

SPLIT DOLLAR

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Notes:

SPLIT DOLLAR

- Split Dollar is a method of financing the payment of premiums of a cash value insurance policy.
- It is a method of sharing the costs of a life insurance policy.
 - The premiums, death benefit and the cash value all may be "split" between the parties.
 - Most common arrangement is employer/employee.
 - But also can be corporation and shareholder, partner and partnership, family member and trust, etc.
- Split Dollar is selective and non qualified and this has made it more attractive as a form of deferred compensation.
- The "split" of cash values and death benefits is determined by the Employer's interest in the split.
 - return of premiums ("equity split") to Employer; or
 - return of cash value to Employer; or
 - return of greater of premiums or cash value to Employer.
- The "split" of premiums is determined by the Employee's contribution to the arrangement.
 - "Employer Pay All" - often used.
 - Classical Split - Employer pays an amount equal to the increase in cash value - published opinions deal with this.
 - Level amount split.
 - Term cost split - Employee pays term cost.
- **ENDORSEMENT METHOD:**
 - Corporation owns the policy and through a policy endorsement filed with insurance company endorses Employee's interest in policy.
- **COLLATERAL ASSIGNMENT METHOD:**
 - Employee or third party (such as a trust) is the owner and files a collateral assignment with insurance company to protect the Employer's interest. Historically this has been the most frequently used method.
- **EQUITY SPLIT DOLLAR:**

- Employer's interest is limited to its premium advances.
 - Any "equity" or excess policy values will belong to the Employee or a third party owner.
 - NOTICE 2001-10, 2002-8 and the proposed regulations address the income tax aspects of equity split dollar.
- **ROLLOUT SPLIT DOLLAR:**
 - An unwinding of the Split Dollar arrangement.
 - Employer usually recoups its investment.
 - Question here is what is the income taxation to the respective parties.
- **THIRD PARTY SPLIT DOLLAR:**
 - A third party, i.e., a trust, owns the policy.
 - It is usually estate planning motivated.
 - The trust owns the policy and the death benefit is removed from the estate.
 - The "gift" is not the full premium but the economic benefit.
 - Often used with survivorship policies.
 - Allows packing of more insurance into an irrevocable crummy trust covered by the insured's annual exclusion, unified credit or GST exemption because the Gift Tax is based on the economic benefit.
- **REVERSE SPLIT DOLLAR:**
 - The most extreme position in split dollar.
 - Employee owns the policy and endorses the Employer's interest in the policy's death benefit to it.
 - relies on old PS 58 rates.
 - Notice 2001-10 severely damaged reverse split dollar as a viable method.
 - very little authority on reverse split dollar.
 - Notice 2002 -59 essentially eliminates reverse split dollar and indicates that there may be income and gift tax problems with PS 58 cost reverse split dollar arrangements.
- **CONTROLLING SHAREHOLDERS:**
 - Those who own more than 50% of the voting power of the corporation, disregarding any shares owned by family members or other entities which might be attributable to the shareholder.

- Even if the policy is owned by a third party (i.e., an irrevocable crummy trust), the proceeds will be taxed in the controlling shareholder's estate if the corporation has any incidents of ownership (i.e., the corporation has the right to borrow).
- Thus, in these situations the corporation owned by a controlling shareholder cannot have a right to borrow against the policy and may not retain any other incident of ownership in the policy. This will be stated in the split dollar agreement.

- **INCOME TAX:**

- Prior Law

Split Dollar as a method of financing cash value life insurance dates back to the 1930s.

The IRS initially treated split dollar as an interest free loan.

Revenue Ruling 64-328 (1964):

said split dollar arrangements were not loans.

- Employee taxed on the "economic benefit" to the employee (NOT the Employer's premium advances) less any employee contributions plus any other benefit of the arrangement.
- No deduction for Employer.
- The economic benefit is essentially the cost of an equivalent amount of pure term insurance.
- However, there may be "other benefits" that may be treated as additional income.
- PS 58 Table - outdated mortality tables that were used to measure the economic benefit.
- If Employee contributes (i.e., pays for the cost of the term insurance), it is not deductible, but the Employee receives an offset to the economic benefit.
- The "economic benefit" has been the lower of the PS 58 Tables or the insured's published generally available yearly renewable term rates.
- The "economic benefit" for survivorship policies are the "PS 38" rates.
- **NOTICE 2001-10** addresses income tax of equity split dollar and gives a new table to determine the economic benefit.

- **LOAN CHARACTERIZATION:** Notice 2001-10 indicated that the IRS would generally accept the parties classification of the Employer's payment as a loan to the employee for tax purposes. The tax consequences would be decided under IRC section 7872 (imputed interest). Therefore, no taxation on the equity buildup or the value of the life insurance benefit.

- **NON LOAN CHARACTERIZATION:** Notice 2001-10 indicated that the Employee would have compensation income under section 61 for the

value of the life insurance protection (reduced by the Employee's portion of the premium), dividends and cash value received by the Employee.

- **NOTICE 2002-8** differentiated between employer owned and employee owned life insurance policies.
 - **EMPLOYER OWNED SPLIT DOLLAR POLICY** - The value of the current life insurance and any other economic benefits will be taxed to the Employee (IRC section 61) and the transfer of a life insurance policy to the employee will be taxed under IRC section 83.
 - **EMPLOYEE OWNED SPLIT DOLLAR POLICY AND OBLIGATED TO REPAY LOANS** - Premiums that the Employer pays are a series of loans subject to imputed interest rules.
 - **EMPLOYEE OWNS SPLIT DOLLAR POLICY BUT NOT OBLIGATED TO REPAY** - Premium payments of the Employer are compensation to the Employee at the time paid.
 - **NOTICE 2001-10 IS REVOKED BY NOTICE 2002-8. HOWEVER TAXPAYERS MAY RELY ON BOTH NOTICES FOR SPLIT DOLLAR CONTRACTS ENTERED INTO BEFORE THE PUBLICATION OF FINAL REGULATIONS.**
 - **NOTICE 2002-8** provides that the equity buildup of preexisting arrangements will not be taxed under section 83 before rollout.
- **NOTICE 2002-8 STATES “NO INFERENCE SHOULD BE DRAWN FROM THIS NOTICE REGARDING THE APPROPRIATE FEDERAL INCOME, EMPLOYMENT AND GIFT TAX TREATMENT OF SPLIT DOLLAR LIFE INSURANCE ARRANGEMENTS ENTERED INTO BEFORE THE DATE OF PUBLICATION OF FINAL REGULATIONS.”**
- **SAFE HARBORS OF NOTICE 2002-8:**
- **SAFE HARBOR for split dollar arrangements entered into before January 28, 2002**
 - **FIRST SAFE HARBOR** - Terminate the split dollar arrangement before January 1, 2004. The IRS will not assert a taxable transfer of property at termination. Useful for mature split dollar arrangements. Policy will have sufficient cash value after repaying employer without future premium payments

- SECOND SAFE HARBOR - treat all payments by the employer as loans for all periods beginning on January 1, 2004. The IRS will not assert a taxable transfer of property at termination. Best for immature split dollar arrangements. Could also be advantageous if the insured is in poor health.
- SAFE HARBOR for split dollar arrangements entered into after January 27, 2002 but before issuance of final regulations. These two safe harbors may also be used by pre January 28, 2002 split dollar arrangements.
 - FIRST SAFE HARBOR - If the annual term rate of the insurance carrier is paid by the employee or included in his or her income, presumably any equity build up will not be taxed. However, term rates become higher as the insured gets older, resulting in higher taxable income.
 - SECOND SAFE HARBOR - All employer premium payments from the beginning of the split dollar arrangement plus all future payments are treated as loans. Most useful for arrangements that do not currently have equity buildup.
- PROPOSED REGULATIONS - On July 9, 2002, the IRS issued proposed split dollar regulations promised in Notice 2002-8 and asked for written or electronic comments and a public hearing was held on October 23, 2002.
 - There are two regimes under the proposed regulations - the Economic Benefit Regime and the Loan Regime.
 - The Economic Benefit Regime - When the employer, corporation or donor is the owner of the life insurance policy, will result in income, employment and gift tax similar to the old endorsement method. Presumably, the IRS like to tax currently part of the employer's premium rather than the equity cash value itself. The rest of the equity would probably be taxed at rollout. Thus there would be some tax as the equity is building up. There are provisions providing for the taxation of dividends, withdrawals, partial surrenders and policy loans paid to the non owner.
 - The Loan Regime - When the employee, donee, service provider, or shareholder is the owner of the policy, the below market interest rules will apply.
 - The person named as the owner in the policy is generally the owner for purposes of the proposed regulations. There are some exceptions.
- **SARBANES - OXLEY ACT AND SPLIT DOLLAR**

- The Sarbanes - Oxley Act, effective July 30, 2002, provides “It shall be unlawful for issuer ... directly or indirectly, ... to extend or maintain credit, to arrange for extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or an equivalent thereof) of that issuer.” An extension of credit in existence on the effective date of the act is not subject to the provisions of the subsection. The question then becomes does the act apply to split dollar arrangements? For example, collateral assignment split dollar may be a loan. The answers are unclear. Senator Charles Sumner who sponsored the loan provision, stated that he intended to bar split dollar life insurance arrangements. This is a criminal statute with fines of up to one million dollars for individuals and 2.5 million for corporations for each violation. Possibly try other alternatives, i.e. suspend the loans and the employee pays the premiums with a gross up bonus, or convert the collateral assignment to an endorsement split dollar without the loans.

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