current access” by retaining all of the cash values under the non-equity endorsement split dollar arrangement and then provides a cash benefit to the executive at some future date by entering into a separate deferred compensation agreement.

***4. If a portion of the premium is taxed to the non-owner (e.g., the employee), does this have any effect on his/her basis?***

Yes, in certain circumstances. The regulations provide that the non-owner receives no basis in the contract for any portion of the premium paid by or taxed to him/her under the split dollar arrangement. While it seems reasonable that a non-owner who includes in income a portion of the cash value should be credited with basis, this only occurs where there is an actual transfer of the ownership of the underlying life insurance contract from the owner to the non-owner. Under the regulations, the non-owner’s investment in the contract will include the amount of the economic benefits previously taken into account by the transferee prior to the transfer, to the extent that this amount exceeds the cost of the life insurance protection. However, in the absence of such a transfer the Service’s position is that the non-owner does not have an asset to which basis is attached. From a practical point of view, this situation may be uncommon. If the non-owner does not receive basis for his/her contributions, there is no incentive to pay more than the economic benefit amount.

***5. Do the same safe harbors available to non-equity arrangements apply to an equity endorsement arrangement?***

Partially. The safe harbors for measuring economic benefit apply to both equity and non-equity endorsement split dollar arrangements. However, Notice 2002-8 makes no provision for protecting current access to cash value from taxation and the rationale of the final regulations could be applied to pre-9/18/03 equity endorsement split dollar arrangements. The Service could take the position that each year the employee/donee must take into income any amount the non-owner (e.g., employee/donee) could have accessed under the arrangement (whether or not any such access actually takes place) to the extent such amount was not actually taken into account in a prior taxable year.

## **Appendix III            Impact of 409A**

### ***1. How does IRC Section 409A impact split dollar life insurance arrangements?***

Notice 2007-34 addresses the application of 409A to split dollar arrangements. Split dollar arrangements that provide solely for death benefits will generally be excluded from 409A under the exemption for death benefit plans. In addition, split dollar arrangements qualifying as loans for tax purposes generally will not be subject to 409A provided there is no agreement for the employer to forgive the loan or no obligation on the part of the employer to continue to pay premiums without charging a market rate of interest on the funds advanced. Lastly, 409A will not apply to private (or family) split dollar arrangements. However, some split dollar arrangements may be subject to 409A, such as: (i) where the employer owns the policy but agrees to a future transfer of an interest in the policy to the executive; (ii) where the employer commits to pay premiums beyond normal retirement age; or (iii) where an equity collateral assignment split dollar arrangement is expected to terminate at normal retirement age and the employee has a legally binding, earned and vested right to compensation that is payable in a later year. This means that the terms of a split dollar agreement subject to 409A must now comply with the 409A rules regarding distributions, time and form of payments, definition of separation from service, deferral elections, and anti-acceleration.

If the arrangement is subject to 409A but is not in compliance with the rules of 409A, all deferred compensation under the arrangement is subject to immediate recognition of income. In addition, a 20% penalty tax and an interest charge also apply.

### ***2. Does 409A provide for grandfathering of existing equity split dollar arrangements?***

All amounts deferred before January 1, 2005 under an equity split dollar arrangement are not subject to 409A, unless the split dollar arrangement is materially modified after October 3, 2004. This also includes increases in the policy cash values after 2004 attributable to grandfathered amounts, but Section 409A will generally apply to an increase in the cash value attributable to continued services performed, compensation earned, or premium payments or other contributions made after 2004.

Note that IRS Notice 2007-34 provides a way to amend the split dollar arrangement to comply with Section 409A without “materially modifying” the split dollar arrangement and causing the split dollar arrangement to be taxed under the final regulations. Employers had been allowed (up to 12/31/08) to comply with 409 A by showing “good faith” compliance with the statutory requirements.

However, as of January 1, 2009 all covered plans are required to be in full compliance with the 409A regulations.

**3. How does one determine which portion of the policy's equity (i.e., the cash values in excess of the cumulative premiums) is subject to 409A and which portion of the policy's equity is not subject to section 409A?**

The Notice allows the use of any reasonable method to allocate these grandfathered benefits. The Notice offers the "proportional allocation method" as a reasonable method of calculating the grandfathered benefits. The proportional allocation method grandfathers the greater of (1) the policy's equity as of 12/31/04 that was earned and vested; or (2) the policy's equity on the valuation date (e.g., the date the split dollar arrangement is converted to a loan or the date the split dollar arrangement is terminated) multiplied by the sum of the premiums paid prior to 1/1/05 over the sum of all premiums paid as of the valuation date.

Under the proportional allocation method provided by the Service, the parties prorate the equity between these two time periods based upon the total net premiums paid. The parties first calculate the total net premiums paid prior to 1/1/05 and then calculate the total net premiums paid under the split dollar arrangement from inception until the valuation date. The amount of the policy's equity which is grandfathered (and not subject to 409A) would be calculated as follows:

$$\frac{\text{Net Premiums Paid Prior to 1/1/05}}{\text{Net Premiums Paid for all Years}} \times \text{Policy Equity on Valuation Date} = \text{Equity which is Grandfathered}$$

The difference between the policy's equity on the valuation date and the portion of the equity which is grandfathered is required to be reported as income. If the agreement is not compliant with 409A, the amount is subject to current tax and penalties. Otherwise, it is subject to tax upon rollout under the plan. If the policy is owned by a third party, this same amount (i.e., the equity subject to 409A) will also be treated as a gift from the employee to the third party owner.

**4. Upon a lifetime termination of the equity split dollar arrangement how is the equity which is not subject to 409A taxed?**

Notice 2002-8 still controls the tax consequences for the policy's equity which is not subject to 409A. Under that Notice the parties to the split dollar agreement, working closely with their tax advisors, have two choices. First, the parties may treat such equity as taxable income and report that amount on their income tax returns. If the policy is owned by a third party, this same amount would be treated as a gift from the executive to the third party owner. Alternatively, the parties may rely on the "no inference" rule and chose not to report that portion of the gain. The Service will likely take the position that the equity is taxable upon rollout

although some practitioners relying on the “no inference rule” may advise their clients not to report the equity as taxable.

**5. How does Section 409A impact the planning for equity split dollar arrangements?**

In order to avoid the application of 409A, the parties to the split dollar arrangement, working with their advisors, may elect to treat the arrangement as a loan as of the first day of the tax year in which the cash value exceeds the cumulative premiums paid. This would require that the interest on the loan amount (i.e., the applicable federal rate (AFR) times the net premiums paid by the company) be either paid or if not paid reported on the income tax return. Again, the client should discuss these issues with his or her tax and legal advisors.

As an alternative to the loan, the parties to the split dollar arrangement could agree, at any time prior to the crossover point (i.e., where the cash values first exceed the cumulative premiums paid) to amend the equity split dollar arrangement to a non-equity arrangement.

## **Appendix IV            Impact of Sarbanes Oxley**

### ***How does Sarbanes Oxley affect split dollar life insurance?***

The Sarbanes Oxley Act amended the Securities Exchange Act of 1934 to generally prohibit direct or indirect corporate loans to certain executive officers and directors of publicly traded companies. Because Sarbanes Oxley does not directly address split dollar life insurance, there is substantial confusion as whether it was intended to cover such arrangements. Unfortunately, until the SEC issues guidance on the question, and to date it has not, the question will remain unclear. Because there could be criminal penalties imposed on the company and the affected executives if a company makes a prohibited loan, any continued utilization of split dollar loan arrangements involving a public company and executive officers and directors is prohibited.

There is an argument that a non-equity endorsement or a non-equity collateral assignment split dollar arrangement does not involve a loan and therefore, should not be prohibited. Unfortunately, even non-equity split dollar arrangements involve some risk and such arrangements should not be implemented without the approval of the client's independent and competent counsel. Executive bonus life insurance arrangements may be an attractive alternative for public corporations until this issue is resolved.

## **Appendix V            Impact of COLI Best Practices Act**

### ***1. How does the COLI Best Practices Act affect split dollar life insurance?***

The COLI Best Practices Act (part of the *Pension Protection Act*) imposes "notice and consent" requirements on employers who acquire life insurance on employees' lives. The rules directly affect many employer owned life insurance arrangements including Endorsement Split Dollar plans. While the provisions were intended to curb perceived abuses in the "pure" COLI market (i.e., "Janitor Insurance"), the final law encompasses all policies where a business is the owner. In general, the law affects all such policies issued or materially changed on or after August 18, 2006. If the requirements of the Act are not met, then under Section 101(j) the death benefits in excess of premiums paid will be income taxable to the employer/beneficiary. The IRS has released Notice 2009-48 which provides significant guidance on the application of Section 101(j), including its application to split dollar life insurance arrangements.

### ***2. Will a modification of a split dollar life insurance arrangement that does not entail any change to the underlying life insurance contract be treated as a material change for purposes of section 101(j)?***

Notice 2008-42 provides that "if the parties to a split dollar life insurance arrangement modify the terms of the arrangement but do not modify the terms of the life insurance contract underlying the arrangement, the modification will not be treated as material change in the life insurance contract for purposes of Section 101(j) even if the modification is treated a material modification of the split dollar arrangement for purposes of the split dollar final regulations."

## **Appendix VI          Impact of FASB**

### ***What is the impact of the Financial Accounting Standards Board's (FASB) Accounting Changes on Split Dollar?***

Emerging Issues Task Force (EITF) Issue 06-4 which addresses endorsement split dollar arrangements and Issue 06-10 which addresses collateral assignment split dollar arrangements change the manner in which banks and other employers must account for split dollar life insurance arrangements that provide a "post retirement benefit". The new requirements apply to both endorsement and collateral assignment arrangements, whether equity or non-equity, that provides any type of benefit to an employee extending to post-retirement periods. The new requirements take effect for fiscal years beginning after December 15, 2007 and apply not merely to split dollar arrangements entered into after the effective date but rather to all arrangements that exist when the new requirements take effect or are entered into thereafter.

With respect to endorsement arrangements, Issue 06-4 provides that if the employer has effectively agreed to maintain a life insurance policy during the employee's retirement, then the employer should accrue the cost of the insurance policy allocable to post-retirement periods. In other words, if the employer has effectively agreed to maintain a life insurance policy during the employee's retirement, then the employer should report in its financial statements over the employee's anticipated period of active service the estimated cost of maintaining the insurance policy during the post-retirement period. These costs must be expensed and accordingly, reduce an employer's current accounting earnings. Accumulated post retirement benefit obligations must be reported as liabilities on the employer's balance sheet. Issue 06-10 reached essentially the same conclusions with respect to collateral assignment split dollar arrangements.

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