IRS Proposes New Tax Treatment for Split-Dollar Arrangements

Based on various prior IRS rulings, the income tax treatment of split-dollar arrangements had been fairly settled for nearly 40 years. However, to address certain perceived abuses of split-dollar arrangements and to provide a uniform statutory framework for determining the income tax consequences of split-dollar arrangements, the IRS in 2002 and 2003 issued proposed Regulations and a Notice. These new Regulations and the Notice affect the income tax treatment of new split-dollar arrangements and may change the income tax treatment of existing split-dollar arrangements.

1. Background

For many years employers have utilized split-dollar arrangements to provide a benefit to their owners and/or key employees. Generally speaking, split-dollar arrangements allow an employer to provide the insured with life insurance coverage at little or no net cost to the insured. There are two types of split-dollar arrangements that our clients utilize:

(a) Collateral Assignment Split-Dollar.—In these arrangements, the insured (or a trust established by the insured) owns the insurance policy while the employer pays all or substantially all of the premiums. As part of the arrangement, the insured (or trust) pledges the policy as collateral for the repayment to the employer of the premiums paid by the employer.

These types of arrangements are generally structured in an “equity” fashion. This means that during the lifetime of the insured, any cash surrender value that exceeds the aggregate premiums paid by the employer generally would inure to the benefit of the insured (or trust). This is the “equity” aspect of this type of arrangement.

If the parties decide to “roll out” (i.e., terminate) the split-dollar arrangement during the insured’s lifetime, the insured (or trust) would repay the employer its premium payments, and the insured (or trust) would retain the insurance policy. In the event the insured dies prior to a roll out, the designated beneficiary (or trust) would receive the net death benefit after repaying the employer its premium payments.

(b) Endorsement Split-Dollar.—In these arrangements, the employer owns the insurance policy and pays the premiums on the policy but endorses to the insured (or a trust established by the insured) a portion of the death benefit. Generally, these arrangements are “non-equity” in nature, meaning that the premium payer (the employer) will be entitled to receive all of the cash surrender value of the policy if the split-dollar arrangement is terminated during the insured’s...
lifetime. If the endorsement split-dollar arrangement is not terminated prior to the death of the insured, then upon the insured's death, generally an amount equal to the cash surrender value will be paid to the employer and the net death benefit will be paid to the designated beneficiary under the policy.

2. Change in IRS Policy

On July 1, 2002, the IRS issued proposed Regulations regarding split-dollar arrangements. The proposed Regulations will generally be effective for split-dollar arrangements entered into as of the date the final Regulations are published. Although it is still uncertain, it is expected that the final Regulations will be published before the end of this year.

The proposed Regulations provide for two mutually exclusive “regimes” to govern split-dollar arrangements: (i) the “Loan Regime” and (ii) the “Economic Benefit Regime”. The proposed Regulations also provide that the IRS will not honor any split-dollar arrangement that has not been documented in writing by the parties.

(a) Collateral Assignment Split-Dollar

(i) Prior to the Proposed Regulations.—It was generally believed among practitioners that the equity build-up in the cash surrender value would not be taxed to the insured. The insured simply reported the economic benefit of the insurance coverage as income, and the employer paid the premiums; there were no other tax implications. Upon a roll out of the policy, the equity was not taxed. The economic benefit is generally the one-year term rate provided by the life insurance provider.

(ii) Under the Proposed Regulations.—The proposed Regulations require the parties to an equity collateral assignment split-dollar arrangement to follow the Loan Regime. This type of arrangement treats the employer's premium payments as a “loan” to the insured.

If the split-dollar loan does not provide for sufficient interest, then the IRS will impute interest based upon the appropriate applicable federal interest rate (“AFR”).

(b) Endorsement Split-Dollar

(i) Prior to the Proposed Regulations.—Since these arrangements are typically structured as non-equity arrangements, a roll out does not create an income tax issue. In these arrangements, the insured would be taxed on the economic benefit of the insurance coverage each year.

(ii) Under the Proposed Regulations.—The Economic Benefit Regime governs endorsement split-dollar arrangements. Under this regime, the only economic benefit provided to the insured (or trust) is the current life insurance protection. The determination of the cost of the current life insurance protection has yet to be provided by the IRS. The IRS will deem this amount to be taxable to the insured.

3. Treatment of Existing Arrangements

The IRS issued a Notice in 2002 regarding the proposed income tax treatment of existing split-dollar arrangements. Unfortunately, the proposed Regulations do not specifically address the treatment of existing arrangements.
In the Notice, the IRS stated that with respect to equity collateral assignment split-dollar arrangements in place before January 28, 2002, the equity will not be subject to income tax so long as there has been a roll out of the split-dollar arrangement prior to January 1, 2004, or the arrangement has been recast to comply with the Loan Regime requirements prior to January 1, 2004. If neither of the foregoing options is completed prior to January 1, 2004, the IRS will likely attempt to tax the equity if a roll-out occurs after December 31, 2003. The IRS will not tax the equity if the arrangement is terminated on account of the insured’s death. However, most equity collateral split-dollar arrangements have been designed to roll out prior to the death of the insured.

4. Sarbanes-Oxley Act

The Sarbanes-Oxley Act, which Congress enacted last year, only applies to publicly held corporations and provides penalties for loans provided to corporate officers. This Act was Congress’ reaction to the recent corporate scandals in an effort to limit the amount of benefits corporate officers receive. Although it may not have been intended, the Act could apply to certain split-dollar arrangements between a publicly traded company and its employee. Accordingly, these arrangements need to be carefully reviewed to avoid severe penalties.

5. Planning Recommendations

Although final Regulations have not been issued, planning for split-dollar arrangements entered into prior to January 28, 2002, should begin now.

(a) Collateral Assignment Split-Dollar.—With respect to equity collateral assignment split-dollar arrangements, there are various options to consider, including the following:

(i) Convert to Loan Regime.—The employer can charge the insured (or trust) interest on its premium payments. While this option reduces the planning benefits currently available to the insured, the published AFRs are historically low and the split-dollar arrangement may still be advantageous to the insured. **This option requires that the split-dollar arrangement be amended in order to provide for the loan treatment using the appropriate AFR.**

(ii) Convert to a Non-Equity Arrangement. For arrangements where no equity has built-up in the policy, the employer and employee can convert the arrangement into a non-equity arrangement. **This option also requires that the split-dollar arrangement be amended.**

(iii) Roll-Out Prior to January 1, 2004.—For arrangements where equity has built-up in the policy, the insured can choose to roll out of the split-dollar arrangement prior to January 1, 2004, without incurring any adverse tax treatment.

There are a number of other options that may be available depending on the specific circumstances. In order to determine which of the various options may be best suited for your situation, please contact us at your earliest convenience.

(b) Endorsement Split-Dollar. With respect to non-equity endorsement split-dollar arrangements (which are much less frequently used by our clients), the income taxation of such arrangements has not materially changed so these plans may not require restructuring.
We Can Help

We recommend that you contact a member of Katten Muchin Zavis Rosenman’s Trusts and Estates Practice before you take any action with respect to an existing split-dollar arrangement or in the event you are considering any new arrangement.

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