

Pre-Regulation Equity Split-Dollar Arrangements: The Section 409A Riddle, and More!

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Introduction

After almost 40 years of a relatively stable history with respect to the taxation and regulation of collateral assignment split-dollar (CASD or “Equity”) arrangements, the rules have changed:

- The IRS issued final split-dollar regulations in 2003 which modified the tax treatment going forward.
- The Sarbanes-Oxley Act, enacted in July 2002, eliminated “premium loans” to executive officers of publicly-traded companies.
- Section 409A, enacted in 2004 to provide greater regulation of deferred compensation programs, is also applicable to certain CASD arrangements.
- EITF 06-10, ratified by the FASB in 2007, changed the accounting treatment for such programs.

The response to these changes among sponsors of CASD programs has been varied. Many adopted a “wait-and-see” attitude with respect to the issuance of the final split-dollar regulations in 2003. However, that approach may no longer be prudent. The complicated interaction of Section 409A and the split-dollar regulations creates potential exposure to participants for back taxes, interest, and penalties. In addition, the new accounting requirements of EITF 06-10 will likely have a negative impact on shareholders’ equity. In essence, the future benefits to participants in a CASD program are less attractive than in the past, and the cost to the company will be greater.

This article focuses on the impact of these tax and regulatory changes on CASD programs implemented prior to the September 18, 2003, effective date of the final regulations (so-called “grandfathered” plans). It includes a review of the related compliance requirements for Section 409A, where applicable, as well as a discussion of certain practical re-structuring options.

Historical Tax Treatment of Equity Split-Dollar Arrangements

Since the 1960s, the tax treatment of CASD arrangements was based on Revenue Rulings 64-328 and 66-110 which generally held that:

- The taxable economic benefit of a CASD policy to the employee is the value of the life insurance protection provided, plus the value of other benefits received (such as cash dividends), minus any contributions made by the participant under the plan.

- The growth of the participant’s “equity” in the CASD policy—that is the growth of cash value in excess of the aggregate amount of premium payments advanced by the employer—was generally not taxable to the participant until he/she elected to make a taxable withdrawal of cash value from the policy.

Development of Current Tax Law

Beginning with Technical Advice Memorandum 9604001 (the 96 TAM), and ending with the publication of the final split dollar regulations (effective for arrangements entered into after September 17, 2003), the IRS made it clear that it did not agree with the historical tax treatment. In the 96 TAM, the IRS held that the participant must include in income each year the growth of the policy cash value in excess of the employer’s share as if it were a transfer of property taxable under Section 83.

In Notice 2001-10, issued in January 2001, and in successor Notice 2002-8, issued in January 2002, the IRS indicated that the substance of a split-dollar arrangement is either a below market interest loan, taxable under Section 7872, or a transfer of property from the employer to the employee, taxable under Section 83. Notices 2001-10 and 2002-8 were followed in 2003 by issuance of final regulations, effective for split-dollar arrangements entered into after September 17, 2003. The final regulations continue the Notice 2002-8 approach under which the tax treatment follows the ownership of the underlying policy. If the policy is owned by the participant and is structured on a CASD basis, it will be taxed under the below market interest “loan” regime set forth in the regulations. If the policy is owned by the employer under an endorsement split-dollar arrangement, it will be taxed under the “economic benefit” regime set forth in the regulations.

Pre-Regulation CASD Arrangements

Split dollar arrangements entered into before September 18, 2003, are not covered by the final regulations (unless subsequently modified), but rather are covered by Notice 2002-8, which indicates that:

- The value of the life insurance protection provided should be determined using a specified term rate table (Table 2001) or the insurer’s lower published term rates (for pre-January 28, 2002, split-dollar arrangements).
- The arrangement could be converted to loan treatment.
- If not terminated or converted to loan treatment under the safe harbor provisions, the Notice indicates that the IRS will not assert that there has been a taxable termination of the arrangement as long as the economic benefit continues to be recognized. That is, the IRS will not assert that the growth of the participant’s equity is taxable each year as it held in the 96 TAM. While the taxation of the participant’s equity at the time of the termination (at “roll-out”) is not specifically addressed in the Notice, the implication is that it is taxable at that time.

Finally, Notice 2002-8 indicated that, “*No inference should be drawn from the changes in tax treatment of split-dollar arrangements under the final regulations regarding the appropriate tax treatment of pre-regulation arrangements.*” One might interpret this “no inference” language to mean that the roll-out of a pre-September 18, 2003, CASD policy is not taxable, as old law (Revenue Ruling 64-328) should apply. However, IRS representatives have stated informally that, in their opinion, notwithstanding the “no inference” language of Notice 2002-8, the participant’s equity in a CASD arrangement represents deferred compensation that is taxable at the time of the roll-out.

Section 409A

Section 409A was added to the tax code as part of the American Jobs Creation Act of 2004. It was intended to provide additional regulation of deferred compensation programs to prevent the recurrence of certain perceived executive compensation abuses associated with some of the corporate scandals in the late 1990s and early 2000s. Guidance regarding the application of Section 409A to split-dollar arrangements, however, was not provided until April 2007 in the form of Notice 2007-34 issued in conjunction with the final Section 409A regulations. Notice 2007-34 indicates that:

- A split-dollar arrangement that only provides a death benefit is not subject to Section 409A.
- A split-dollar arrangement that is taxed as a series of loans is not subject to Section 409A (unless the loans are forgiven).
- Section 409A is applicable to premium payments (and the related growth in the participant’s share of cash value) that were/are earned and vested after January 1, 2005.
- Section 409A is not applicable to premium payments made before or after January 1, 2005 or to the related growth in the participant’s share of cash value (before or after January 1, 2005), if those payments were earned and vested prior to January 1, 2005.
- If there are both grandfathered and non-grandfathered components of cash value, earnings should be allocated among the two components.
- And finally, the modification of a split-dollar arrangement for compliance with Section 409A will not constitute a “material modification” under the final split-dollar regulations eliminating “grandfathered” status, if certain conditions are met.

The Section 409A Riddle

While there are valid arguments that the equity in a pre-September 18, 2003, CASD arrangement should not be taxable to the participant at the time of roll-out, the IRS does not agree. It has indicated that, notwithstanding the “no inference” language in Notice 2002-8, the equity is taxable to the participant at the time of termination of the split-dollar arrangement. Therefore, regardless of the merits of the arguments for non-taxation (as best outlined by the

AALU in its response to the issuance of the 96 TAM), plan participants are exposed to the possibility of back taxes, interest, and penalties if the IRS ultimately prevails in its position.

Furthermore, some tax commentators have pointed out that the “no inference” language included in Notice 2002-8 is not repeated in Notice 2007-34. Does this mean that a pre-September 18, 2003, CASD arrangement that is not subject to Section 409A (because all premium payments were earned and vested before January 1, 2005) has the “no inference” protection of Notice 2002-8, but a pre-September 18, 2003, CASD arrangement that is subject to Section 409A (because premium payments are made after January 1, 2005, which were not earned and vested before that date) does not have the “no inference” protection because the controlling law is Notice 2007-34?

The Answer to the Riddle—Multiple Choice, Check 1

The participant’s equity in a pre-September 18, 2003, CASD arrangement:

- ✓ Is taxable at roll-out because Section 409A applies and there is no “no inference” protection under Notice 2007-34.
- ✓ Is not taxable at roll-out because Section 409A does not apply and, therefore, application of old law is appropriate based on the “no inference” language of Notice 2002-8.
- ✓ Is taxable at roll-out notwithstanding the “no inference” language of Notice 2002-8, but only non-grandfathered amounts are subject to Section 409A (IRS position).

Planning Alternatives with Respect to Pre-September 18, 2003, CASD Arrangements

Because of the uncertainty regarding the ultimate tax treatment of the participant’s equity at the time of roll-out, and the potential exposure to back taxes, penalties, and interest, it may be prudent to consider one of two alternatives:

1. Amendment of the CASD plan for compliance with Section 409A, or
2. Restructuring of the plan to a non-split-dollar format.

Amendments Required for Section 409A Compliance

To comply with Section 409A, a typical CASD plan must be amended to:

- Restrict the timing of the roll-out to a specified date or permissible event.
- Delay access to cash value for Key Employees for 6 months beyond the termination/roll-out date.

- Eliminate any provision that allows the participant to exercise his or her discretion to terminate the arrangement.
- To eliminate automatic termination provisions (such as for non-payment of the participant's premium contribution).

Modifications to comply with Section 409A will not be considered "material modifications" under the final split-dollar regulations if:

- The modifications consist only of changes to applicable definitions, payment timing requirements, and/or changes to conditions of forfeiture.
- The modifications are consistent with the terms of the original agreement.
- The beneficiary's rights under the agreement are not materially enhanced.

Non-Split-Dollar Re-Structuring Alternatives

1. Conversion to a "Bonus" Plan - The most commonly used re-structuring alternative is to convert the CASD arrangement to a Section 162 "Bonus" plan structure. Many publicly-traded companies did this in 2002 in response to the prohibition against making premium loans to Executive Officers under the Sarbanes-Oxley Act. While a bonus plan structure is straightforward from a tax standpoint, and is easy to communicate to participants, there are issues involved in the transition:
 - If the CASD plan is frozen and the bonus structure is used going forward, many of the issues and tax uncertainties noted above would still apply to the frozen CASD plan.
 - If the CASD plan is terminated and a new bonus plan is implemented, there is still the open question of the taxation of the roll-out upon termination and the application of Section 409A.
2. Conversion to an "Executive Roth Plan"SM – RCG has developed the Executive Roth PlanSM (ERP) in response to the need dictated in the marketplace for a supplemental tax-advantaged savings vehicle that offers benefit security and protection from future tax rate increases. The savings vehicle is an institutionally-priced life insurance contract that offers:
 - After-tax contributions,
 - Tax-deferred accumulation in a wide range of competitive investment choices,
 - Potentially tax-free withdrawals,
 - Protection from creditors,
 - Portability, and
 - A death benefit to replace the current split-dollar benefit.

An additional, unique feature of the ERP is the availability of a “tax restoration” policy loan. Unlike traditional life insurance policy loans, the tax restoration loan feature of the ERP allows the participant to leverage-up his or her after-tax investment to a pre-tax equivalent amount. For example, if the participant earmarked \$25,000 of his or her bonus each year for a supplemental savings plan, the after-tax amount (\$15,000 at an assumed combined federal and state tax rate of 40%) would be invested in the policy. A policy loan in the amount of \$10,000 would be offered by the insurance carrier and the entire \$25,000 could be allocated among the various investment choices. The policy cash value would grow based on the full amount of the earnings on the \$15,000 premium payment, and the spread earned on the \$10,000 policy loan. Finally, assuming that the policy is properly administered, accumulated cash value can be withdrawn tax free up to the amount of the participant’s basis, and then tax free loans can be made from cash value.

In summary, the ERP is ideally suited for a situation in which there are concerns about the benefit security of a traditional nonqualified deferred compensation plan, there is a desire to diversify retirement savings with respect to the exposure to future tax rate increases, and there is a need for a supplemental life insurance benefit.

Accounting for Split-Dollar Arrangements

In recent years, the FASB’s Emerging Issues Task Force (EITF) has considered the accounting for split-dollar arrangements. It had been concerned that the historical accounting treatment for such programs was inconsistent and, in some cases, inappropriate. In 2006, the FASB ratified EITF 06-4, “Accounting for Deferred Compensation and Post-Retirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements.” Then, in 2007, it ratified EITF 06-10, “Accounting for Deferred Compensation and Post-Retirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements.” In each case, the new accounting rules are effective for fiscal years beginning after December 15, 2007. Also in each case, the rules are designed to properly reflect the substance of the arrangement. While the focus of this article is CASD arrangements, the following is a brief overview of the concepts underlying both EITF 06-4, dealing with endorsement split-dollar arrangements, and EITF 06-10, dealing with CASD arrangements, since much of the analysis and findings of EITF 06-10 follows that of EITF 06-4.

EITF 06-4, “Accounting for Endorsement Split-Dollar Arrangements”

In the past, many employer/sponsors did not recognize a liability for a post-retirement benefit provided under an endorsement split-dollar plan. It was generally believed that the purchase of an insurance policy on the life of each participant was sufficient to settle the obligation. Since the death benefit under the plan would be paid by the insurance company, it made no sense to record a liability on the company’s books for an obligation that it would never pay. On the asset side of the balance sheet, the employer/sponsor would typically record 100% of the cash value of the insurance policies purchased under the plan, or its share of the death benefits if less. After studying the issue, the EITF concluded that the accounting treatment described above was incorrect. It determined that a liability should be recorded under FAS 106 for any post-retirement benefit under the plan because the purchase of an insurance policy on the life of each participant, as typically structured in an endorsement split-dollar plan, does not meet the FAS 106 definition of an insurance contract and, therefore, does not settle the liability. (To meet

the FAS 106 definition, the insurance company must unconditionally assume the obligation and the contract must be irrevocable.)

The method of accrual of the liability depends on the nature of the employer's promise to:

- Maintain a policy on the life of the employee/participant after retirement, or
- Pay a specific post-retirement death benefit.

If the nature of the promise is to maintain a policy after retirement, the present value of the projected post-retirement cost of insurance is accrued over the service period of the employee/participant. The liability is relieved after retirement as the cost of insurance is incurred, and any remaining liability is reversed at death.

If the nature of the promise is to provide a specific post-retirement death benefit, the present value of the projected death benefit at the expected mortality date is accrued over the service period of the participant (or prior to the full eligibility date, if earlier). After retirement, the present value of the liability continues to grow at the assumed discount rate until it equals the nominal death benefit at expected mortality. At death, assuming that the policy is still in-force, the liability is reversed. No deferred tax benefit is recorded in conjunction with the recognition of the liability since the employer will not pay the death benefit and, therefore, will never receive a related tax benefit.

Finally, the implementation of EITF 06-4 is treated as a change in accounting principle recorded in a cumulative effect adjustment (an adjustment to beginning retained earnings), or through retrospective application to all prior periods.

EITF 06-10, "Accounting for Collateral Assignment Split-Dollar Arrangements"

The EITF followed up its work on Issue 06-4 with the consideration of the accounting for CASD arrangements, and in March 2007 FASB ratified EITF 06-10. Once again, the EITF was concerned about the consistency and appropriateness of the historical accounting treatment. Most sponsors of CASD plans recognized no liability for a post-retirement benefit and recorded an asset equal to the lesser of 100% of the cash value of the underlying policies or the cumulative premiums paid under the plan. EITF 06-10 addresses two issues:

- Whether or not a post-retirement benefit obligation should be recorded, and
- The measurement of the cash value asset.

Consistent with EITF 06-4, EITF 06-10 looks to the substance of the arrangement for guidance as to the proper accounting treatment. In the case of a CASD program, the first question is whether the employer's promise represents a post-retirement benefit obligation or a below market loan? If the plan provides a post-retirement benefit, is the nature of the employer's promise to maintain an insurance policy during retirement, or to provide a specific post-retirement death benefit or a target amount of cash value?

If the nature of the employer's promise is to maintain the policy, the estimated cost of insurance in retirement must be recorded as a liability under FAS 106. If the employer's promise is to

provide a specific post-retirement death benefit, the actuarial present value of the death benefit must be accrued during the service period of the participant under FAS 106. The cash value asset should be recorded at 100% of policy cash value.

If the substance of the arrangement is a below market loan, no liability is recognized for a benefit obligation. The issue is the recognition and valuation of the cash value asset. A determination is made as to whether the loan is a term or a demand loan, and if it is impaired. If it is a term loan, the expected premium repayment is discounted at a market rate.

Compensation is imputed to the participant in the year that the arrangement is entered into equal to the amount of the discount. If the substance of the arrangement is a demand loan, compensation is imputed to the participant, and interest income is imputed to the employer each year at the excess of a market rate over the stated rate. If the loan is impaired (i.e., the cash value of the policy is less than premiums advanced), the recorded value of the asset is limited to the cash value.

Since the accounting treatment under EITF 06-10 varies depending on the substance of the arrangement—a benefit obligation versus a below market loan—it is important (but not always easy) to distinguish between the two. Consider the following questions:

- Does the arrangement provide for a specific post-retirement death benefit?
- Does the arrangement target an amount of cash value accumulation at retirement?
- Has the employer/sponsor promised to continue premium payments into retirement?
- Who bears the risks and rewards of policy performance?
- Is there an agreement to forgive repayment of some or all of the premiums advanced?
- How is the arrangement treated for Sarbanes-Oxley—as a loan?
- Can the employer cancel the arrangement and demand repayment at any time?

Finally, as is the case for EITF 06-4, the implementation of EITF 06-10 is treated as a change in accounting principle recorded as a cumulative effect adjustment (an adjustment to beginning retained earnings), or through retrospective application to all prior periods.

Conclusion

After issuance of the 2003 final split-dollar regulations, many corporate sponsors of CASD arrangements adopted a “wait-and-see” approach. However, the world of CASD taxation and regulation has changed, and that approach may no longer be prudent. The possible applicability of Section 409A creates potential exposure to participants to back taxes, interest, and penalties. The accounting implications of EITF 06-10 are likely to be negative and require analysis. Finally, the communication to participants regarding the costs and benefits of a CASD plan has reached a new level of complexity.

In summary, CASD plans have become more expensive—to both the employer and the employee. Corporate sponsors need to address the issues discussed above as soon as possible and decide whether to amend the plan for Section 409A compliance or consider restructuring alternatives.