StatonWalsh

Financial Clarity Through Transparency

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Federal Taxation of Split-Dollar Arrangements

On September 11, 2003, the Treasury Department and the Internal Revenue Service (IRS) released Treasury Decision 9092, containing final regulations on the taxation of split-dollar arrangements for the purpose of federal income, employment, self-employment and gift taxes.[1] The issuance of these final regulations came after several years of regulatory review and largely follow proposed regulations issued in 2002 and 2003.

The final regulations were effective for split-dollar arrangements entered into after September 17, 2003, and to arrangements entered into before September 18, 2003, but later materially modified. Certain “grandfathering” and “safe harbor” provisions apply to arrangements entered into before September 17, 2003.

What Is a Split-Dollar Arrangement?

In general terms, a split-dollar arrangement is an agreement between two or more parties to share the benefits and/or costs of a permanent life insurance policy. Under the final regulations, it is generally any arrangement with the following elements:

- **Parties:** Includes the owner of the life insurance contract and a non-owner.
- **Premium payer:** Either party pays all or part of the premiums.
- **Premium recovery:** One of the parties paying the premiums is entitled to recover (conditionally or otherwise) all or any portion of those premiums.
- **Premium security:** Recovery of premiums paid is made from, or secured by, the proceeds of the life insurance policy.

This definition covers a range of relationships, like those between employer and employee, service recipient and service provider, corporation and shareholder, or donor and donee.

Who Owns the Policy?

The benefits of split-dollar arrangements will be taxed under one of two mutually-exclusive “regimes”, depending on who owns the life insurance policy. Generally, if the employer, service recipient, corporation, or donor is the owner, the “economic benefit” regime applies.

[1] The rules discussed here concern federal law; state and local law may differ.

If the employee, service provider, shareholder, or donee is the owner, the "loan" regime applies.

The "owner" is generally the person or entity named in the life insurance contract as the owner. Under a major exception to this rule, an employer, service recipient, or donor will be treated as the owner (regardless of who actually owns the contract) if, at all times, the only benefit available to an employee, service provider, or donee is the value of current life insurance protection. The final regulations include ownership attribution rules for certain compensatory split-dollar arrangements. A "non-owner" is generally any person or entity other than the contract owner who has an interest in the policy.

Economic Benefit Regime

Under the economic benefit regime, the owner of the policy is considered to be providing economic benefits to the non-owner. This regime generally applies to split-dollar agreements traditionally described as "endorsement" arrangements.

Depending on the relationship between the owner and non-owner, these economic benefits could be treated for tax purposes as compensation, dividends, a capital contribution, a gift, or "a transfer having a different tax character." The value of these benefits, reduced by any consideration paid by the non-owner to the owner, is generally measured on the last day of the non-owner's taxable year[1] and may include the following:

- **Current life insurance protection:** The value of current life insurance protection is generally calculated using an IRS-provided premium factor, published in the Internal Revenue Bulletin. Currently, this is Table 2001. If certain requirements are met, the insurer's one-year term rates may be used.
- **Cash values available to the non-owner:** Defined as cash values to which the non-owner has current[2] access, to the extent not taken into account in a prior taxable year.
- **Other:** These include the value of any other economic benefits provided to the non-owner, to the extent not taken into account in a prior taxable year.

There are a number of other tax consequences to keep in mind:

[1] As an alternative, the parties could agree to use the policy anniversary date.

[2] In general, these are cash values to which the non-owner has a current or future right, which are directly or indirectly accessible by the non-owner, and which are inaccessible to the owner or the owner's general creditors.

- **Non-owner payments are income to the owner:** Any amount paid by the non-owner to the owner for any economic benefit is included in the owner's gross income.

- **Investment in the contract:** In a split-dollar arrangement, only the owner of a life insurance policy may have a basis in the contract. Therefore, a non-owner has no basis in the policy until the policy (or an undivided interest) is transferred to the non-owner.

- **Amounts received under the life insurance contract:** The final regulations provide that any amount received under the life contract (other than an amount received by reason of death) and provided to the non-owner is treated as though paid by the insurance company to the owner and then by the owner to the non-owner. Death benefits paid to a beneficiary (other than the owner of the policy) are excluded from income under IRC Sec. 101(a) only to the extent such amounts are due to current life insurance protection provided to the non-owner under the agreement, the cost of which was paid by the non-owner, or which the non-owner has taken into account as an economic benefit.

Loan Regime

Under this regime, the non-owner is viewed as making an interest-bearing loan to the owner. The loan regime generally applies to "collateral assignment" arrangements.

A payment made pursuant to a split-dollar life insurance arrangement is a split-dollar loan, and the owner and non-owner are treated, respectively, as borrower and lender, if:

- **Payments:** A payment is made (directly or otherwise) from the non-owner to the owner;

- **Payment is a loan:** The payment is a loan under general federal tax principles, or a reasonable person would expect the payment to be repaid in full; and

- **Payment source:** The repayment is to be made from (or is secured by) the policy's death benefit, cash surrender value, or both.

Each premium payment under a split-dollar arrangement is a separate loan for federal tax purposes. If a split-dollar loan does not provide for an adequate rate of interest, it is considered a "below-market" loan and is recharacterized as a loan with interest at the applicable federal rate (AFR). The regulations presume a transfer by the lender to the borrower of the interest shortfall, and further presume this amount to be repaid to the lender as interest due. Other regulations with regard to forgiven interest apply.

Gift-Tax Treatment of Private Split-Dollar Arrangements

The final regulations make clear that the same general principles apply to private split-dollar arrangements. Premium payments in private split-dollar arrangement may be considered gifts or loans, with consequent federal tax results.

Sarbanes-Oxley Act of 2002

One section of the Sarbanes-Oxley Act of 2002 prohibits publicly traded companies from making certain loans to directors and executives. The final IRS split-dollar regulations leave the interpretation and administration of Sarbanes-Oxley to the Securities and Exchange Commission (SEC). In the absence of any guidance from the SEC, it remains unclear as to whether or not Sarbanes-Oxley applies to split-dollar arrangements.

IRC Sec. 409A – Nonqualified Deferred Compensation

IRC Sec. 409A concerns the federal income tax treatment of nonqualified deferred compensation arrangements. Income deferred under an arrangement which does not meet the requirements of IRC Sec. 409A is generally subject to taxation in the current year, including substantial penalties and interest. Most of the final regulations concerning IRC Sec. 409A were released in TD 9321, on April 10, 2007.

Notice 2007-34, released at the same time as the final 409A regulations, provides general guidance regarding on how IRC Sec. 409A applies to split-dollar arrangements. As explained in the notice, split-dollar arrangements which provide only death benefits are generally exempt from IRC Sec. 409A. Arrangements which provide for certain short-term (2-1/2 months) deferrals of compensation are also generally exempt.
Notice 2007-34 also listed examples of split-dollar arrangements to which IRC Sec. 409A would apply. For example, an endorsement split-dollar arrangement, taxed under the economic benefit regime, would come under IRC Sec. 409A if it includes a promise by the employer to transfer a policy's cash value to the employee at retirement. A split-dollar arrangement taxed under the loan regime would come under IRC. Sec. 409A if it provides that loan amounts can be waived, cancelled, or forgiven in the future.

Because both the federal law and regulation are complex, caution is advised to ensure that a split-dollar arrangement does not come within the scope of IRC Sec. 409A.

Employer-Owned Life Insurance Contracts

Under federal law, amounts received under a life insurance contract paid by reason of the death of the insured are generally excluded from income. Under the provisions of the Pension Protection Act of 2006, however, death proceeds from a life policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. This law was effective for contracts issued after August 17, 2006, except for policies acquired in an IRC Sec. 1035 exchange. See IRC Sec. 101(j).

Seek Professional Guidance

Given the complexities involved, those considering or involved in a split-dollar arrangement are advised to seek the help of appropriate professional counselors.

Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

Disclosure Notice