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IRS FINALIZES SPLIT-DOLLAR REGULATIONS - TIME FOR ACTION FOR EXISTING ARRANGEMENTS

On September 11, 2003, the IRS issued final regulations governing the tax treatment of split-dollar life insurance arrangements. The final regulations largely reflect the proposed regulations that the IRS issued July 9, 2002 and again on May 9, 2003. Although the final regulations are not a significant departure from the proposed rules, the final rules do affirm the IRS's intention to significantly change the tax treatment of split-dollar life insurance arrangements from the treatment that employers and practitioners applied in prior years.

The final regulations are effective for split-dollar life insurance arrangements entered into or materially modified after September 17, 2003. Non-material modifications include, but are not limited to, changes to the premium payment deadline, policy beneficiary (unless the beneficiary is a party to the arrangement), and interest rate. IRS Notice 2002-8 remains the primary source for transition guidance for arrangements entered into before January 28, 2002.

Background

A split-dollar life insurance arrangement is an employee benefit that employers typically provide to executives. (Although these arrangements can arise in a private, non-employer context, for purposes of this Management Alert, we summarize the rules affecting employer-provided split-dollar arrangements.) Under this arrangement, an employer and the executive share the costs and benefits of a life insurance policy. Typically, the employer pays the premiums on behalf of the executive. The policy insures the life of the executive. The executive and his or her beneficiaries enjoy current death benefit protection. Once the arrangement ends (termination of employment, retirement, the executive's death, etc.), the employer is generally entitled to repayment of the premiums it paid. These arrangements are typically funded through a whole or variable life insurance policy. The insurer repays the employer's premiums from the cash value component of the policy. The executive may be entitled to the cash value component minus the employer's premiums. This constitutes the executive's "equity" and is where the term "equity" split-dollar life insurance derives. These arrangements can be structured many different ways and, as the final regulations confirm,

depending on the nuances and structure of the arrangement, different tax rules will apply.

Two Tax Regimes

The final regulations confirm that the IRS will tax split-dollar arrangements under one of two "regimes" depending on who owns the policy. If the policy names the employer as the owner, as is the case under the "endorsement" method of split-dollar arrangements, then the economic benefit regime applies. Alternatively, if the policy names the executive as owner, as is the case under the "collateral assignment" method, then the loan regime applies.

Economic Benefit Regime

If the policy names the employer as the policy owner, then the arrangement is taxed under the economic benefit regime which requires that the employee be taxed on (1) the value of the current life insurance protection, (2) the amount of cash value to which the executive has current access, and (3) the value of any other economic benefits. In the case of the latter two, such value is taxed only to the extent not taken into account in a prior tax year.

The value of the life insurance protection is measured using a published table. (Note: for arrangements entered into before January 28, 2002, lower P.S. 58 costs or the insurer's lowest published term rate can be used as the basis for determining the value). The final regulations establish that the IRS will broadly construe when an employer has "current access" to the cash value resulting in taxable income. An executive will be considered to have current access to the cash value if the executive has a current or future right to it and the cash value currently is directly or indirectly accessible to the executive, inaccessible to the employer or inaccessible by the employer's general creditors. The preamble to the final rules provides some examples of "current access" including the executive's ability to withdraw amounts from the policy, borrow from the policy, partially or totally surrender the policy, anticipate, assign, alienate, pledge, or encumber the policy cash value or if the policy's cash value is available to the executive's creditors. Additionally, the cash value is inaccessible to the employer

(resulting in income to the executive) if the employer does not have the full rights to policy cash value normally held by an owner.

Loan Regime

Alternatively, where the policy names the employee as owner, then the arrangement is taxed under the loan regime which requires that the employer's premium payments be treated as a series of loans to the employee. Unfortunately for employers, the final regulations require application of a complex set of rules. Despite comments to the proposed regulations pressing for an administratively simpler route, the final regulations treat each premium payment as a separate loan. If the arrangement does not provide for sufficient interest on the premium payment, the regulations treat the premium payment as a below-market split-dollar loan subject to Code Section 7872 and Treasury Regulation Section 1.7872-15. (For split-dollar demand loans, the regulations determine whether the arrangement charges sufficient interest on the loan by comparing the rate at which interest accrues on the loan's adjusted issue price during the year to the blended annual rate published in the Internal Revenue Bulletin. For term loans, the regulations determine whether the arrangement charges sufficient interest on the loan by comparing the imputed loan amount and the actual amount of the loan.) If the arrangement does not charge sufficient interest, the regulations recharacterize the premium payment as a loan with interest at the applicable federal rate and an imputed transfer by the employer to the executive. In the employment context, the transfer is characterized as compensation income. If the arrangement provides for sufficient interest, then the Code's general rules for debt instruments apply.

Dealing With Existing Arrangements

For employers with arrangements in place which were entered into before January 28, 2002 and not materially modified after such time, IRS Notice 2002-8 offers valuable transition guidance. However, action will be needed by December 31, 2003.

- ◆ If either a collateral assignment or an endorsement arrangement is terminated before January 1, 2004, by repayment of the employer's premium advances, the employee will not be taxed on any then existing policy equity. This option will be most valuable for "mature" arrangements where premiums are paid-up and the arrangements have substantial policy equity after repaying the employer. However, this option is not ideal for "immature" policies where substantial future premiums remain to be paid.
- ◆ Endorsement arrangements can switch to loan treatment before January 1, 2004, which will avoid taxation to the employee of policy equity existing at the time of the switch. This option requires that all pre-January 1, 2004 premium payments be treated as the beginning loan balance (with no retroactive interest applied) on January 1, 2004 and that subsequent premium payments by the employer be treated as a series of additional loans.
- ◆ No change is also an option if the employee is taxed on the value of the life insurance as an economic benefit. At rollout, there may be a tax issue, however.

The options for existing arrangements are complicated and will require careful review of the policy and split-dollar agreements with the assistance of a financial advisor and legal counsel well before December 31, 2003. Employers considering changes to their existing split-dollar arrangements should also consult with their legal counsel to determine whether the changes are material, thereby triggering application of the final regulations. Public companies need to take special care in making decisions to consider the impact of the Sarbanes-Oxley Act of 2002. Note, also, that under the final regulations tax-exempt organizations may have additional timing of taxation issues to address.

If you have any questions about the application of this new guidance to split-dollar arrangements, please contact the Seyfarth Shaw LLP employee benefits group attorney with whom you work or any employee benefits group attorney listed on the website at www.seyfarth.com.

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