WRMarketplace

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Knowing What You're Doing: Troubleshooting Common Oversights in Split-Dollar Plans.

MARKET TREND: While split-dollar life insurance arrangements remain an important tool for life insurance funding, it is critical to avoid seemingly minor oversights that could have significant and unintended tax consequences.

SYNOPSIS: Easily over-looked trouble spots in split-dollar life insurance arrangements and suggestions for how to avoid them include: (1) confirming the availability of term insurance rates used to measure annual economic benefits, (2) filing nonrecourse representations for split-dollar loans, (3) using properly drafted collateral assignments for policies subject to split-dollar loans, (4) determining whether an arrangement is grandfathered before making changes, and (5) checking, before issuance, whether the policy intended for purchase under the arrangement may be subject to tax as an employer-owned life insurance contract.

TAKE-AWAYS: The prevalence and potential benefits of split-dollar arrangements offer advisors with significant opportunities to provide value to their clients, particularly if they can help clients avoid minor mistakes that could otherwise generate significant tax liabilities. Certain issues, such as ensuring the reporting of proper annual economic benefit amounts or filing nonrecourse representations for split-dollar loans, allow advisors to both assist clients and maintain regular contact to ensure the arrangement and coverage continues to serve the client's needs or to recommend adjustments that address changing tax, economic, or client circumstances.

Split-dollar arrangements ("**SDAs**") are a common yet powerful planning tool for the acquisition of life insurance in both private and business contexts, but they require careful planning and attention to detail to obtain the intended results. This Bulletin summarizes some easily over-looked trouble spots in SDAs and suggestions for how to avoid them.

SDAs GENERALLY

SDAs share the costs of buying a life insurance policy between two parties (such as a company and its executive or a grantor and his or her trust). One party funds most or all the premiums, retaining a right to repayment (which may be secured by or paid from the policy proceeds) upon the insured's death or earlier termination of the SDA. Depending on the arrangement, upon termination, the insured or the insured's desired beneficiary (such as an irrevocable life insurance trust, "**ILIT**") may retain the policy or the remaining benefits (if any).

BUSINESS & PRIVATE PLANNING APPLICATIONS

SDAs can provide insurance planning flexibility in both business and private settings. Business SDAs generally are between a company and an insured employee or owner (or, commonly his or her ILIT if the insured wishes to keep the proceeds out of his or her estate). A company may incorporate a SDA into the overall compensation structure of a key executive or employee to provide the benefit of personal insurance coverage, may use it to fund retirement benefits for the insured (such as through a supplemental executive retirement plan), or to assist in purchasing life insurance that will be used to fund the buy-out of business owners upon death or retirement.

In private planning, SDAs typically are established between the insured, as grantor, and his or her ILIT. These SDAs facilitate the purchase of personal life insurance on a gift-tax favorable basis, often in lieu of, or as a supplement to, funding with annual exclusion gifts.

TWO REGIMES

Under the final split-dollar Treasury Regulations made effective as of September 17, 2003 ("**final regulations**"), SDAs entered into or materially modified after September 17, 2003 are taxed under two mutually exclusive tax regimes for income, gift and employment tax purposes: (1) the economic benefit regime[1] and (2) the loan regime.[2]

Economic Benefit SDAs. In a typical economic benefit SDA, one party (the business or the ILIT's grantor) funds the policy premiums in exchange for an interest in the policy equal to the greater of its cash value or the total premiums paid. The payment of premiums results in an annual "economic benefit" to the insured (or his or her ILIT if it owns the policy), in an amount equal to the term cost of the current insurance protection provided under the policy. The term cost is determined by using premium rates published by the IRS (as set forth in Table 2001) or, if lower, the qualifying one-year term rates published by the issuing insurance carrier. Unless paid by the insured or ILIT, the annual economic benefit is taxable, for example, as compensation to an insured employee, if under a business SDA (and as an imputed gift from the insured to the ILIT, if the ILIT owns the policy under a business SDA), or as a gift from the grantor to the ILIT in a private SDA, and will increase each year with the age of the insured.

Split-Dollar Loans. With a split-dollar loan, interest-bearing loans are made to the insured, or, most commonly, to his or her ILIT, to pay the policy premiums. The ILIT has an obligation to repay the loans at the specified maturity dates, typically secured by a limited collateral assignment of the policy to the lender (*i.e.*, the business in a business SDA and the ILIT's grantor in a private SDA). If the loan provides for sufficient interest (generally, the federally-set AFR), it is governed by the general tax rules for debt instruments.[3] The lender has no specific powers over the policy or any interest in the policy's cash value apart from its security interest; rather,

the ILIT retains all rights to the policy's cash value and death benefit, subject to the obligation to repay the loan(s) (with interest), at the specified maturity dates.

AVOID MINOR OVERSIGHTS TO PREVENT MAJOR PROBLEMS

While SDAs can provide significant flexibility in life insurance planning for both individuals and businesses, minor oversights in implementation or administration may have significant and unintended tax consequences. The following are just some often overlooked steps that, if addressed, can help advisors add significant value for their clients' split-dollar plans.

1. Confirm Availability or Use Updated Term Rates to Measure Annual Economic Benefit. As noted, for economic benefit SDAs, the term cost of the current life insurance protection provided under the arrangement is determined by using the Table 2001 rates, or, if lower, the ***qualifying*** one-year term rates published by the issuing insurance carrier. As an insurer's term rates generally are much lower than the Table 2001 rates, parties to the SDA will prefer to use the insurer's rates to determine the taxable annual economic benefit.

   For an insurer's term rates to qualify, however, (a) these rates must be published and available to all standard risks who apply for term insurance with that company, and (b) the insurance company must regularly sell term insurance at such rates through normal distribution channels to individuals who apply for term insurance.[4] Thus, a schedule of term rates obtained at the commencement of a SDA, which illustrates the annual increase in rates as the insured ages, may become outdated if the carrier makes changes to the distribution or rates for its term product, no longer sells the term product, or goes out of business.[5] If the parties relied on an outdated schedule, they may need to re-determine the cost of current life insurance protection using the correct rate (or the higher Table 2001 rate if the carrier no longer has a compliant term rate) and face a corresponding adjustment (potentially an increase) in any federal income and gift tax liability. Thus, it is important that the availability and amount of the insurer's term rates be confirmed annually for economic benefit SDA reporting.

   - ✓ ***Advisors can maintain contact and add value by sending updated term rate schedules annually to their clients with economic benefit SDAs.***

2. File Nonrecourse Loan Representations for Split-Dollar Loans. Most split-dollar loans are considered "nonrecourse" to the insured or his or her ILIT, since repayment of the loan typically is only secured by a collateral assignment of the insurance policy. The final regulations treat payments made under nonrecourse split-dollar loans as "contingent payments," which can adversely impact the determination of whether the loan charges sufficient interest and may result in unexpected tax exposure.

   Contingent payment treatment can be avoided if both parties to the split-dollar loan execute and file with the IRS a written representation that a reasonable person would believe that all payments under the loan will be made.[6] The parties should include the representation with their respective federal tax returns for each year a loan is made to which the representation applies.

   Note that the IRS has not provided any specific procedure for correcting a failure to file this representation, although it has issued private letter rulings allowing late filings where the parties requested relief under Reg. § 301.9100-1 (procedure for requesting an extension of time to make an election). As private ruling and extension requests are expensive, lengthy

and uncertain, the parties likely should file the representations (to the extent accurate), as a matter of course.

- ✓ ***Advisors can assist clients entering into split-dollar loans by advising them of the possible need for the representation. Also, as with economic benefit SDAs, sending reminders to attach the representations to income tax filings can offer an annual point of contact for clients with outstanding split-dollar loans.***

3. Use Properly Drafted Collateral Assignments. In many split-dollar loans, whether business or private, an ILIT owns the policy to keep the proceeds out of the insured's estate. As noted, the ILIT will collaterally assign the policy to the lender to secure the loan's repayment. However, if the lender under the SDA is (1) the insured, as grantor of the ILIT (as in a private SDA) or (2) a corporation in which the insured is a majority owner (as under a business SDA), the collateral assignment must not provide the insured, directly or indirectly, with any powers over, or "incidents of ownership" in, the policy (*e.g.*, the power to name or change a policy beneficiary), since they may result in estate tax inclusion. Thus, the collateral assignment should be a restricted or "bare-bone" assignment that limits the lender's rights in the policy solely to a security interest, with no other rights or powers.

   - ✓ ***Advisors should be wary of "standard form" collateral assignments, as they often provide the lender with excessive powers over the policy for split-dollar loan purposes. Preferably, the parties to the SDA should have a special collateral assignment drafted to ensure it is sufficiently restrictive and tailored to the specific terms of the split-dollar transaction.***

4. Determine Whether an Existing SDA is "Grandfathered" Prior to Changes. SDAs entered into on or before and not "materially modified" after September 17, 2003 (the effective date of the final regulations) are considered "grandfathered" from the application of the final regulations. For this purpose, a SDA is entered into upon the ***latest to occur*** of the date (1) the policy is issued, (2) the policy is effective, (3) the first policy premium is paid, (4) the parties enter into the SDA, or (5) the arrangement satisfies the definition of a "split-dollar arrangement" under the final regulations.

   Grandfathered SDAs generally are taxed based on various pieces of guidance issued by the IRS before the final regulations (*e.g.*, Rev. Ruls. 64-328 and 66-110; Notice 2002-8). The tax consequences of these SDAs can differ dramatically from those governed by the final regulations. For example, if a business and an insured enter into a SDA governed by the economic benefit regime under the final regulations, an insured's current or future access to policy cash value in excess of premiums paid (*i.e.*, the policy equity) will be currently taxable to the insured. Under a grandfathered SDA, however, this policy equity appears not to be taxable while the arrangement remains in place, but may become immediately taxable if accessed (*i.e.*, withdrawn) or if the SDA is terminated ***or materially modified.***

   The final regulations do not define "material modification"; they only provide a non-exclusive list of mainly administrative changes to a SDA and/or the underlying policy that will not be deemed material (*e.g.*, changes in the mode of premium payments (annual to monthly) or in interest rates on policy loans).[7] The final regulations also do not address whether a tax-free exchange of a policy under Internal Revenue Code § 1035 will be considered a material medication for these purposes. Thus, any modification to a grandfathered SDA or the underlying policy that impacts the economics of the arrangement

or the costs/benefits to either party, including a "1035 exchange" of the policy, may be deemed material.

- ✓ ***Many grandfathered SDAs remain in place, and parties to the SDA may approach advisors for assistance in making adjustments to terms or coverage without realizing the potential tax consequences of their desired changes. When dealing with any existing SDA, advisors must first determine when it was "entered into" for purposes of the final regulations, since recommendations for changing the policy or restructuring or terminating the SDA will hinge substantially on this initial assessment.***

5. Check, Before Issuance, Whether the SDA Policy May Qualify as EOLI. Internal Revenue Code §101(j) requires the owner of certain employer-owned life insurance ("**EOLI**") contracts ***to include in gross income otherwise excludible policy death benefits*** to the extent they exceed the total premiums and other amounts paid by the owner (*i.e.*, the business) for the contract. Broad exceptions to taxation apply (including for benefits paid to the insured's heirs or designated beneficiaries),[8] which will exclude most EOLI proceeds from taxation. To fall under an exception, however, ***the business must satisfy certain notice and consent requirements with regard to the insured employee before issuance of the EOLI contract*** (see *WRMarketplace Report* No. 12-24 for a detailed discussion of these requirements).

   With regard to split-dollar planning, ***any policy underlying a SDA where the business owns the policy, and the business (or a related person) will receive the death benefits (i.e., most employer-employee economic benefits SDAs) can constitute EOLI***. Compliance with the notice and consent requirements is the policyholder's responsibility, and the IRS has provided for specific corrective measures only in very limited circumstances (*i.e.*, failure to obtain notice and consent only after evidence of a good faith effort to comply).[9] Otherwise, correcting the failure likely will involve (1) cancelling the existing policy and issuing a new one or (2) affecting a material change in the policy (and obtaining notice and consent prior to issuance of the new policy or changes to the existing policy).

   - ✓ ***If there is any doubt about whether a business SDA may be an EOLI contract, the advisor will want the parties to the SDA to satisfy the EOLI notice and consent requirements before policy issuance to preserve all available exceptions to income taxation.***

TAKE-AWAYS

- The prevalence and potential benefits of SDAs offer advisors with significant opportunities to provide value to their clients, particularly if they can help clients avoid minor mistakes that could otherwise generate significant tax liabilities.

- Certain issues, such as ensuring the reporting of proper annual economic benefit amounts or filing nonrecourse representations for split-dollar loans, allow advisors to both assist clients and maintain regular contact to ensure the arrangement and coverage continues to serve the client's needs or to recommend adjustments that address changing tax, economic, or client circumstances.

NOTES

[1] Reg. §1.61-22(d)-(g).
[2] Reg. §1.7872-15.
[3] Whether interest is sufficient for a split-dollar loan depends on the type and term of the loan (*e.g.*, term, demand, or hybrid (*i.e.*, loans payable on the death of an individual or conditioned on the future performance of services)) and the month of issuance. The sufficiency of interest for term and hybrid loans will be based on the monthly AFRs issued by the IRS for the term period of the loan (*i.e.*, short-term (3 years or less), mid-term (4 to 9 years), or long-term (more than 9 years)). Demand loans are a separate category, with AFRs based on the blended average of the January and July short-term AFRs for the applicable year.
[4] Carriers generally will not certify that their term rates are "qualifying" rates for purposes of determining the economic benefit under a SDA. It is up to the parties to the SDA to decide whether the carrier's rates satisfy these requirements.
[5] *E.g.,* as with The Hartford's sale of its life insurance division.
[6] *See* Reg. §1.7872-15(d)(2) for specific requirements. Both parties should retain the originals of the representations.
[7] Reg. §1.61-22(j)(2)(ii).
[8] *See* Code § 101(j)(2). The exception are if: (1) the insured under the contract was (a) an employee at any time during the 12 months prior to death, or (b) a director or a highly compensated employee or individual at the time the contract was issued, or (2) the contract death benefits are either (1) paid to the insured's estate, family members, or other designated beneficiaries (other than the policy-holder), or a trust for the benefit of any such individuals, or (2) used to purchase an equity (or capital or profits) interest in the policyholder from any person described above.
[9] *See* Notice 2009-48, providing that the only situations in which the IRS will not challenge inadvertent failures to satisfy the EOLI notice and consent requirements are if (1) the applicable policyholder made a good faith effort to satisfy the notice and consent requirements (*e.g.*, maintains a formal system for notice and consent for new employees); (2) the failure to satisfy the requirements was inadvertent; and (3) the failure to obtain the notice and consent was discovered and corrected by the due date of the tax return for the taxable year in which the EOLI contract was issued (failure to obtain consent cannot be corrected if the insured employee has died).

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