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MEMORANDUM

TO: *Professional's Name*

FROM: Strauss & Malk

DATE: August 6, 2003

RE: IRS Changes in the Tax Treatment for a Split-Dollar Life Insurance Plan ("Split-Dollar Plan")

In January 2002 the IRS issued a brief Notice outlining new tax rules for the taxation of Split-Dollar Plans. The Notice followed earlier attempts by the IRS to modify the Split-Dollar rules. The rules published in the Notice were a departure from the long-standing treatment of Split-Dollar Plans as a tax free loan between the parties to the plan. Under the old rules, an employer and employee could purchase life insurance for the employee and the employee would only recognize income equal to the cost of the term life insurance coverage provided by the employer, calculated using outdated IRS tables. This favorable tax treatment allowed the employer to provide substantial amounts of life insurance coverage at a very small tax cost. The favorable tax treatment was justified under the theory that the employer would eventually be repaid for the policy's premium payments upon the employee's death or the termination of the employment relationship. This tax treatment was highly controversial because the economic reality appeared to be that the employee had borrowed the premium payments with an interest free loan that could last for the employee's lifetime.

Under the new rules outlined in the IRS Notice, the IRS mandated that the tax treatment follow the economic reality of the arrangement between the parties. As a result, many employers and employees would have to begin treating the Split-Dollar Plan as a loan with taxable interest payments calculated using the IRS' published interest rates. An alternative approach was also outlined requiring the parties to treat the transaction as taxable compensation calculated using newly published IRS tables or the insurer's premium rates for term insurance policies sold by the insurer. Under the Notice, the parties had the ability to choose one of the two mutually exclusive tax treatments, and under either method the parties would incur an increased tax liability.

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Out of fairness to the public, the IRS delayed the time for implementing the new rules by making them effective as of January 1, 2004. The Notice also stated the IRS' intent to publish new comprehensive Income Tax Regulations governing the taxation of Split-Dollar Plans. Most importantly, the Notice contained limited safe harbors for plans in existence before January 28, 2002 allowing those plans to terminate on or before December 31, 2003 without the adverse tax consequences that would occur if the plans terminate on or after January 1, 2004.

In July 2002 the IRS published the comprehensive new proposed regulations[1] regarding the treatment of Split-Dollar Life Insurance Policies (the "Proposed Regulations"). The Proposed Regulations replace the rules outlined in the January Notice and require that all Split-Dollar Plans be taxed under one of two sets of mutually exclusive rules: the economic benefit rules or the loan rules. Unlike the Notice, the applicable tax treatment will be mandated by the regulations once the IRS publishes the regulations in their final form.

Economic Benefit Rules

The economic benefit rules apply to policies in which the company owns the policy and the insured (or another person) has the power to name the beneficiary of the life insurance proceeds. The company is the beneficiary of the cash value portion of the life insurance proceeds. Under the economic benefit rules, the company is treated as having provided an "economic benefit" that is taxable income to the insured. In addition, if the proceeds of the policy are payable to a third-party, such as an Irrevocable Life Insurance Trust, then the IRS would treat the "economic benefit" as a taxable gift from the insured to the trust's beneficiaries.

The value of the "economic benefit" will differ depending on whether the arrangement entered into is a "non-equity" or an "equity" split-dollar agreement. In a non-equity arrangement the company is entitled to receive the greater of the cash value of the policy or the amount of premiums it has paid. In this arrangement the insured will be taxed annually on the amount of the life insurance provided, multiplied by a life insurance premium factor to be determined under IRS rules (the IRS has not yet published this factor).

[1] As the name implies, proposed regulations are not final and are subject to change by the IRS. In order for the regulations to become final, the IRS must follow a lengthy procedure that includes publishing the proposed regulations in the federal register, holding public hearings to allow the general public to make comments on the proposed regulations, and then publishing the final regulations in the federal register prior to the final effective date of the regulations. In the mean time, the taxpaying public is aware of the likely future tax treatment and may elect to follow the new rules before the final effective date. While the regulations for Split-Dollar Plans have not yet been published in final form, the numerous IRS publications on the topic make it clear that, after January 1, 2004, any taxpayer failing to comply with either the January 2002 Notice or the proposed regulations will be subject to heightened scrutiny and possible legal challenges by the IRS.

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In an equity split-dollar arrangement the insured (or another person) has the power to name the beneficiary of the term life insurance proceeds and has the right to receive some or all of the policy's cash value. In this arrangement the insured will be taxed annually on (a) the value of the life insurance, as described above, plus (b) the increases in the insured's right to the policy's cash value and (c) any additional benefits the insured receives. The company may also be taxed on any amounts actually received by the insured under the life insurance policy because those amounts would be treated as if they were first paid to the company and then paid by the company to the insured.

Under the economic benefit rules, a substantial tax liability would occur on the "roll-out" of the policy when the insured (or another person) becomes entitled to all or a part of the policy. The roll-out would be a taxable transfer that is taxed as income to the insured and it also may be treated as a taxable gift if the policy is transferred to a third party, such as an irrevocable life insurance trust. The taxable amount would likely be the policy's cash surrender value.

Loan Rules

The loan rules apply to insurance policies owned under the collateral assignment method in which the insured (or a related party, such as an irrevocable life insurance trust) is the owner of the life insurance policy and the owner collaterally assigns the policy to the company as security for the company's premium payments on the policy. Under the loan rules, the company's premium payments are treated as loans made by the company to the insured. If the insured is not the owner of the policy, then the insured is treated as having made a second loan of the premium payments to the owner. The insured is then treated as a borrower that makes periodic interest payments to the lender/company. If the Split-Dollar Plan does not require the insured to pay a fair rate of interest to the company for the deemed loans, then the insured will be deemed to have paid interest to the company at the "applicable federal rate." The company, in turn, will be treated as having transferred this amount back to the insured as compensation. If the insured is not the policy owner, then an additional layer of deemed transactions would exist between the insured and the policy owner. The relationship between the insured and the policy owner would dictate the tax treatment, but it is most likely that there would be a gift of imputed interest between the insured and the owner. Under existing gift tax and income tax rules, the imputed interest would first be treated as a taxable gift from the insured to the policy owner and then as taxable income as a deemed interest payment from the policy owner to the insured.

The tax effect of the deemed payments outlined in the previous paragraph are that in an employee-employer situation, the company will be taxed on the interest payments deemed to have been made to it and the insured will be taxed on the compensation deemed to have been paid to him. In a gift situation, the donor would have income tax liability on the interest payments deemed to have been made to it and would also have a gift tax liability on the amount it is deemed to have transferred to the donee. To further complicate matters, the amount of

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deemed interest paid each year and how it is calculated is determined based upon whether the loan is characterized as a demand loan or a term loan. The burdensome rules for determining if a loan is a demand loan or term loan are beyond the scope of this memo, but it is important to understand that they could require the plan sponsor to make complex calculations to determine the amount of interest income to be reported each year.

Effective Date and Safe-Harbor Termination

Both the insured and the company are required to report their split-dollar arrangement in a consistent manner. The rules in the Proposed Regulations become effective on January 1, 2004 and will apply to all split-dollar life insurance arrangements entered into or materially modified after January 28, 2002. Split-Dollar Plans in existence before January 28, 2002 have the ability to apply either the tax rules outlined in the IRS Notice published in January 2002 or the rules in the Proposed Regulations published in July 2002. The Split-dollar Plans in existence before January 28, 2002 may also be terminated before January 1, 2004 without incurring tax liability on the value of the policy distributed to the insured, if the company is entitled to a return of all the premiums it has paid.

How the Change In the Tax Treatment May Effect Your Clients

In our experience, many Split-Dollar Plans utilize the Collateral Assignment arrangement. Under this arrangement, the insured/employee owns the policy directly or through an irrevocable life insurance trust. The insured, or his trust, has typically entered into an agreement with the employer whereby the employer pays the insurance premiums in return for a collateral assignment of the policy securing repayment of the policy premiums. Under the agreement, the employer is typically entitled to receive an amount equal to the lesser of the cash surrender value of the policy or the premiums paid by the employer. Before the recent tax law changes, the employee only reported income based upon the value of the life insurance coverage provided by the Split-Dollar Plan, and the employer and trust did not report any taxable income. Under the Proposed Regulations, the Collateral Assignment arrangement would be treated as a taxable loan. The employer and employee would both recognize income in the amount of the imputed interest calculated based upon a loan with a principal balance equal to the total amount of all premiums paid by the employer since the arrangement's inception. If the policy is owned by an irrevocable life insurance trust, then an extra layer of taxable transactions would exist between the employee and the trust. This means that each party would probably incur a significantly larger tax liability under the Proposed Regulations, if no changes are made to the Split-Dollar Plan.

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Your Client's Options

Each Split-Dollar Plan will require an individually designed solution due to policy considerations (such as the policy age, face amount of the policy and the present cash surrender value), the insured's ability to replace the policy, and the potential impact of the tax changes. With that in mind, we believe that there are viable options generally for parties in Split-Dollar Plans. We would be pleased to discuss them with you on a case by case basis.

How **Strauss & Malk** Can Help You

In order to evaluate the tax treatment of your client's plans we will need to obtain complete information regarding the agreement between the parties, the amount of premium payments paid to date by the company and the employee, if any, the present cash surrender value of the policy, the present amount of any policy loans, the ability to borrow against the policy, and the policy projections for premiums and build-up in cash surrender value for the near future (including the assumptions used to calculate the projections). This information will help you and us to calculate the projected tax liability under the Proposed Regulations, the ability of the policy to fund any form of plan termination, and the likely impact of a change to the alternative tax treatment. In addition, an insurance professional should determine the cost and availability of alternative insurance products, including projects specifically designed for the new split-dollar tax rules. Please call us if you would like us to assist you in this process.

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