

THE TAO OF KARL MALDEN AND SPLIT DOLLAR PLANS:
AFTER NOTICE 2002-8, WHAT WILL YOU DO?

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The Tao of Karl Malden and Split Dollar Plans:

After Notice 2002-8, What Will You Do?

- I. In Notice 2002-8, the Internal Revenue Service gave notice of the intended tax regime for split dollar life insurance plans under regulations to be issued in the future.
 - A. Under the anticipated treatment of split dollar life insurance plans, there will be no annual taxation of cash value build up in excess of premiums paid (the “equity”).
 - B. Unlike Notice 2001-10, Notice 2002-8 provides for grandfathering of split dollar plans existing before the date that final regulations are published.
 - C. Notice 2002-8 uses the term “arrangement,” rather than “plan,” to refer to split dollar plans. This outline will use the term “plan.”
 - D. Notice 2002-8 anticipates “future guidance” in addition to proposed and final regulations. Presumably this future guidance will be issued before the final regulations are published.

- II. Split Dollar Plans
 - A. Split dollar plans are nothing more than a form of premium financing.
 - B. Typically, an employer pays the premiums on a permanent life insurance policy on behalf of an employee.
 - 1. The advantage is that a lower tax bracket taxpayer bears the cost.
 - 2. The life insurance policy may be owned by the employee or a third party, most commonly the trustee of an irrevocable life insurance trust.
 - C. Plans outside of the employment context are commonly referred to as “private split dollar plans.”
 - 1. The focus of this outline is on employer-employee split dollar plans.

- D. The employee realizes income equal to the value of the life insurance protection (sometimes called the “economic benefit”).
 - 1. The value of the life insurance protection is substantially less than the premium paid.
 - 2. The value is determined using the P.S. 58 rates or the insurer’s lower published premium rates that are available to all standard risks for renewable one-year term insurance.

III. Payment of Premium Loan

- A. As is the case with all loans, the employee must eventually repay the premiums advanced by the employer (or be taxed on the forgiven debt).
 - 1. There are two methods for splitting the interests in the life insurance policy and securing the payment of the loan:
 - a. The employer can own the policy and evidence the employee’s interest by an endorsement to the life insurance policy (hence, an “endorsement method” plan).
 - b. The employee can own the policy and partially assign the policy as collateral for the employer’s loan (hence, a “collateral assignment method” plan).
- B. If payment occurs at the death of the employee, the loan will be paid out of the life insurance proceeds.
- C. The employee can pay off the loan during life and distribute or roll the policy out of the split dollar plan (hence, the policy “roll out”).
 - 1. The employee will use the policy’s cash value to pay the employer an amount equal to the premiums paid by the employer.

IV. Equity Split Dollar Plans

- A. Eventually, a permanent life insurance policy builds up cash value in excess of the premiums paid. When the cash value of a life insurance policy crosses over the premiums paid, there is “equity” in the policy.
- B. In “traditional” split dollar plans, the employer is entitled to receive an amount equal to the greater of the premiums paid or the cash value of the life insurance policy.
- C. In “equity” split dollar plans, the employer is entitled to receive no more than an amount equal to the premiums paid, thereby shifting the equity to the employee.
- D. The proposed scheme for taxing split dollar plans is designed to tax to the employee the equity in equity split dollar plans.

V. The Proposed Regime

A. Endorsement Method

- 1. In the case of an endorsement method split dollar plan, the employee will continue to be taxed on the annual economic benefit.
 - a. The Internal Revenue Service is searching for a method of valuing the economic benefit that will be the same for all taxpayers of (presumably) the same age and has requested comments.
- 2. At roll out, the employee will be taxed on the value of the policy transferred to the employee under Section 83 of the Internal Revenue Code.
 - a. Although Notice 2002-8 is silent on this point, the employee should be able to off set premiums paid by the employee, if any, against the value of the property received.
 - b. The employee may be able to off set amounts previously taxed to the employee against the value of the property received, although Notice 2002-8 is silent on this. The Internal Revenue Service’s

unofficial opinion is that this would inappropriately double count the employee's payments. Commentators have noted, however, that the Internal Revenue Service's position is contrary to the calculation of "investment in the contract" under Section 72 of the Code. Lawrence Brody, *Analysis of IRS Notice 2002-8*, fn. 1 (Am. Bar Assn. Feb. 6, 2002).

B. Collateral Assignment Method

1. Under a collateral assignment method split dollar plan, premium payments will be treated as a series of loans to the employee.
 - a. The below market interest rules of Section 7872 of the Internal Revenue Code will apply.
2. There will be no income to the employee at roll out. Because the employee already owns the policy, nothing is transferred from the employer to the employee to be taxed under Section 83 of the Code.

VI. Grandfathered Split Dollar Plans

- A. Plans in existence before the date the final regulations are published are grandfathered.
- B. The rules applicable to a grandfathered plan vary by the date on which the split dollar plan is entered into:
 1. Pre-January 28, 2002 Plans
 2. January 28, 2002 Plans (this one-day period is created by a drafting error in Notice 2002-8)
 3. Post-January 28, 2002/Pre-Future Guidance/Pre-Final Regulations Plans
 4. Post-January 28, 2002/Post-Future Guidance/Pre-Final Regulations Plans

C. When is a Plan “Entered Into?”

1. While Notice 2002-8 refers to “arrangements entered into” before a date or event, the Notice does not flesh out this concept.
 - a. The safest course is to have all pieces of the split dollar plan in place before the controlling date or event:
 - (1) Plan drafted and executed by all parties
 - (2) Corporation resolution adopted that authorizes the split dollar plan
 - (3) Policy issued
 - (4) Endorsement or collateral assignment executed and filed with insurance company
2. The Notice is silent as to whether any modifications or only substantial modifications to the split dollar plan will destroy grandfathered status.
3. The Notice is silent as to whether policy acquisitions or policy exchanges will destroy grandfathered status.

VII. Taxation of Plans Entered Into Before January 28, 2002

- A. Split dollar plans entered into before January 28, 2002 may elect to continue the traditional treatment accorded split dollar plans (that is, each year the employee takes into income the economic benefit of the life insurance coverage) or may elect loan treatment.
 1. The value will be measured by the lower of the Table 2001 rates (the rates published with Notice 2001-10) or the insurer’s published, generally available, annual renewable term rates.
 2. Commentators suggest that it is likely that insurers’ traditional annual renewable term rates will increase because of the interplay between state regulation of insurance rates and the stricter requirements for annual renewable term rates imposed by the Internal Revenue Service on post-

January 28, 2002 split dollar plans. The stricter requirements become effective January 1, 2004.

3. The table at the end of this outline compares the P.S. 58 rates to the Table 2001 rates. Insurers' annual renewable term rates are usually lower than the Table 2001 rates.
- B. No current taxation on the annual build up in equity.
- C. So long as the employee continues to report the annual economic benefit and the employer retains some economic interest in the policy, there will be no deemed transfer of the equity to the employee.
- D. Unless the parties make the election described below, on the roll out of a policy after December 31, 2003 the Internal Revenue Service will argue that the employee is taxable on the equity that has been transferred to the employee.
1. The taxation of the equity will be determined under the law as it existed before Notice 2001-10. Just what that law is has been the subject of speculation for some time.
 2. The Internal Revenue Service can be expected to challenge any claim that the equity is not subject to taxation.
- E. The employee may avoid the potential taxation of the equity on roll out by electing to convert the treatment of the split dollar plan from the traditional method to the loan method on or before December 31, 2003.
1. The premium loan balance as of the date of conversion must include all premiums paid by the employer prior to the conversion to the loan method.
 2. To be eligible to make this "safe harbor" or "grandfather" election, the employer must have received or be entitled to receive full repayment of all of its payments.
 - a. What if the split dollar plan provides that the employer is entitled to the payment of the lesser of the cash surrender value or the premiums paid?

VIII. Thoughts on Plans Entered Into Before January 28, 2002

- A. If the cash value of the life insurance policy in the split dollar plan will have sufficient cash value by December 31, 2003, the split dollar plan probably should be terminated and the policy rolled out.
- B. If the short fall in cash value of the life insurance policy is not substantial, the employee may be able to make up the difference from other funds and roll the policy out of the split dollar plan before January 1, 2004.
- C. Unless your client has a deep-seated desire to be famous, any policy that cannot be rolled should be converted to a loan to avoid taxation of the equity on a roll out after December 31, 2003.
- D. If the policy cannot be rolled out before January 1, 2004 (and the employee is unwilling to risk a challenge by the Internal Revenue Service), consider using the cash value to pay down the balance on the premium loan as of January 1, 2004.
- E. Factor in the employee's life expectancy. The equity will escape tax if the employee dies before rolling out the life insurance policy.
- F. If the life insurance policy will have little or no equity, it may not make sense to terminate the split dollar plan or convert the split dollar plan to the loan method.
- G. Compare the present value of the loan method to the present value of tax on the equity triggered by a roll out after December 31, 2003. Which is cheaper?
- H. Can the employer bonus the employee sufficient funds to pay the tax on the equity rolled out after December 31, 2003?

IX. Advisability of Post-January 28, 2002 Split Dollar Plans

- A. Whether it makes sense to enter into a split dollar plan after January 28, 2002 depends, as it did before January 28, 2002, on the expected return on the investment. However, the analysis must contend with more variables, including, but not limited to:

1. The projected short-term Applicable Federal Rate.
 2. Projected insurance premiums.
 3. Projected annual term insurance rates.
 4. Projected dividend rate and rate of return within insurance policy.
 5. Projected equity.
 6. Projected roll out date.
 7. Age of insured.
 8. Life expectancy.
 9. Marginal tax rate of employer.
 10. Marginal tax rate of employee.
- B. The insurance companies will modify their proprietary policy illustration software to take these additional variables into account. Someone (Anyone? Anyone? Bueller?) will develop a program for the rest of us.
- C. Any analysis must consider the alternatives, including, but not limited to:
1. A term loan (with advances timed to match premium payments?).
 2. Bonus life insurance.
 3. Co-owned life insurance.

Comparison of P.S. 58 and 2001-10 Term Life Insurance Rates

EOY Age	P.S. 58	2001-10	EOY Age	P.S. 58	2001-10	EOY Age	P.S. 58	2001-10
0		0.70	33	2.86	0.96	67	37.31	15.20
1		0.41	34	3.02	0.98	68	40.59	16.92
2		0.27	35	3.21	0.99	69	44.17	18.70
3		0.19	36	3.41	1.01	70	48.06	20.62
4		0.13	37	3.63	1.04	71	52.29	22.72
5		0.13	38	3.87	1.06	72	56.89	25.07
6		0.14	39	4.14	1.07	73	61.89	27.57
7		0.15	40	4.42	1.10	74	67.33	30.18
8		0.16	41	4.73	1.13	75	73.23	33.05
9		0.16	42	5.07	1.20	76		36.33
10		0.16	43	5.44	1.29	77		40.17
11		0.19	44	5.85	1.40	78		44.33
12		0.24	45	6.30	1.53	79		49.23
13		0.28	46	6.78	1.67	80		54.56
14		0.33	47	7.32	1.83	81		60.51
15	1.27	0.38	48	7.89	1.98	82		66.74
16	1.38	0.52	49	8.53	2.13	83		73.07
17	1.48	0.57	50	9.22	2.30	84		80.35
18	1.52	0.59	51	9.97	2.52	85		88.76
19	1.56	0.61	52	10.79	2.81	86		99.16
20	1.61	0.62	53	11.69	3.20	87		110.40
21	1.67	0.62	54	12.67	3.65	88		121.85
22	1.73	0.64	55	13.74	4.15	89		133.40
23	1.79	0.66	56	14.91	4.68	90		144.30
24	1.86	0.68	57	16.18	5.20	91		155.80
25	1.93	0.71	58	17.56	5.66	92		168.75
26	2.02	0.73	59	19.08	6.06	93		186.44
27	2.11	0.76	60	20.73	6.51	94		206.70
28	2.20	0.80	61	22.53	7.11	95		228.35
29	2.31	0.83	62	24.50	7.96	96		250.01
30	2.43	0.87	63	26.63	9.08	97		265.09
31	2.57	0.90	64	28.98	10.41	98		270.11
32	2.70	0.93	65	31.51	11.90	99		281.05

	33	2.86	0.96		66	34.28	13.51	
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