

## NEW GUIDANCE REGARDING SPLIT DOLLAR ARRANGEMENTS

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**A. INTRODUCTION:** The Internal Revenue Service issued Notice 2002-8 on January 28, 2002. This Notice:

- 1) Revokes Notice 2001-10, which was issued on January 29, 2001.
- 2) Announces that the Treasury and IRS intend to publish proposed regulations providing comprehensive guidance regarding the Federal tax treatment of split dollar life insurance arrangements.
- 3) Outlines rules expected to be included in the forthcoming proposed regulations and the expected effective date of those regulations; and
- 4) Provides guidance regarding the valuation of current life insurance protection under a split dollar arrangement, under qualified retirement plans and under employee annuity contracts.

**B. SCOPE OF NEW NOTICE:** Although Notice 2002-8 addresses a split dollar arrangement specifically in the context of an employer/employee relationship, the same principles are expected to govern the Federal tax treatment of split dollar arrangements in other contexts, including arrangements that provide benefits in gift and corporation/shareholder contexts.

### **C. MEASURING THE VALUE OF CURRENT LIFE INSURANCE PROTECTION PROVIDED TO THE EMPLOYEE**

#### 1. Split Dollar Arrangements Entered Before January 28, 2002:

- i) The parties may continue using the PS 58 cost to measure the value of current life insurance protection provided the contractual arrangement was executed before January 28, 2002, and the arrangement provides for the use of the PS 58 cost to measure the value of current life insurance protection; or
- ii) The premium rate table attached to the Notice. A copy of this table is attached to this outline.  
Note: This table is captioned Table 2001 and was originally published in Notice 2001-10.  
Note: These rates are considerably lower than the PS 58 rates.
- iii) The insurer's lower published premium rates, which are available for all standard risks for initial issue one year term insurance.

Note: For periods after December 31, 2003, the IRS will not consider an insurer's published premium rates to be available to all standard risks unless:

- a) The insurer generally makes the availability of such rates known to persons who apply for term insurance coverage from the insurer; AND
- b) The insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels.

2. For Split Dollar Arrangements Entered after January 28, 2002 but Before the Effective Date of Future Guidance:

- i) Table 2001 rates; or
- ii) The insurer's lower published premium rates, which are available for all standard risks for initial issue one year term insurance.

Note: For periods after December 31, 2003, the IRS will not consider an insurer's published premium rates to be available to all standard risks unless:

- a) The insurer generally makes the availability of such rates known to persons who apply for term insurance coverage from the insurer; AND
- b) The insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels.

**D. WHAT DOES THIS NOTICE TELL US ABOUT THE EXPECTED FEDERAL TAX TREATMENT OF SPLIT DOLLAR ARRANGEMENTS?**

- 1. Two Mutually Exclusive Tax Regimes: This Notice provides that the tax treatment of the split dollar arrangement depends entirely on which party owns the policy.
  - A. Endorsement Method: This method applies to situations where the employer is the owner of the policy. Once the employer receives repayment for premiums paid, the policy is endorsed or transferred to the employee.
    - i) Current Income to the Employee: The employer is treated as providing current life insurance protection and other

economic benefits to the employee. These benefits are taxable under Section 61 of the Code.

ii) Interim Taxation of Equity Prior to Termination of Collateral Split Dollar Arrangement:

-Equity is defined as the excess of the cash surrender value over the amount required to be paid to the employer under the terms of the split dollar agreement.

-Section 83 of the code includes in an employee's income all or part of the value of property transferred to the employee in connection with the performance of services.

1. Endorsement Split Dollar Arrangements Entered Before Date of Publication of Final Regulations: The employer will not be treated as having made a transfer of a portion of the cash surrender value to an employee for purposes of Section 83 solely because the interest or earnings credited to the cash surrender value causes the cash surrender value to exceed the portion payable to the employer under the split dollar arrangement.

Note: It is imperative that the parties continue to report the value of life insurance protection as an economic benefit to the employee under section 61 to avoid the arrangement from being treated as having been terminated.

2. Endorsement Split Dollar Arrangements Entered After Date of Publication of Final Regulations: At the present time, it is not clear whether that the equity in such arrangements will be taxed prior to the termination of the arrangement.

iii) Taxation of Equity Upon Termination:

1. Grandfather Treatment for Endorsement Split Dollar Arrangements entered before January 28, 2002. As long as the arrangement was entered prior to January 28, 2002, and the employer is entitled to full repayment for all premiums paid, no taxable transfer of equity portion of cash surrender value upon termination of the arrangement provided:

A) The arrangement is terminated before January 1, 2004;  
OR

B) For periods beginning January 1, 2004, all payments made by the employer from the inception of the

arrangement (reduced by repayments to the employer) are treated as loans for Federal tax purposes, and parties report the tax treatment in a manner consistent with loan treatment. All payments prior to January 1, 2004 need to be treated as a loan at the beginning of the first year in which payments are treated as a loan.

2. All Other Endorsement Split Dollar Arrangements: The equity (the portion of the cash surrender value in excess of what is required to be paid to the employer) will be taxed at termination of the arrangement.

B. Collateral Assignment Method: This method applies to situations where the employee owns the policy under a split dollar arrangement. The premiums paid by the employer are treated as a series of loans to the employee assuming the employee is obligated to repay the employer. The loans are subject to the principles of sections 1271-1275 (regarding the taxation of original issue discount on debt instruments), and section 7872 (taxation of below market loans).

i) Current Income to the Employee: If the employee is not obligated to repay the employer for the premiums paid, then the premiums will be treated as compensation to the employee at the time the premiums are paid by the employer.

ii) Interim Taxation or Taxation Upon Termination?

-Non-Equity Collateral Assignment Arrangements: Where the employer is deemed to receive sufficient interest on its loan to the employee, there will be no taxation of equity even upon the termination of the arrangement. This is sometimes accomplished by returning the excess of the cash surrender value above the premium payments made by the employer to the employer. As long as the arrangement is entered before the date of publication of final regulations, the IRS will not challenge reasonable efforts to comply with the requirements of sections 1271-1275 and section 7872 regarding the tax treatment of loans.

-Equity Collateral Assignment Arrangements: If the employer receives repayment of premium payments only, and the arrangement does not provide for any equity (the excess of the cash surrender value above the premium payments made by the employer) or other interest to be paid

to the employer, the equity will likely be taxed upon termination of the arrangement.

## **E. CONCLUSION**

There are tremendous benefits for split dollar arrangements entered before January 28, 2002.

1. The parties may continue to use of PS 58 costs to measure value of current life insurance protection if desired.
2. No interim taxation of equity prior to termination.
3. No taxation of equity under endorsement method at termination provided the arrangement is terminated prior to January 1, 2004, or the arrangement is converted to the collateral assignment method before January 1, 2004.
4. No taxation of equity under collateral assignment split dollar arrangements if reasonable efforts are made to comply with sections 1271-1275 and 7872.

Note: It is not clear whether signing the agreement prior to January 28, 2002 is sufficient. The safe approach would have been to also have the policy issued prior to this date.

If the arrangement is entered after January 28, 2002, but before the date of publication of final regulations:

1. The parties can no longer use PS 58 cost to measure the value of current life insurance protection. The parties must use Table 2001 or the insurance company's rates (although these rates may be subject to IRS scrutiny).
2. No interim taxation of equity prior to termination.
3. Taxation of equity under endorsement method at termination.
4. No taxation of equity under collateral assignment split dollar arrangements if reasonable efforts are made to comply with sections 1271-1275 and 7872.

