

**NEW IRS SPLIT-DOLLAR LIFE INSURANCE RULING
CHANGES POPULAR EXECUTIVE RETIREMENT PERK**

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After some forty years without a change of heart on tax practices for split-dollar life insurance (SDLI) arrangements, we witnessed the passage of the all-encompassing Sarbanes-Oxley Act (the Act) in 2002. In September 2003, the U.S. Treasury Department and Internal Revenue Service jointly adopted these sweeping new regulations. These rules, codified as 26 CFR Parts 1, 31 and 602, promise to radically restructure how employers provide executive life insurance, how employees handle premium payments, and how both report on their actions.

What led up to such a bold action after so many decades? For so long, we were operating under an interpretation of Revenue Ruling 64-328 that went far beyond the original intent of its authors. Creative minds had prevailed. And, SDLI became an unintended cure-all.

The ruling interpretation treated equity split-dollar and endorsement split-dollar the same. Yet we knew equity split-dollar provided the greater benefit. Now, the new ruling brings us back to reality. And, it took forty years to clarify the original intent.

However, split-dollar life insurance might still be used on an endorsement basis by public companies without any violation of Sarbanes-Oxley. Good legal opinion is being drafted daily to support this position, however it's not crystal clear.

In short, split-dollar life insurance is a valuable vehicle to provide tax-free death benefits for pre- and post-retirement that always needed to, and now does, stay within the letter of the law. Clearly, SDLI will continue to be a very attractive executive benefit and now, with clarification, we can design plans that will better attract and retain key people.

Just as its name implies, a split-dollar arrangement is one in which two parties—typically a company and employee—agree to share the premium payments and/or benefits of a life insurance policy. These arrangements are most often set up in a Supplemental Executive Retirement Plan to offer non-taxable compensation.

The final regulations offer two different tax treatment scenarios—loan and economic benefit schemes—depending upon who “owns” the policy.

Loan Scenario

If the employee owns the policy, the new rules treat the employer's premium payments as below market, interest-free loans. Thus, the executive is required to pay the employer market-rate interest on the loan and will be taxed on the difference between the market rate and the actual interest. These are generally collateral-assignment arrangements.

Interestingly, one provision in the Act called, "Prohibition on Personal Loans to Executives" amends section 13 of the Securities Act of 1934 prohibiting companies and their subsidiaries that are regulated by the Act from making any loans to a director or executive officer. Some experts believe that collateral assignment of split dollar plans is merely a component of an overall, integrated compensation package and will not be treated as a personal loan, thus not affected by the Act. So what do you do? Consider these alternative strategies:

- SERP/Deferred Compensation/401k Look Alike Plans
- Endorsement Split Dollar Plans (not seen as loans);
- Or, institute a 162 Bonus Plan (not impacted by the Act)

Economic Benefit Scenario

If the employer owns the policy, the employer's premium payments are treated as providing taxable economic benefits to the executive. Those economic benefits include the executive's interest in the policy cash value and current life insurance portion. These are generally viewed as endorsement arrangements.

The economic benefit regime also applies, says the new rule, if the split-dollar arrangement is connected to performance of services and the employer is not the contract owner, or if the arrangement is entered into between a donor and donee, as in a life insurance trust.

If a life insurance contract is transferred from an owner to a non-owner, when payments prior to the transfer have been treated as split-dollar loans, the economic benefit regime also applies from the date of transfer. At that time, the agreement is no longer viewed as a split-dollar loan.

Owner and Non-Owner Defined

What happens if more than one person is named as policy owner? The new regulations stipulate that full ownership is held by the first person listed on the policy. If dual policy owners each have an undivided interest in the rights and benefits of the life insurance contract, however, then each individual is treated as the owner of a separate life insurance contract.

Shareholder/Corporate Arrangements—Yes; Key Man Arrangements —No

Note that these rules govern not just employer/employee split-dollar plans, but corporation/shareholder, and private donor/donee split-dollar arrangements. Note, however, that they do not cover "key man" arrangements in which a company purchases a life insurance contract to insure the life of a key employee but retains all the rights and benefits of the contract.

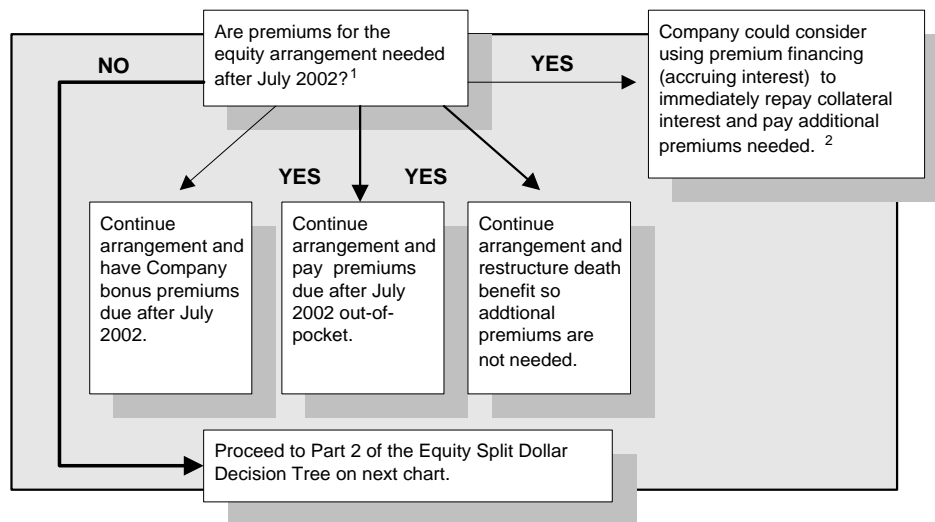
Remember September 17th

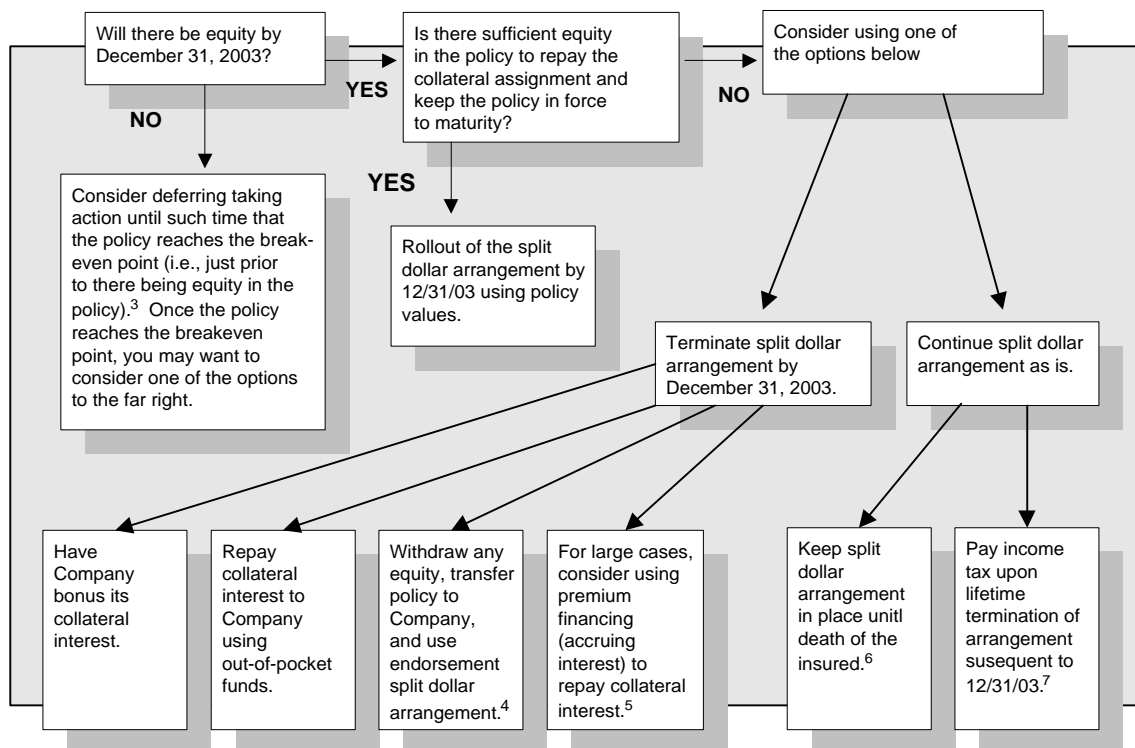
The final regulations apply to arrangements entered into or modified after September 17, 2003. Those entered into before that date are still governed by the interim guidance the IRS and Treasury issued in 2002 (Notice 2002-8), unless they are modified after September 17 of this year.

Don't assume that being grandfathered under these dates justifies ignoring implications of the Act. Review plan objectives and do an economic analysis with new scenarios and solutions to determine if an advantage exists. You may discover that you are not meeting your current plan objectives.

Deriving Tax Basis for Non-Equity and Equity Split-Dollar Arrangements

Both non-equity and equity split-dollar arrangements employ the economic benefits regime. If an employer provides an employee with a split-dollar life insurance arrangement, the employee must report that benefit as compensation for the year in which the benefits are provided. The tax rate depends on the benefit's value, and if it constitutes compensation, a capital contribution, a gift, or a monetary transfer. The employer would reap the benefits of reporting the compensation on employment tax returns. Likewise, in a split-dollar arrangement in which a donor provides economic benefits to an irrevocable life insurance trust, the donor must report those as a taxable gift.





The new regulations deem that non-equity split-dollar life insurance arrangements, which are compensatory or gifts, fall under the economic benefit scenario. For non-equity split-dollar arrangements, current life insurance protection and the average death benefit in the taxable year are used to compute tax requirements. Current life insurance protection is determined on the last day of the non-owner's taxable year, or, if both parties are in agreement, the policy anniversary date can be used.

Under equity split-dollar arrangements, the tax benefit value is derived based on the cost of any current life insurance protection provided to the non-owner and the amount of the policy cash value which the non-owner has access to in the current tax year. The regulation says that in a true equity split-dollar arrangement, the employer relinquishes ownership to the employee, since he has made a commitment not to withdraw funds from the insurance contract. The law contrasts this arrangement with an irrevocable rabbi trust, where the employer effectively remains the tax owner of the assets.

How Death Benefit Proceeds Gain Tax Exclusion

Death benefit proceeds paid to a beneficiary are excluded from the gross income of the beneficiary only to the extent that the amount is allocable to current life insurance protection provided to the non-owner under the split-dollar arrangement. If the non-owner has not paid for those benefits, however, they are subject to taxation.

Taxation under the Loan Regime

Any payment made before a split-dollar life insurance arrangement is entered into treats those payments as split-dollar loans, and the owner and non-owner as borrower and lender, respectively. Each payment under a split-dollar life insurance arrangement is treated as a separate loan for federal tax purposes.

If a split market loan is not below market, it is simply governed by general rules for debt instruments. The borrower may not deduct any qualified stated interest or imputed interest on a split-dollar loan.

Demand versus Term Loans

A split-dollar demand loan is one which is payable in full at any time on the demand of the lender. Rate of taxation is determined by testing for adequate stated interest in each year that the split-dollar demand loan is outstanding. Interest is deemed adequate if the rate is no lower than the "blended annual rate" for the year based on annual compounding. The blended annual rate is an average of the January and July short-term rates. For 2003, the blended annual rate is 1.52 percent.

A split-dollar term loan is anything other than a demand loan. The split-dollar term loan is tested on the day the loan is made to determine if it has adequate stated interest. Interest is adequate if the face amount of the loan is equal to or greater than the "imputed loan amount." The "imputed loan amount" is the present value of all payments due under the loan, as of the date the loan was made, using the applicable federal rate (AFR) on that date. If the split-dollar loan is a below-market loan, it is treated as a loan with interest at the applicable federal rate (AFR) and there will be an imputed transfer by the lender to the borrower. The imputed transfer is viewed as a compensation payment if the lender is the borrower's employer. The rate used to determine the amount of interest each year is not redetermined annually, but is based on the AFR when the split-dollar loan was made. The AFR must be appropriate to the loan's term – short-term (up to 3 years); mid-term (over 3 years but not over 9 years); or long-term (over 9 years). The short-term, mid-term and long-term AFRs for September 2003 are 1.52%, 3.43% and 5.08%, respectively.

Life Insurance Trusts and other Third Party Instruments

The new rules recognize that many split-dollar arrangements involve third parties, such as life insurance trusts, in which an employer/lender advances premiums to a life insurance trust/borrowers of which the employee is the insured. Any foregone interest is computed as if the employer made a compensatory below-market loan to the employee, and the employee took the loan proceeds and made a second below-market gift loan to the life insurance trust.

Net Take Away—Split-Dollar Alive and Well, But Seek Counsel

While we hope this article helps to familiarize you with the basics of the new split-dollar requirements, the regulations are complex. Special rules govern certain terms and conditions. Split-dollar life insurance is alive and well; however, we want to urge you to use caution when designing any executive benefits program. Be sure to analyze your objectives.

If you plan to enter into or modify a split-dollar life insurance arrangement, make certain to seek the counsel of a qualified estate planner and tax attorney to make recommendations on specific actions you can take to minimize tax loss and maximize your retirement investment.

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¹ The Sarbanes-Oxley Act of 2002 (hereinafter the "Act") is prospective only and applies to any company that is required to register their securities under the Securities Act of 1934 or file certain reports (10K, 10Q) under the Securities Act of 1934. It only prohibits new or renewal extensions of credit by the company to an executive officer or director. Therefore, its only impact on collateral assignment split dollar arrangements should be to potentially prohibit the employer paying any further premiums pursuant to the terms of the split dollar agreement after the date of the Act. As a result, the critical issue with regard to collateral assignment split dollar arrangements involving publicly-held companies is whether any further premiums are required for the existing split dollar arrangement. If not, the Act should not impact the split dollar arrangement. However, if it is an equity collateral assignment, the IRS Notice 2002-8 may still have an impact.

² In some large case situations where a third party (e.g., a trust) owns the policy, a bonus to pay additional premiums may not be feasible for income and gift tax reasons. Therefore, it may be appropriate to consider using a commercial loan to repay the employer's collateral interest (as well as pay future premiums) and terminate the split dollar arrangement. Assuming that the interest on the third party loan is accrued, this helps avoid annual gifting issues with respect to the loan interest. Whereas compensation and gift loans may be subject to Original Issue Discount (OID) if loan interest is accrued, third-party loans should not be subject to OID. In addition, third-party loans should also not be subject to I.R.C. section 7872.

³ If an equity split dollar arrangement is terminated during the lifetime of the insured subsequent to December 31, 2003, then pursuant to Notice 2002-8, any equity in the arrangement may be subject to taxation at the time of termination. However, if there is no equity at the time of termination, then there should be no taxation. Therefore, as long as the arrangement is terminated by the time the policy reaches the breakeven point, even if this occurs subsequent to December 31, 2003, there should be no tax consequences resulting from the termination.

⁴ The employee could transfer the policy to the employer's collateral to satisfy the employer's collateral assignment and terminate the existing split dollar arrangement, and then the parties could enter into a new endorsement split dollar arrangement. However, since the employer is only owed the cumulative premiums (or possibly the lessor of the cumulative premiums or the cash surrender value, depending on the wording of the agreement), the employee should withdraw any equity interest he or she has in the policy prior to transferring the policy to the employer.

⁵ In some large case situations where a third-party (e.g., a trust) owns the policy, it may be appropriate to consider using a commercial loan to repay the collateral interest and terminate the split dollar arrangement. Assuming that the interest on the third party loan is accrued, this helps avoid annual gifting issues with respect to the loan interest. Whereas compensation and gift loans may be subject to Original Issue Discount (OID) if loan interest is accrued, third-party loans should not be subject to OID. In addition, third-party loans should also not be subject to I.R.C. section 7872.

⁶ As long as the split dollar arrangement is kept in place until the death of the insured(s), then the equity should not be subject to taxation, assuming the economic benefit costs were properly accounted for every year. However, since the economic costs can become prohibitive at later ages, this strategy can pose long-term adverse tax consequences resulting from the increasing economic benefit costs. Although the arrangement could be terminated at the point when the economic benefit costs become prohibitive, keep in mind that any equity may be subject to taxation at that time.

⁷ If the split dollar arrangement is between the employer and employee, then the equity would be taxed similar to a lump-sum deferred compensation payment, and therefore, this may be an attractive option in some situations. However, if the arrangement involves a third-party owner such as a trust, then the equity could be subject to gift taxes at the time of termination, which may make using this strategy less attractive.