Relief for Failure to File Written Representations with the IRS for Split-Dollar Loans

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In several recent private letter rulings, the Internal Revenue Service has granted extensions to taxpayers to file written representations for split-dollar loans. By being covered under a private letter ruling, affected employees were able to avoid significant tax increases of taxable compensation for all prior periods.

Parties to a split-dollar life insurance arrangement (SDA) who fail to timely file written representations with the Internal Revenue Service (IRS) for split-dollar loans may not be out of luck. Filing written representations with the IRS for split-dollar loans is not always applicable, but it can be very beneficial to an employee to do so. In several recent private letter rulings, the IRS granted extensions to taxpayers to file these representations. By being covered under a private letter ruling, affected employees were able to avoid significant increases of taxable compensation for all prior periods. We suggest reviewing whether written representations have been timely filed for split-dollar loans that are repayable solely from a life insurance policy, because administrative relief may be available to avoid adverse tax and reporting consequences for the parties. The remainder of this *On the Subject* describes the following:

- What is a split-dollar loan
- The significance of failing to file a written representation
- What is required for a written representation
- Administrative relief under Section 9100 of the Internal Revenue Code for regulatory elections
- The circumstances under which the IRS recently provided Section 9100 relief for split-dollar loans

What is a "split-dollar loan"?

SDAs are often structured so that premium payments on a whole life insurance policy made by the employer on an employee's behalf are treated as interest-free loans for tax purposes. For example, an employer pays premiums on a policy owned in all respects by an employee, subject to the employer's right to recover the payments on the employee's death and the employer's restrictions on the use of policy cash value prior to repayment. Typically no interest is payable

by the employee to the employer, and the employer's recovery is limited solely to the policy cash value or death proceeds. The employer has no recourse against the employee's personal assets other than the policy (such an arrangement is considered a nonrecourse split-dollar loan). Unless grandfathered under Notice 2002-8 from current tax rules, this type of SDA is subject to the below-market interest rules under Section 7872 of the Internal Revenue Code. Section 7872 treats each premium payment by the employer as a "split-dollar loan," and the employee is deemed to receive an amount as taxable compensation equal to the value of the use of the premium payments without interest. SDAs under which the employee only has a right to death benefits (*i.e.*, no rights to access policy cash value at any time) are not treated as split-dollar loans. If the employee has used a trust structure to own the life insurance policy on the employee's life, then additional gift tax reporting requirements on behalf of the executive may be required. The implications on the employee's gift tax reporting is important for compliance purposes and is in addition to the recommendations and reporting discussed below.

What is the significance of failing to file a written representation under Section 7872?

The amount of taxable compensation that is imputed under Section 7872 for a nonrecourse split-dollar loan will be much larger than would otherwise be the case in the early years of the policy if the parties do not timely file a written representation with the IRS. If it is reasonable to expect that the split-dollar loan will be repaid, as will usually be the case if the employer has recourse against all of the employee's assets, the amount of taxable compensation under Section 7872 is determined based solely upon the interest-free use of the employer's funds. However, when an interest-free loan is nonrecourse, so-called "contingent payment" rules apply under Section 7872 unless written representations are timely filed with the IRS. The contingent payment rules, when applicable, are quite complicated and require the employer's recovery amount to be calculated at the lowest possible amount, thereby significantly increasing the amount of up-front imputed compensation to the employee. For further details regarding the calculation of imputed compensation for interest-free split-dollar loans under Section 7872, see pages 11 to 15 of this article.

What must be included in a written representation to avoid the contingent payment rule? Who files it and when is it usually due?

A written representation with respect to a nonrecourse split-dollar loan is required to be signed and filed by both the employer and the employee with their respective tax returns. The representation must state that a "reasonable person" would expect that the split-dollar loan will

be paid back to the employer in its entirety. It is advisable for taxpayers to obtain life insurance projections to support this representation in light of any planned policy withdrawals or loans. A copy of this representation should be filed each year that there are subsequent split-dollar loans if the employer continues to pay the premiums (assuming that the representation remains accurate).

When will the IRS provide administrative relief?

The IRS may grant an extension for a taxpayer to file a regulatory election (so-called Section 9100 Relief) by establishing that he or she acted reasonably and in good faith and that the granting of relief will not prejudice the government's interests. The taxpayer must obtain a private letter ruling from the IRS and pay a user fee for requesting the ruling. In general, the reasonableness and good faith standards are met if the taxpayer has done one of the following:

- Requested relief before the IRS discovers the failure to make the regulatory election
- Failed to make the election because of intervening events beyond the taxpayer's control
- Failed to make the election because, after exercising reasonable diligence, the taxpayer was unaware of the need for the election
- Reasonably relied on the written advice of the IRS
- Reasonably relied on a qualified tax professional who failed to make, or to advise the taxpayer to make, the election

A taxpayer is not considered to have acted reasonably or in good faith if the taxpayer does one of the following:

- Seeks to alter a return position for which an accuracy-related penalty could be imposed
- Chooses not to file the election after being informed, in all material respects, of the required election and related tax consequences
- Uses hindsight in requesting relief

As noted above, the IRS will grant a reasonable extension under Section 9100 only when the interests of the government will not be prejudiced by the relief. If granting Section 9100 Relief will result in a lower total tax liability for all years affected by the election than if the taxpayer had made a timely election, the interests of the government are prejudiced. This rule does not mean that prejudice exists if the relief will reduce the taxpayers' taxes. Instead, this applies only if the tax liability is lower than if the taxpayer had made a timely election.

What were the circumstances under which the IRS provided Section 9100 Relief for Split-Dollar Loans?

The rulings involved a situation in which an employer retained a consultant to advise on and administer SDAs that resulted in split-dollar loans being subject to Section 7872. The employer also used a tax preparer to prepare forms for tax reporting. According to the tax preparer, based on confusing language in the documents governing the split-dollar loans and discussions with the consultant, the tax preparer determined that no written representations were required because the employer had recourse against the employee for repayment of the split-dollar loans. The employer subsequently retained a law firm to review the split-dollar loans for unrelated reasons. In the course of that review, the law firm determined that the loans were in fact not recourse against the employee and that a written representation under Section 7872 should have been filed with the IRS. Given these facts, the IRS provided Section 9100 Relief to the employer and employees by extending the time to file the written representations and deeming the representations effective for all prior years.

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