GROOM
LAW GROUP

September 26, 2003

IRS Finalizes Comprehensive New Rules for Split Dollar Plans

In January 2001 – after nearly 35 years without any new official guidance – the IRS reopened the tax treatment of split dollar life insurance plans. Notice 2001-10. After a flurry of Notices and several sets of proposed rules, the IRS has succeeded in establishing new – and generally unfavorable – tax rules for split dollar plans that are established (or materially modified) after September 17, 2003. 68 Fed. Reg. 54336 (Sept. 17, 2003). In Rev. Rul. 2003-105 (Oct. 6 IRS Bulletin), the IRS has declared the seminal split dollar ruling, Rev. Rul. 64-328, obsolete (except for grandfathered programs). A brief report on the latest guidance follows.

Background

In July 2002, IRS issued an extensive set of proposed regulations for split dollar insurance plans not eligible for grandfather treatment under Notice 2002-8. The proposed rules provided for split dollar plans to be structured under a "loan" regime or an "economic benefit" regime.

Under the "loan" regime – similar to the traditional "collateral assignment" split dollar plan – the employee is the owner of the policy, and the employer is treated as loaning the premiums to the employee subject to the below-market loan rules (sec. 7872). Typically, this will result in imputed income to the employee in the amount of the foregone interest on the cumulative premium payments advanced by the employer. The proposed rules provided comprehensive guidance for split dollar arrangements intended to be treated as loans.

Under the "economic benefit" regime, the employer is the policyowner, and the employee has the right to (and is taxed on) life insurance protection. If the only benefit to the employee is current life insurance protection, and the employer has a right to the greater of the premiums it has paid or the cash value of the policy, the employee is only taxed on the value of the protection. The cash value will be taxed if and when ownership of the policy (or an undivided interest therein) is actually endorsed over to the employee under section 83. If, however, the employer's rights in the policy are limited to premiums paid (or some amount less than the cash value of the policy, if that is greater than premiums paid), the arrangement is classified as an "equity split dollar" arrangement and the employee is taxable currently on the "economic benefit."

In May of this year, the IRS issued proposed regulations that provide guidance on potential "economic benefits." The key tax principle here is that the employee will be currently taxed on any portion of the "cash value" to which he has "access." The "access" concept includes not only withdrawal, assignment and loan rights, but any arrangement where policy values – even though not immediately available to the employee in cash – are effectively beyond the reach of the employer or the employer's general creditors. The proposed rules further provided that the cash value is determined without regard to surrender charges on the last day of the employee's tax year (for both income and employment tax purposes).

The proposed rules were reminiscent of the position IRS took in a 1996 tech advice memo that taxed the annual growth in an equity split dollar arrangement (set up on a "collateral assignment" basis) under section 83 principles – a position that was heavily criticized. The IRS asserted in the Preamble to the May 2003 proposed rules that it's new approach is consistent with the "doctrines of constructive receipt, economic benefit and cash equivalence" and is not based strictly on section 83 principles.

The May 2003 proposed IRS rules also would

- deny the employee a "basis" for income previously taxed under the "economic benefit" approach,
- deny the employee a loss deduction if the policy value to which he has access declines from one year to the next (e.g., because of investment performance under a variable policy), and
- tax the employee on any "other economic benefits" which include "any benefit, right or feature" of the life insurance contract (in addition to life insurance protection and cash value).

Final Rules

The IRS has now finalized both sets of proposed rules without significant changes. It rejected substantially all of the positions advanced by insurance companies, agents and brokers in written comments and at the public hearings. As a result, split dollar arrangements are unlikely to be a viable alternative for future compensation and insurance planning in many situations.

Notice 2002-8 provides reasonable transition relief for split dollar arrangements entered into before final regulations are published and not

materially modified thereafter. In particular, as long as the parties to an arrangement continue to tax the employee on the value of insurance protection, IRS will not assert the application of section 83 – even if the employee has a right to all or some of the cash value – before the arrangement terminates. In addition, for arrangements entered into before January 28, 2002, under which the employer has the right to full repayment of premiums, the IRS will not assert tax under section 83 if either (1) the arrangement is terminated by the end of 2003, or (2) beginning in 2004, all employer-paid premiums from inception are treated as loans. The final rules contain a non-exclusive list of adjustments that will not be considered "material modifications" under Notice 2002-8, which include electing either of the two transition approaches just noted. However, the overall tone of the listed items is that there is not much room to make voluntary adjustments without triggering the complex and onerous new rules.

The preamble to final rules (p. 54340) specifically addresses, for the first time, the interaction of the split dollar rules with the rules for nonqualified deferred compensation plans for tax-exempt and governmental employers (Code sec. 457(f)). The IRS states that equity split dollar plans covered by the "economic benefit" regime fall under section 457(f) and, thus, the employee may have income even before he has access to the deferred amounts. Apparently, the transition relief under Notice 2002-8 would not apply to such situations.

We note that these final regulations do not affect the imputed income rates for insurance protection provided under split dollar plans (or under qualified plans and 403(b) contracts). Under Notice 2002-8, the Table 2001 rates (or, where applicable, more favorable one-year term rates of the insurer) generally are used for this purpose. We understand that IRS plans to revisit these valuation rules at some point in the not-too-distant future.