

## TAXATION

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# Employer-Employee Life Insurance Policies

### AN IRS TECHNICAL ADVICE MEMORANDUM PUTS THE SPOTLIGHT ON THE INCOME AND GIFT TAX CONSEQUENCES OF SPLIT DOLLAR PLANS.

Equity split-dollar life insurance has proven to be a useful tool for owners of closely held corporations and family businesses to handle cash flow, succession and buyout issues in a tax-efficient manner. At its most basic, equity split-dollar involves an employer and employee joining in the purchase of a large life insurance policy on the employee.

Earlier this year, the IRS put these arrangements in the spotlight when it issued Technical Advice Memorandum (TAM) 9604001, dealing with the income and gift tax consequences of split-dollar plans.

A TAM is a written opinion of the IRS national office to an IRS field office responding to a request for technical advice on a particular case. While it is important to keep in mind that a TAM applies only to the case at issue, TAMs are often seen as bellwethers of IRS thinking.

Its long-term implications are uncertain, but TAM 9604001 clearly underlines the importance of entering into a split-dollar plan with a workable exit strategy in the event that the plan needs to be altered or terminated.

With that in mind, here are some observations about the short-term impact of the TAM, and some options for how to proceed while it plays out over the coming months.

### Facts Behind the TAM

The specific case that sparked the TAM involved an individual who was the CEI and controlling shareholder of a holding company that was 98 percent of a subsidiary. In 1991, the subsidiary and an irrevocable trust created by the majority shareholder entered into split-dollar arrangements to finance the purchase of two separate paid-up \$500,000 life insurance policies on the shareholder's life. The trust was designated as the owner of the single-premium policies, which were then collaterally assigned to the subsidiary as security for the trust's obligation under the split-dollar arrangements to repay the advanced by the subsidiary.

As the owner of the policies, the trustee possessed all the incidents of ownership in the policies — including he right to borrow against their cash-surrender value in excess of the premiums paid by the subsidiary. The subsidiary's rights in the policies were restricted to the right to receive a portion of the total amount of premiums paid; or, if the policies were canceled or surrendered prior to death, to recover the premiums advanced from the cash-surrender value.

The IRS issued rulings on both the income and gift tax effect of the above arrangement.

What conclusions did the national office of the IRS reach?

1. The economic benefit to the employee continues during the entire period the split-dollar plan is in effect. This is true whether or not the policy is fully paid up and no further premiums are due.

2. Any increase in the policy's cash-

surrender value greater than the amount required to repay the employer in accordance with the terms of the split-dollar arrangement represents currently taxable compensation to the employee.

3. If the life insurance policy is owned by a trust or family member of the insured, the amount included in the insured's income under (1) and (2) each year represents a taxable gift from the insured to the policy owner.

Right now, it's hard to gauge the impact of this TAM. It applies only to the taxpayer whose case is under immediate consideration, and constitutes only the IRS's opinion of the applicable tax consequences under the facts in the case. It has no precedent value in law, nor does it bind the IRS in any future litigation.

A TAM does not ordinarily receive the same high level of IRS review necessary for regulations or public rulings. The IRS's conclusions are substantially different from the tax treatment generally thought to apply in split-dollar cases by most life insurance companies. Until the true tax nature of these transactions can be more definitely determined, no one really knows what the future course of action by the IRS might be.

### How to Proceed

At this point there are three broad approaches to consider before implementing equity split-dollar life insurance in light of the TAM.

- *The "Full Speed Ahead" Approach.* This involves individuals who, notwithstanding the TAM, simply want to proceed with an equity split-dollar plan. These

individuals recognize the risk that the anticipated tax consequences may be inconsistent with the conclusions of the TAM. An example might be a client who receives professional advice that the TAM's conclusions are wrong and are likely to be either withdrawn by the IRS or not upheld if challenged in court.

• *The "Let's Go Ahead, but with an Acceptable Fallback" Approach.*

This involves individuals who are prepared to go ahead with the equity split-dollar plan — as long as there is an acceptable strategy should the conclusions of the TAM eventually become binding.

• *The "Let's Follow the TAM as Best We Can" Approach.*

This is the most conservative approach, but one that can provide attractive solutions as well. It is for individuals who prefer to modify the equity split-dollar plan right now to address and abide by the conclusions of the TAM, recognizing that it may never actually be binding.

Given that many advisers have long considered the tax consequences of equity split-dollar to be uncertain, some advisers and their clients may not consider the TAM to be much of a change. That uncertainty still exists, but at least we now know that the IRS technicians who wrote the TAM feel that the Internal Revenue Code section 83 approach to equity split-dollar is the proper analysis.

One obvious risk is that the TAM, while not technically binding, does accurately state the tax law in effect today. In that case, this approach does not involve tax risk. These individuals may still appreciate knowing that there are strategies that may help deal with the consequences if the TAM does become binding.

In that respect, they may be amenable to the "Let's Go Ahead, but with an Acceptable Fallback" approach as well. The basic idea is pretty simple. In most

cases, the crossover point at which cash values exceed premium payments occurs several years in to the contract. That gives an individual several years to await the resolution of the TAM issues before there is equity subject to tax under the TAMs approach. Don't forget; Any split-dollar agreement can be modified by mutual consent of the parties.

Another option is to proceed to the crossover point as if the TAM were not in effect. If the TAM is withdrawn — or for any other reason the illustrated equity split-dollar tax consequences are upheld — the individual simply proceeds as the policy was initially illustrated.

## Other Approaches

There are some additional approaches to consider for individuals who wish to take the more cautious "Let's Go Ahead, but with an Acceptable Fallback" approach.

1. An individual can consider a bonus rollout — what is sometimes referred to as a "spinout" — at the crossover point, using policy values to pay the employee's income tax. The result is reasonably attractive, allowing an individual to proceed with the equity split-dollar plan knowing that there is an acceptable backup.

2. Another approach would be to use a bonus rollout in which the employer's tax deductions at rollout are used to benefit the executive — i.e., the employer pays an additional amount to help the executive meet his or her tax liability.

3. One way also is to consider a conversion in the crossover year from the equity split-dollar to the traditional split-dollar, in which the employer is entitled to all of the cash values.

There are alternatives available for the individual who simply wants to treat the TAM as binding.

Under an estate planning scenario, when a policy is owned by a third party

(irrevocable trust or adult children) to avoid estate taxation, the primary concern is usually the death benefit rather than equity. Use traditional split-dollar (all cash value to the employer) and maximize the death benefit by using the term dividend.

Under a deferred compensation scenario, use traditional split-dollar (all cash value to the employer) and establish a separate deferred compensation plan which would enable the employer to pay out cash value in satisfaction of its obligation to pay a retirement benefit. (Note: The deferred compensation plan should not reference either the policy or the split-dollar plan.)

Under a business scenario, instead of split-dollar, structure the employer's premium advances as an interest-free loan. This alternative has always been available, and in fact may be more attractive at older ages where the imputed interest may be less than the split-dollar "economic benefit" — particularly where the current imputed interest rate (AMFR) is low.

Attorneys can share any or all of these approaches with their clients. It is important to enter into a split-dollar plan with a workable exit strategy in the event that the plan needs to be altered or terminated.

No one can predict with any degree of certainty as to when this matter may be resolved. However, equity split-dollar is still a viable solution as long as each individual enters in to the plan with a clear understanding of an exit strategy. ■■■

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