

A Split-Dollar Life Insurance Plan Review Imperative

By Dean I. Friedman

July 2003

December 31, 2003 is the deadline to terminate or adapt split-dollar life insurance plans (“Split-dollar Plans”) to IRS “safe harbors.”

Characterizing Split-dollar Plans

Split-dollar Plans are used in employment contexts (though they work for corporations/shareholders). An “arrangement” is reached for sharing premium costs of “permanent” coverage on the employee’s life. The face amount can be any level. The employee usually designates the death beneficiary. Employer premium advances are repaid when the policy matures, or when the arrangement is terminated.

Traditionally, two approaches are used, either the “endorsement method” or “collateral assignment method,” though there are variations. Under the endorsement method, the employer as policy owner conveys the employee’s interest by policy endorsement. Under collateral assignment, the employee owns the policy and signs a collateral assignment securing repayment of the employer’s “loan.” The method selected depends upon control of the policy.

“Equity” plans (endorsement or collateral assignment) usually limit the employer’s interest in policy cash value to its aggregate premium advances; the balance goes to the employee. Equity is shared disproportionately to the financial burden of the premium obligation (or the employer pays all). The employee also receives the benefit of current life insurance protection. “Non-equity” plans provide employees only the value of current life insurance protection.

It is proposed for equity endorsement plans that the employee's total "economic benefit" equals the cost of current life insurance protection, the "accessible" equity and any other benefit conferred. That cost would be determined by an IRS life insurance premium factor applied to the amount of protection provided, including paid-up additions, i.e., the excess of the average contract death benefit over the amount repayable to the employer, policy loans and equity taken into account. "Split-dollar loans" (demand or term) result under collateral assignment plans and may impute taxable income to the employee if stated at below-market interest rates.

Tax Law Changes

Old Revenue Rulings 64-328, 66-110 and 67-154 tax the value of initial issuance, one-year term insurance protection (even though permanent coverage is purchased) to the employee using Table PS-58 rates. IRS Notices 2002-8 and 2002-59 provide that:

- A. P.S. 58 rates may be used for pre-January 28, 2002 plans expressly providing for P.S. 58 rates (but Table 2001 rates are lower).
- B. Before Final Regulations, lower one-year, insurer-published, term rates for standard risks, to the extent provided by the old Revenue Rulings, may continue to be used for pre-January 28, 2002 plans; after year-end, post-January 28, 2002 plans may use published rates only if such coverage is generally available and regularly sold.
- C. Table 2001 rates may be used for pre- and post-January 28, 2002 plans adopted before Final Regulations (with adjustments needed for "two-life" policies).
- D. Insurer-published rates cannot be used if a third party receives policy benefits.

Before Year-End

For plans adopted before Final Regulations, the employee's equity "build-up" will not be taxed solely because of accretion. And those plans will not be "deemed"

terminated so long as the value of current life insurance protection is annually reported, or all employer premium advances are treated as loans. For pre-January 28, 2002 collateral assignment plans, the IRS will not assert that there is a taxable equity transfer upon “actual” plan termination by December 31, 2003, or loan treatment is applied after year-end for all employer-paid premiums. The transfer of an endorsement method policy to the employee is taxed according to value.

After Year-End

It is not clear when Final Regulations will be issued. Proposed Regulations published July 9, 2002 (providing for the “economic benefit” regime for endorsement method plans and “loan” regime for collateral assignment plans) and May 9, 2003 (valuing the economic benefit of endorsement plans) will only be effective then (if unchanged). A cautionary note: A “material” modification of an old Split-dollar Plan makes it a “new” plan.

It does not matter whether you are an officer, shareholder or key employee of your company or an advisor to one who is. A follow-up should occur once Final Regulations are issued.