TAX ACCOUNTING

BY JAMES E. SALLES

This month's column analyzes the IRS's latest pronouncement on tax treatment of "split-dollar life insurance."

SPLIT-DOLLAR GENERATES HEAT

"Split-dollar life insurance" refers to a number of different arrangements under which the rights to recovery —and the obligation to pay premiums—on a whole life insurance policy are split between two parties, typically, though not necessarily, employer and employee. The tax treatment of these types of arrangements suddenly surfaced as a major issue in January, when the IRS issued Notice 2001-10,[1] purportedly "clarifying" its earlier, and very dated, guidance in the area. Understanding the Notice, and why it has generated literally dozens of communications to Treasury—many quite heated—requires some background.

Revenue Ruling 55-713: Employee Treated as "Owner"

The first published authority on split-dollar insurance was Revenue Ruling 55-713, involving a corporate employer that insured its employee's life. The parties agreed the employer would pay the annual premiums to the extent of the "inside buildup" on the policy and recoup its outlays when the policy was cashed in or paid off. The employee was obligated only to pay any additional "out-of-pocket" premium for coverage that was not reflected in an increased cash value. The ruling held that the employee recognized no income, on the grounds that the same result would have occurred if the employee owned the policy directly. The owner of a life insurance policy is not taxed on either the value of current insurance coverage or on its "inside buildup" (increases in cash value). If the employee were the owner, logically, the premiums that the employer paid must have been loans to the employee. This did not create a potential issue at the time, however, because interest income and expense was not imputed on loans for income tax purposes.[2]

Over time, the IRS gradually became convinced that the employee's being treated as policy owner was the wrong model for taxing these types of arrangements. A life insurance policy that is bought over time is a lot like a typical mortgage loan under which the borrower makes a series of level payments over time. At the beginning, a substantial portion of the premiums paid go for the value of current life insurance coverage, just as, in the case of a mortgage, most of the early payments normally represent interest. As time goes on, a greater portion of the charge for the current coverage is absorbed by the earnings (however labeled) on the amount already invested in the contract. Either the policyholder pays less in the way of out-of-pocket premiums, or a greater portion of the premiums that *are* paid translate into an increase in cash value, just as the later mortgage payments pay down more principal.

In the arrangement described in Revenue Ruling 55-713, each dollar the employer paid would ultimately entitle it to an additional dollar of cash value. However, the employer was not getting any return on its money. The earnings on the money that the *employer* was putting into the contract were going into reducing the premium that the *employee* would have to pay for current coverage. After a few years, the employee might not be called upon to pay anything at all because the entire cost of the current coverage would be taken care of by the earnings on the amount already invested in the contract. The employee would get term life insurance for free, with no tax consequences. This is exactly what would have happened if the employee had bought the policy with the proceeds of an interest-free loan. However, the result "felt" wrong to some, possibly because the employer usually puts up the lion's share of the money and seems the more likely-looking "owner."

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Revenue Ruling 64-328: The Employer as the "Owner"

The IRS's solution was to change models. Revenue Ruling 64-328 revoked Revenue Ruling 55-713 and treated split-dollar transactions as though the *employer* owned the policy from the outset. The employer's paying premiums on a policy that it owned, of course, would not produce taxable income to anybody. A side effect of these payments, however, would be to give the employee the equivalent of term insurance coverage. The IRS ruled that to the extent the employee obtained this "economic benefit"[4] without paying the associated premium, he or she would have compensation income, just as if the employer had actually paid premiums on a term policy.[5]

The IRS allowed taxpayers to use either the "P.S. 58 rates"[6] or the insurer's "published premium rates. . . available to all standard risks"[7] to value the coverage provided. Revenue Ruling 67-154[8] ruled that the requirement that the rates be "available to all standard risks" excluded special "dividend option rates" for existing policyholders to purchase additional coverage with their dividends. A later private ruling elaborated that eligible rates "may not be applicable to only nonsmokers, they may not be applicable only to policies in excess of a certain dollar amount, they may not be 'dividend option rates,' and they may not be applicable to, for example, only five-year term insurance."[9] Little authority addresses the requirement that the rates be "published." The government argued in *Healy v. United States*[10] that a rate could not be "published" unless it was included in a "general circulation publication" such as A.M. Best's rating guide, but the court did not confront the issue because it found that the challenged rate had appeared in the publication concerned.

Substance Over Form

Revenue Rulings 55-713 and 64-328 both held that substance should govern over form, although they disagreed about what that substance was. Revenue Ruling 55-713 treated the employee as owning the policy even though the paperwork said the employer did, and the employee was merely obligated to pay part of the premium. Revenue Ruling 64-328 recognized both this "endorsement system," and the contrasting "collateral assignment system" under which the employee owns the policy and pledges it as collateral to secure the loan, as "split dollar" arrangements. However, unlike its predecessor, Revenue Ruling 64-328 treated both types of cases as though the *employer* owned the policy.

Note that while the key rulings concern employers and employees, and it is common shorthand to refer to the parties as such, "split dollar" arrangements can exist outside the employment setting. For example, a corporation may purchase insurance for its non-employee shareholder, in which case the value of the insurance coverage represents a constructive distribution.[11] Even in the employment situation, the policy need not be on the life of the employee, or held by the employee;[12] in several rulings, the employee's rights were assigned to a trust.[13] Nor need the employee necessarily pay any portion of the premium.[14] However, there has to be a genuine sharing of ownership rights.[15]

New Issues

The years since the IRS developed its split dollar policy in the 1960s have seen quantum leaps in sophistication in dealing with time value of money issues and corresponding changes to the Code. Code Section 7872, enacted in 1984, imputes interest income and expense to certain loans bearing no or below-market interest. Covered loans include "compensation-related loans" and loans between corporations and their shareholders. Commentators have speculated that Code Section 7872 might apply to some split dollar arrangements,[16] and several private rulings explicitly avoided ruling on the issue.[17]

Other new issues have reflected more sophisticated transactions. So-called "equity split-dollar" arrangements may entitle the employee not only to current insurance coverage but to a portion of the "inside buildup." For example, if the employer's rights are confined to repayment of the premiums paid, and the earnings on the investment in the contract are sufficient to not only provide current coverage but to produce an increase in the cash value as well, the employee may be entitled to that increase. Much more complicated, and aggressive, arrangements exist.[18]

In the meantime, as life expectancies have risen since 1947, market premiums have dropped. This meant that P.S. 58 rates normally overstated the employee's taxable income, although under Professor Martin Ginsberg's well-known Moses' Rod Principle ("every stick crafted to beat on the head of a taxpayer will, sooner or later, metamorphose into a large green snake and bite the Commissioner on the hind part"[19]), "reverse split-dollar" arrangements have been crafted under which the opposite is true.

Notice 2001-10: Form Over Substance?

Notice 2001-10, which purports to "clarify" the existing guidance, attempts to address Code Section 7872 and these other issues. The Notice's basic approach is to allow taxpayers a free choice between the "employee owns the policy" approach of Revenue Ruling 55-713 and the "employer owns the policy" approach of Revenue Ruling 64-328, provided (paraphrasing somewhat) that the treatment is reasonable and consistent, and that "the parties fully account for all economic benefits conferred on the employee in a manner consistent with that characterization."[20] Employees will no longer be able, as the expression goes, to have their cake and eat it too by excluding "inside buildup" as if they own the policy while avoiding Section 7872 on the grounds that there is no loan. Policy payments must also be treated consistently with the characterization chosen: as distributions taxable under Code Section 72 if the employee is treated as owner, or otherwise as payments from the employer to the employee.

If the parties treat the employee as owner under these standards, the arrangement will be treated as including a loan, the normal result being imputed interest income and nondeductible[21] interest expense. Otherwise, the employer will be treated as owning the policy and the employee taxed on the coverage provided, as under Revenue Ruling 64-328—except using an updated table of premium rates and, after 2003, a tighter definition of "standard risk" rates. Employees that become entitled to cash value increases attributable to premium payments by the employer will be taxable under the "economic benefit" doctrine[22] and/or Code Section 83, which applies to the receipt of property interests in exchange for services. However, pending further guidance, which the IRS promises will not be retroactive,[23] employees will not be taxed on increase in cash value resulting solely from inside buildup, even if the employer is treated as owning the policy.

Outlook

The Notice requested comments on, among other things, the standard for treating employer outlays as loans, how the employee should be taxed on increases in cash value, and methods of valuing the insurance protection provided. Hardly had it appeared than the letters began pouring in, ranging from staccato allegations of sinister motives on the part of the outgoing Clinton administration to lengthy technical comments from the ABA Tax Section and industry trade groups. Where all this is leading it is as yet too early to tell. Further split dollar guidance is listed on the IRS "2001 Business Plan" (which actually covers the period through June 30, 2002).[24] Deputy Benefits Counsel Deborah Walker was recently quoted as saying she expects guidance later this year, but it would appear from her comments that Treasury and the IRS are still wrestling with basic issues, such as the degree to which the manner in which the deal is structured for nontax purposes should determine its tax treatment.[25]

Interested taxpayers should stay tuned.

1. 2001-5 I.R.B. 459.

2. *E.g.,* Dean v. Commissioner, 35 T.C. 1083 (1961) (reviewed); *see generally* PLR 9836003 (May 29, 1998) and authorities cited. *Compare* Dickman v. Commissioner, 465 U.S. 330 (1984) (gift tax).

3. 1964-2 C.B. 11.

4. *Cf.* Commissioner v. Smith, 324 U.S. 177 (1945).

5. *See, e.g.,* Reg. §1.61-2(d)(2).

6. P.S. 58 (revised) (Mar. 7, 1947), republished as Rev. Rul. 55-747, 1955-2 C.B. 228.

7. Rev. Rul. 66-110, 1966-1 C.B. 12.

8. 1967-1 C.B. 11.

9. PLR 9604001 (9/8/95); *see also* PLR 8547006 (8/23/85) (preferred non-smoker rates ineligible).

10. 843 F. Supp. 562 (D. S.D. 1994).

11. *E.g.,* Johnson v. Commissioner, 74 T.C. 1316 (1980); Rev. Rul. 79-50, 1979-1 C.B. 138; *see also, e.g.,* Young v. Commissioner, 70 T.C.M. (CCH) 357, 361 (1995), *taxpayer's app. dism'd* (11th Cir., Dec. 31, 1998) ("typical" arrangement involves employer and employee or corporation and shareholder).

12. *E.g.,* Rev. Rul. 78-420, 1978-2 C.B. 67.

13. *E.g.,* PLR 9604001 (9/8/95); PLR 9348009 (8/31/93).

14. *See, e.g.,* Genshaft v. Commissioner, 64 T.C. 282 (1975) (employee who paid nothing taxed on gross premiums paid minus increase in cash value under Revenue Ruling 55-713).

15. *Compare, e.g.,* Young, *supra;* Goos v. Commissioner, 61 T.C.M. (CCH) 2300 (1991), *aff'd without published opinion,* 947 F.2d 935 (3d Cir. 1991) (*opinion at* 68 A.F.T.R.2d ¶ 91-5180), *cert. denied,* 503 U.S. 940 (1992); Hagen v. Commissioner, 57 T.C.M. (CCH) 1489, 1533 & n.154 (1989), *aff'd, rev'd, and rem'd on other issues without published opinion,* 951 F.2d 1259 (10th Cir. 1991)

(*opinion at* 92-1 U.S.T.C. ¶S50,030), holding various arrangements failed to pass muster.

16. *See, e.g.,* Sherwin P. Simmons, "Economic Benefit Under a Split-Dollar Arrangement," 62 Tax Notes 1445, 1446-47 (Mar. 14, 1994).

17. *E.g.,* PLR 9348009 (8/31/93); PLR 9235020 (5/28/92).

18. Kirk D. Sherman, "Split-Dollar Compensation Planning Post-Notice 2001-10," 91 Tax Notes 1301 (May 21, 2001).

19. Martin D. Ginsburg, "The National Office Mission," 27 Tax Notes 99, 100 (Apr. 1, 1985).

20. Notice 2001-10, Section IV.A.1, 2001-5 I.R.B. at 461.

21. *See* I.R.C. §264(a)(4).

22. *E.g.,* Pulsifer v. Commissioner, 64 T.C. 245 (1975); Sproull v. Commissioner, 16 T.C. 244 (1951), *aff'd per curiam,* 194 F.2d 541 (6th Cir. 1952).

23. Notice 2001-10, Section IV.A.4, 2001-5 I.R.B. at 462.

24. News Release IR2001-48 (Apr. 26, 2001); the plan is reprinted in full in "2001 IRS/Treasury Business Plan Goes to Fiscal Year," __ Tax Notes 708 (Apr. 30, 2001).

25. Daily Tax Report, May 25, 2001, at G-1.