Skeletons in the Closet: What to Do With "Grandfathered" Split-Dollar Arrangements

By David Houston & Maggie Mitchell, ING Life Companies

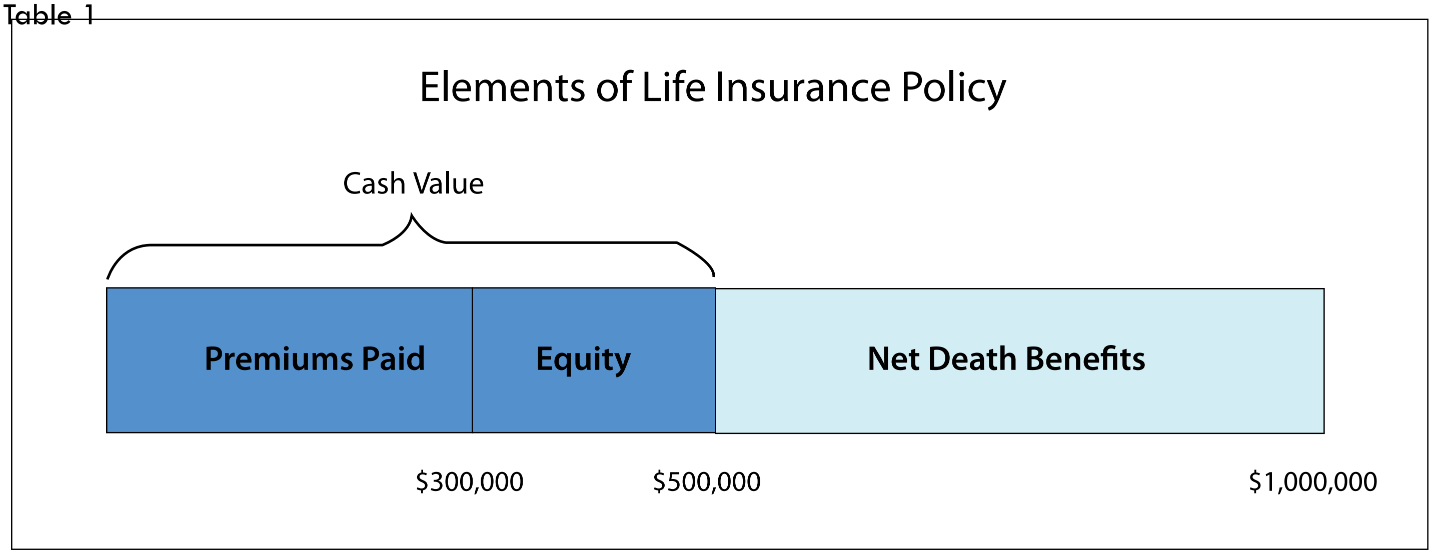
When Notice 2002-8 was published by the IRS, it created a divide in the world of split-dollar arrangements – a divide between arrangements entered into prior to January 28, 2002, and those entered into on or after that date. While the main purpose of the Notice was to introduce a new (and complicated) approach to taxing split-dollar arrangements, it also provided limited "grandfathering" for existing split-dollar arrangements. Clients with existing split-dollar arrangements were given the option to convert to the new tax regime or to terminate arrangements without taxation by December 31, 2003.

However many split-dollar participants did nothing. They either did not hear about the new rules, did not understand the new rules, or simply didn't act. Now these split-dollar arrangements are "skeletons in the closet": waiting to pop out during the course of seemingly innocent life insurance reviews. If you find that your client has a policy which is subject to an old split-dollar arrangement, what should you do?

As you review the arrangement, you should consider the following:

- Diagnose whether this is an **equity** or **non-equity** arrangement
- For non-equity arrangements, you need to consider whether making changes will force your client to use the IRS Table 2001 to measure economic benefit costs
  - Arrangements entered into prior to January 28, 2002 may freely use the insurance carrier's one-year term rates to measure economic benefit costs
  - Arrangements entered into (or modified) on or after January 28, 2002 can use carrier one-year term rates only if the carrier has a one-year term product that is available to all applicants and that the insurer regularly sells; otherwise such arrangements must use IRS Table 2001
- For equity arrangements, you need to consider whether making changes will cause your client to have an immediate tax bill for all equity build-up in the policy
  - Arrangements that don't yet have any equity can be treated like non-equity arrangements for the purpose of review
  - Any modification to arrangements that do have equity may force the participant to pay income

Table 1



taxes on the amount by which the policy's current cash value exceeds the total premiums paid.

Diagnosis: Equity or Non-Equity

The first step is to diagnose the situation: What type of split-dollar arrangement is it? Equity or non-equity? It makes no difference whether it is an endorsement arrangement (where the policy is owned by the employer) or a collateral assignment arrangement (where the policy is owned by the employee). The real issue is whether the arrangement was designed to provide cash value (equity) to your client.[1]

Notice 2002-8 and the final split-dollar regulations provide two different types of grandfathering. Permanent grandfathering was given to all non-equity split-dollar arrangements entered into prior to January 28, 2002. However, the tax-free treatment of cash value build-up in equity

arrangements was made available only for those arrangements that were either terminated or converted to split-dollar loans by December 31, 2003. So your first step in reviewing an existing split-dollar arrangement is to diagnose it as equity or non-equity.

What Is Equity?

To make this diagnosis you need to understand what is meant by "equity." Think of a cash value life insurance policy as having three components: cash value up to the total premiums paid, cash value in excess of total premiums paid, and net death benefit above the policy's cash value. Equity refers to the cash value in excess of premiums paid. So for example, if your client has paid a total of $300,000 in premiums for a policy that will pay a $1 million death benefit and the policy currently has a $500,000 cash value, then the equity in the policy is $200,000 ($500k cash value minus $300k total premiums paid). (see Table 1)

To determine whether your client's split-dollar arrangement is an equity arrangement or a non-equity arrangement, you need to look to the underlying agreement to see who is entitled to the "equity" portion of the life insurance policy. Most split-dollar agreements have

a section that describes how the death benefit will be allocated. If the employer is entitled to an amount equal to the greater of the total premiums paid or the policy's cash value, then the employee is not entitled to any equity and so it is a non-equity arrangement. If, on the other hand, the employer is only entitled to an amount equal to the total premiums paid, then the equity in the policy is assigned to the employee and it is an equity split-dollar arrangement.

Once you have diagnosed your client's split-dollar arrangement as being an equity or non-equity arrangement, you are ready to explore treatment options.

Options for Non-Equity Arrangements: It's All About the Tables

As mentioned earlier, Notice 2002-8 provides permanent grandfathering for the taxation of non-equity split-dollar arrangements entered into prior to January 28, 2002. If, however, such an arrangement is modified after that date, the final split-dollar regulations (Treas. Reg. 1.61-22) will apply instead. As you consider planning options for policies subject to a grandfathered non-equity split-dollar arrangement, one of the factors to consider is the potential impact on taxation that any policy changes might bring.

Taxation of Non-Equity Arrangements

Taxation of non-equity split-dollar arrangements was originally outlined in a

Revenue Ruling issued by the IRS in 1964. In Rev. Rul. 64-328, the IRS determined that where an employer provides an employee with the right to designate the beneficiaries of a portion of the death benefits of a life insurance policy whose premiums have been paid by the employer, a benefit has been conferred upon the employee even if the death benefit is not paid out. According to the IRS, the effect of a non-equity split-dollar arrangement is, "to provide an economic benefit to the employee represented by the amount of the annual premium cost that he should bear and of which he is relieved" (Rev. Rul. 64-328).

In other words, in a non-equity split-dollar arrangement, the employee receives an "economic benefit" in the form of term life insurance coverage. Each year a split-dollar arrangement is in effect, the employee should be taxed on the value of such coverage. According to Rev. Rul. 64-328 this amount can be determined by using factors for one-year term coverage set out in the P.S. 58 Table, originally published by the IRS in Rev. Rul. 55-747. Later, in Rev. Rul. 66-110, the IRS indicated that parties to split-dollar arrangements could use one-year term rates published by the insurance carrier that issued the policy if these rates were lower than the P.S. 58 rates. Eventually, in Notice 2001-10, the IRS replaced Table P.S. 58 with Table 2001.

Taxation After January 28, 2002

When the IRS issued Notice 2002-8, it took away the ability of parties to split-dollar arrangements to freely choose to use the insurance carrier's one-year term rates as a substitute for the rates published by the IRS in Table 2001. For arrangements entered into on or after January 28, 2002, insurance carrier's one-year term rates could not be used unless, "(i) the insurer generally makes the availability of such rates known to persons who apply for term insurance coverage from the insurer, and (ii) the insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels" (Notice 2002-8).

This is what is ultimately at stake for your clients with grandfathered split-dollar arrangements: the choice of tables that may be used to determine the annual value of "economic benefits" for income tax purposes. Grandfathered arrangements are free to choose between using Table 2001 or the carrier's one-year term rates, while non-grandfathered arrangements must use Table 2001 unless the insurance carrier has a qualifying one-year term product that meets a two-part test set out in Notice 2002-8.

Policy Review for Non-Equity Arrangements

So how should you approach a policy review where there is a grandfathered non-equity split-dollar arrangement?

Most of the review should be the same as if no split-dollar arrangement were present. You need to ask the same questions: Is the policy performing as originally expected? Do the clients have the same goals today as when they entered the arrangement? Would a different policy provide the same benefits for a lower cost? But then you need to ask some additional questions: What would be the additional tax cost for my client if the split-dollar arrangement loses its "grandfathered" status? Does the carrier for the proposed replacement policy have a qualifying one-year term product that meets the two-part test outlined in Notice 2002-8? If not, do the potential premium savings justify the higher tax costs?

As always, reviewing an existing life insurance policy involves a balancing act. Do the potential benefits of a new policy outweigh the potential disadvantages of making a change, including underwriting and tax considerations?

Options for Equity Arrangements: Bigger Stakes

Unlike non-equity arrangements, Notice 2002-8 provided only limited grandfathering for equity split-dollar arrangements. The central focus of Notice 2002-8 and the final split-dollar regulations was to address the tax treatment of equity build-up in a split-dollar arrangement. When the IRS issued its original guidance in Rev. Rul. 64-328, the only benefits conferred to the employee in the underlying arrangement were death benefits. In later years, however, employers and employees began to create equity split-dollar arrangements. These arrangements were structured to provide the employee with both the death benefit coverage addressed in Rev. Rul. 64-328 and with the potential to use the cash value build-up inside the life insurance policy without any additional taxation.

Taxation of Equity Arrangements

Equity split-dollar arrangements were designed to take advantage of the dual nature of cash value life insurance contracts (i.e., as providers of both death benefits and cash value) and a "loophole" or ambiguity in the split-dollar guidance from the IRS (no distinction between equity and non-equity arrangements). Prior to the new IRS guidance, employers and employees could establish split-dollar arrangements where a portion of the policy's cash value would be transferred to the employee tax-free (so long as the employee paid income taxes on the "economic benefits" associated with the death benefit coverage). In Notice 2002-8, the IRS indicated its intent to change the taxation of arrangements providing equity to the employee.

Starting on January 28, 2002, all new equity split-dollar arrangements would be taxed in one of two ways depending on who owned the life insurance policy. If the policy was owned by the employer (endorsement arrangements), the employee would continue to pay taxation on the economic benefits for death benefit coverage, and, in addition, would recognize as income each year the growth from the previous year in policy equity available to the employee. This type of taxation is referred to as the "economic benefits regime" (codified in Treas. Reg. 1.61-22). If, on the other hand, the policy was owned by the employee (collateral assignment arrangements), there would no longer be any taxation of economic benefits, but instead the employer premium payments would be treated as a series of loans to the employee. If the employer charged no interest on the loans, then the amount of interest that the IRS deemed should be paid on such a loan (using published applicable federal rates or "AFRs") would be recognized by the employee as "imputed interest" income. This type of taxation is referred to as the "loan regime" (codified in Treas. Reg. 1.7872-15).

For existing equity split-dollar arrangements, there was limited grandfathering. In order to avoid taxation of the existing equity build-up in these arrangements, participants had until December 31, 2003 to terminate the arrangements or convert them to the loan regime. But, of course, many participants in these partially grandfathered arrangements did nothing. What should you do if you come across one of these "grandfathered" equity split-dollar arrangements?

No Need to Panic

The first question that may come to mind is whether your client's failure to convert or terminate their split-dollar arrangement means that they owe taxes for equity build-up in the underlying policy. Fortunately, according to Notice 2002-8, the answer is no. While missing the window for limited grandfathering means that your client has lost the opportunity to access whatever equity then existed income tax-free, it does not force your client to recognize that equity build-up as income until your client actually accesses the policy's cash value or until the split-dollar arrangement is terminated, so long as the employee continues to pay taxes on the economic benefits for the death benefit coverage under the arrangement (see Notice 2002-8, sections IV.1 and IV.2). If or when your client does terminate the split-dollar arrangement or accesses cash from the policy, then all of the equity build-up will have to be recognized as income in that year. It is not clear, however, whether equity in a grandfathered arrangement must be recognized as income if the arrangement remains in place until the employee's death.

Policy Review for Equity Arrangements

Ignoring what may or may not have happened in 2003, your first issue when examining a grandfathered equity split-dollar arrangement is whether or not there actually is any equity in the policy: Is the policy's cash value greater than the total premiums paid?

If the answer is no, then you may want to focus your review on whether the split-dollar arrangement is still an appropriate benefit for the employee. How important was the potential for cash value build-up to what the employer and employee were trying to accomplish? Was this primarily an arrangement for death benefits, or were the parties really trying to create a retirement benefit? In either case, the fact that there is not currently any equity indicates that either the policy is under performing or that the employer has not been able to maintain the original schedule of premiums. A grandfathered arrangement with no equity may suggest a need to re-evaluate your client's needs and start from scratch.

If the policy does have equity, then you will need to exercise more caution as you review the arrangement. It is still a good idea to review whether the split-dollar arrangement is serving the goals that the parties had when they entered into it and whether those goals have changed. And it is still a good idea to review whether the policy is performing well and whether a new product might perform even better. But these questions must be tempered by the awareness that any changes to a grandfathered equity split-dollar arrangement can have immediate adverse tax consequences: terminating the existing arrangement or replacing the existing policy may require the employee to recognize all existing equity as taxable income.

So as is the case with a policy review for non-equity arrangements, there is a balancing act for reviewing grandfathered equity split-dollar arrangements. Here, however, the stakes are higher. Any changes to the arrangement could cause significant immediate taxation for the split-dollar participant.

Summing it Up

Accidentally discovering an old split-dollar arrangement can be a cause for panic, especially if you have little or no experience with split-dollar arrangements. Yet by keeping some simple concepts in mind, you can still provide your client with guidance. First, find out if there is any equity involved in the arrangement. If the arrangement was designed to be a non-equity arrangement or if the policy has not yet created equity, your only real concern is whether making any changes will change the table used for valuing economic benefits going forward. If, however, this is an equity arrangement and the policy does have cash value in excess of premiums paid, then you need to avoid making any changes to the arrangement unless your client is willing and able to pay taxes on the existing equity.

Sources

[1]This article focuses on split-dollar arrangements in an employment context. Keep in mind, however, that the final split-dollar regulations indicate that the same principles may be applied to split-dollar arrangements used in gift and estate planning arrangements (i.e., "private" split-dollar arrangements).

David Houston is an advanced sales consultant for ING U.S. Insurance. Prior to joining ING, he was an advanced sales attorney with several major life insurance companies and a major vendor of bank-owned life insurance (BOLI). Houston has experience in estate and business planning, life insurance sales, and non-qualified employee benefits. David can be reached at David.Houston@us.ing.com.

Maggie Mitchell is vice president of Advanced Sales for ING U.S. Insurance. She has more than 25 years experience in the financial services, tax, legal and insurance industries. Prior to joining ING, she worked as a life insurance consultant for high net-worth individuals and business owners, and practiced law as an estate planning and business attorney. She is prior chairperson of the LIMRA Advanced Sales Committee and has published numerous articles for industry and legal publications. Maggie can be reached at Maggie.Mitchell@us.ing.com.