Split-Dollar Insurance and the Closely Held Business

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Introduction

Split-dollar is a mechanism for owning and paying for life insurance that can provide considerable flexibility when planning for closely held businesses. Split-dollar arrangements can be used for a variety of business related purposes that can aid in succession planning for closely held businesses. For example, split-dollar can be used:

- As a means of providing compensation to a key employee. In the context of planning for the succession of a closely held business this can be used as a financial incentive to entice a key employee to continue to perform after the demise of the business founder.
- To fund certain buyout arrangements.
- For estate and succession planning purposes for the business owner.

Tax Framework for Business Split-Dollar

The general manner in which a split-dollar arrangement will be evaluated from a tax perspective will depend on the characterization of the capacity of the individual involved with the business.

- If the insured/employee is also a shareholder the determination as to whether the benefits the employee/shareholder/insured are receiving are in the context of being an employee or rather of being a shareholder, are fundamental to the determination of the tax consequences of the split-dollar arrangement.
- If the insured receives benefit in his or her capacity as an employee, that benefit will be taxed as compensation income.
- If he or she receives benefit in his or her capacity as a shareholder, that benefit will be treated as a distribution that might be taxed as a dividend, return of capital, etc. With the tax rate on dividend income presently at 20% and that on compensation nearly double, there can be substantial advantages to documenting the shareholder connection as predominant over the employee connection. See Rev. Rul. 79-50, 1979-1, CB 138. In one case the court rejected the conclusion that the benefits were taxed to an employee/shareholder as compensation. Johnson v. Comr., 74 T.C. 1316 (1980). The above tax relationships may change substantially when tax rates are increased and other changes made to address federal budget deficits.

Decisions to Make in Structuring Business Split-Dollar Arrangements

There are several broad categories of issues to address in structuring a business split-dollar arrangement: (1) premiums, (2) cash values, (2) death benefits, and (4) other issues. Each of these must be addressed.

With respect to the payment of insurance premiums there are a number of options. The employer/business can pay the entire insurance premium on the policy subject to the split-dollar arrangement. The employee/insured would then contribute nothing to the cost of the insurance coverage. Another option would be for the employee to pay the cost of term coverage for the insurance policy. If a permanent policy is involved this could be substantially less than the actual premium. These term costs are presently estimated using Table 2001 rates or qualifying alternative term rates. However, the Service may issue a different updated rate schedule in the future in which case that would be the means of calculating the payment. If the employee pays the 2001 term cost, the employer/business pays the balance of the premium cost. Another approach is for the employer/business to pay the premiums up to the amount of the increase in the cash value of the policy each year. Under this approach, which is not commonly used, the employer/business would pay a small portion in early years, but a growing portion as the cash value grows in later years.

Cash values and death benefits must be addressed in planning the split-dollar arrangement. The employer/business could be entitled to receive the greater of the premiums actually paid, or the cash surrender value of the policy. Another option is for the employer/business only to receive back the premiums advanced, and the employee/insured to receive the cash value in excess of this amount (this excess constitutes the “equity” in the policy).

Other contractual issues should also be addressed in structuring the split-dollar arrangement. Which party will have the authority to make the investment selection decisions if the policy is a variable policy? Which party will determine the amount of premiums to pay each year if a universal life insurance policy is involved? Which party pays the interest on any policy loans?

How Benefits under Business Split-Dollar Arrangements are Treated

The status and nature of the relationship of the individual involved in the split-dollar arrangement with the employer/business determines the income tax consequences. Unfortunately, while the categories are easy to identify, characterizing the relevant relationship in any actual situation can be subject to considerable uncertainty. The individual can be characterized as an employee. If, as an employee, the individual receives benefit under a split-dollar arrangement that benefit will generally be treated as compensation income. If the individual is characterized as a C corporation shareholder the benefit received under a split-dollar arrangement should be treated as a C corporation distribution. This will generally be taxed as a dividend to the extent that the corporation has earnings and profits. IRC Sec. 301(c); Treas. Reg. 1.66-22(d)(1). If the individual is characterized as an S Corporations shareholder the tax treatment will be similar to that of a C corporation shareholder, but there are important differences. Because S corporation shareholders report earnings of the S corporation on their personal tax returns as a result of the conduit nature of S corporation taxation, S corporation payments towards the split-dollar arrangement will effectively made with post-tax dollars. This negative, however, may not offset the estate planning benefits of using a split-dollar arrangement with an S corporation.

If the individual is characterized as a partner the tax treatment remains uncertain. There are no regulations for split dollar life insurance arrangements involving partnerships. The only mention is in Treasury Regulation §1.61-22(c)(1)(iv) indicates “Reserved”. One approach for the tax treatment of a partner receiving a benefit under a split-dollar arrangement, might be for that benefit to be treated as a guaranteed payment to the partner under the concepts of Rev. Rul. 91-26. The IRS has permitted a partnership to be a party to a split-dollar arrangement in which the insured is a partner, but not an employee, of the partnership. PLR 9204041 and PLR 9639053.

Finally, if the individual is a member of a limited liability company (“LLC”) there is even more uncertainty than for a partner. No rules have been provided for LLCs. The determination as to how an LLC member will be treated will not necessarily follow from the paradigm of how a partner should be treated even if rules governing partners are eventually issued. If the LLC member is a mere passive owner, the tax treatment might be as a partnership distribution. If the member is also active in the management of the LLC, or is also a manager, the treatment as a guaranteed payment analogous to a partner might be appropriate.

Endorsement and Collateral Assignment

There are two common forms of structuring the ownership of a split-dollar insurance arrangement: endorsement or collateral assignment. Each has potentially important implications to the consequences of the plan.

When an endorsement split-dollar arrangement is used in a business context the employer typically pays the premiums on a life insurance policy on the life of the employee. The employer/business owns the life insurance policy and endorses the excess death benefit (this is the amount of death benefit which exceeds the greater of the premiums paid or cash surrender value of the policy) to the employee’s designated beneficiary. An advantage of using the endorsement approach (in contrast to the collateral assignment approach discussed below) is that the endorsement approach enables the employer/business to retain control over the ownership of the insurance policy. A disadvantage to the use of the endorsement approach in the context of a closely held corporation is that incidents of ownership held by the corporation may be attributed back to a controlling shareholder, thereby triggering estate tax inclusion. Treas. Reg. Sec. 20-2042-1(c)(6). This refers to incidents of ownership in a policy in which the corporation has an interest under a split-dollar arrangement that is not payable to the corporation and for which the corporation is not the beneficiary. Similarly, it follows that if a partner controls a partnership that owns the policy under an endorsement arrangement, the proceeds could be included in the partner's estate. Rev. Rul. 83-147. Remember that regulations governing split-dollar life insurance arrangements with partnerships is "reserved".

Another approach to structuring the split-dollar arrangement is to use a collateral assignment. When a collateral assignment split-dollar arrangement is used in a business context the employee (or an irrevocable life insurance trust established by the employee) typically owns the policy. The employer pays for the policy and retains a security interest in the policy to protect its right to be repaid. This can be structured in one of three ways:

- Non-equity. The employer receives the greater of the premiums it paid on the policy, or the policy's cash surrender value.
- Equity. The employer receives the premiums it paid (if the cash surrender value is greater that excess over premiums paid inures to the benefit of the employee (or the employee's beneficiary).
- Loan. The employer is lending the employee premiums to pay for the policy with or without AFR interest..

A key advantage of a collateral assignment approach, in contrast to the endorsement approach above, is that the life insurance can be owned by an irrevocable life insurance trust ("ILIT") established by the employee. The use of an ILIT can facilitate the proceeds not being included in the employee's estate even if the employee is a controlling shareholder or partner of the employer/business involved. Another advantage of the collateral assignment as compare to the endorsement approach is that with a collateral assignment arrangement the policy is not owned by the employer entity and therefore should not be subject to the reach of the employer entity's creditors.

Despite the confusing language in the Regulations about collateral assignments being treated as loans under the loan regime, an economic benefit arrangement between an employer/employee will be treated as such even if the policy is collaterally assigned, if both parties to the arrangement consistently treat it as an economic benefit arrangement.

Pre-2003 Regulations Employee/Close Business Split-Dollar Arrangements

What happens to employee/employer split-dollar arrangements that pre-date the final 2003 Regulations? Employee split-dollar arrangements that were in existence prior to the September 18, 2003 effective date of the 2003 Regulations and were not materially modified thereafter are governed by Notice 2002-8. Under these rules, taxpayers could have elected on the policy anniversary after December 31, 2003 to apply a loan treatment, or if they did not, then the economic benefit treatment under Notice 2002-8 (not the 2003 Regulations) governs.

An economic benefit arrangement created prior to the 2003 Regulations may have been for an employee to own an insurance policy, and the employer to pay the premiums for the policy. The employer may have been assigned, pursuant to a collateral assignment agreement, an interest in the policy to secure the repayment of the premiums advanced. v If this arrangement is unwound (e.g., via a rollout to a loan arrangement) the transfer for value rules should be considered to avoid tainting the insurance proceeds as taxable. IRC Sec. 101(a)(2). This tax taint may be avoided, for example, if the transferee is the insured. Also, the repayment of the employer, and the release of the collateral assignment, should generally not constitute a transfer for value. Treas. Reg. Sec. 1.101-1(b)(4).

Alternatively, the pre-2003 Regulation arrangement could have been characterized as a loan, however this is more a theoretical matter since few if any were. With loan treatment was elected then interest is imputed under IRC Sec. 7872. If the imputed interest exceeded the actual interest the employee/insured paid, that excess was taxable as income to the employee.

Employee/Employer Economic Benefit Regime Post-2003 Regulations

The post 2003 Regulations' economic benefit regime applies to all employer/employee non-equity split-dollar arrangements. These are arrangements in which the employee/insured does not share in the policy cash surrender value. It also applies to an all equity split-dollar arrangement if, for example, an employer owns the policy, and the employee shares in the policy cash surrender value.

When the employer owns the policy the "endorsement method" is typically used. This is the paradigm of the 2003 Regulations. With the endorsement method the employer as policy owner endorses over to the employee (or a beneficiary designated by the employee) the policy death benefit in excess of the premiums advanced by the employer.

Each year the employee, under an economic benefit regime, must include in taxable income as compensation the sum of the following:

- The value of the term insurance benefit provided by the employer. This is reduced by any premiums paid for by the employee. If the employee pays the Table 2001 amount, or the qualifying alternative term rate, for the insurance involved he or she will be deemed to have paid the full value of the term insurance benefit and thereby avoid any income imputation under this criteria.
- Any cash surrender value to which the employee had "access" (i.e., provided to the employee) during that tax year. The term "access" is broadly defined. If the employee has a current, or even future, right to the cash value of the policy, that is not available to the employer, or creditors of the employer, it could be deemed sufficient "access" to trigger current income taxation. If the employee can realize economic benefit from the cash value, by making a withdrawal, borrowing, using the policy as collateral, or surrendering part or all of the policy, the employee will be deemed to have access to the policy thus triggering taxation of the entire value, not merely the portion of the value that can be accessed.
- If the life insurance policy is transferred to the employee, the employee must recognize compensation income equal to the cash surrender value of the policy. This amount is reduced by amounts payable by the employee to the employer, or previously reported in income by the employee.

If the employee has a third party, such as an ILIT, own the policy, there will be a deemed indirect gift from the employee to the ILIT upon the employer's payment of the policy premiums. However, it is not the actual premium cost that constitutes the gift, but rather the measure of the insurance value under the Table 2001 (or the insurance company term rates if applicable) that is the measure of the gift. If the insurance trust benefits skip persons (e.g., grandchildren) then GST exemption would have to be allocated to the ILIT in order to assure that it remains GST exempt. The correct amount of exemption needed to keep the trust GST exempt is the Table 2001 calculated insurance amount (or the insurance company term rates if applicable). Tremendous GST leverage can be obtained using this mechanism. If the employee's health is such that the actual cost of the policy exceeds the Table 2001 rate this could provide a more valuable benefit to the employee as the Table 2001 rate could be substantially lower than the actual insurance cost.

If the employer corporation held rights in the policy that rose to the level of incidents of ownership, and the employee owned more than 50% of the voting stock in the corporation, the employee could be deemed to have held the incidents of ownership in the insurance policy causing estate tax inclusion. Treas.

Reg. Sec. 20.2042.1(c)(6). This can be avoided by using a restricted collateral assignment arrangement.

Corporation/Cross-Purchase Arrangement-Economic Benefit Regime

In a simple cross-purchase buyout arrangement, shareholder 1 buys life insurance on shareholder 2, and vice versa. Whichever shareholder dies first the surviving shareholder collects life insurance proceeds and is obligated under the buyout agreement to repurchase the shares of the deceased shareholder with those proceeds. If this common arrangement is structured with a split-dollar overlay, the corporation could pay for a substantial portion of the premiums on each shareholder's life, while retaining the right to recover the cumulative premiums paid. To implement this type of plan the shareholders would each execute an endorsement providing the corporation with the right to an interest in the policy each holds on the other shareholder equal to the greater of aggregate premiums paid or cash surrender value. If there are age and/or health differences between the insured employees/owners employing a split-dollar approach can provide a mechanism to make the purchase of the cross-purchase insurance policies more palatable. This issue can be avoided by having a partnership own the insurance, with one policy per insured.

The use of split-dollar to fund a cross-purchase agreement does have a special risk that needs to be addressed. Cross-purchase buyouts are simplest to use when there are only two shareholders of the corporation. In such cases, each shareholder owns a policy on the other, with both policies being subject to a split-dollar agreement with the corporation. If there are three shareholders, each shareholder needs to own a policy on the other two shareholders, so a total of six policies are needed. As the number of shareholders increases beyond two, the number of policies required to fund the cross-purchase buyout quickly becomes unwieldy. One approach to dealing with this dilemma that is sometimes used is to utilize a first-to-die insurance policy that pays on the death of the first of the participating shareholders to die. However, there are no rulings supporting the application of first to die insurance under a split-dollar arrangement. The only rulings pertain to survivorship insurance. PLR 974019.

Stock Redemption Funded with Reverse Split-Dollar

In a reverse split-dollar arrangement the shareholder/employee/insured would own the life insurance policy (or perhaps a trust for the employee's benefit) and the employer/corporation would receive the death benefit. The corporation would enter into a redemption agreement with the insured shareholder providing that in the event of his or her death the corporation would use the insurance proceeds (received under the reverse split-dollar agreement) to fund the repurchase or redemption of that shareholder's shares. Assuming the shareholder/employee/insured survived until retirement, the plan would be unwound. Following retirement, the corporation would no longer require the use of the death benefit for key man coverage so that the corporation could relinquish its rights in the policy. In this context some corporations have tried to use an artificially high (rather than a low) term rate. The use of as higher rate could, if successful, would permit the corporation to effectively fund a large cash value in the policy that following retirement would inure to the benefit of the employee/insured. The IRS responded with Notice 2002-59 expressing its disapproval with these types of abuses.

S Corporations/Family Trust-Economic Benefit Regime

S Corporations present special split-dollar considerations. An S corporation shareholder/employee a split-dollar agreement provides no income tax benefit since any premiums paid for by the S corporation are paid with the shareholders' after-tax dollars because of the conduit nature of an S Corporation. However, a split-dollar arrangement within an S corporation can still provide gift and estate planning benefits, as illustrated below.

The more significant concern in structuring split-dollar arrangements with an S corporation is not violating the single class of stock requirement that could jeopardize S corporation status. S corporations are only permitted to have one class of stock. IRC Sec.1361(b)(1)(D). If the split-dollar arrangement results in dividend treatment to one shareholder, and there are two or more shareholders, the arrangement could be treated as a second class of stock thereby disqualifying the corporation from “S” status.

When properly structured this issue can be avoided. See PLR 200914019. In this Ruling the split-dollar arrangement between the S corporation and the third party trust required each to contribute an amount, each tax year, equal to the economic benefit generated by the coverage provided under the plan. Under this paradigm, the trust paid its fair share as did the S corporation. Thus, under the split-dollar construct no incremental economic benefit could have inured to the particular shareholder from this arrangement. So the single class of stock status was protected, and the amount the trust had to pay was significantly lower than the entire premium would have been without this arrangement. If the S corporation shareholder who is a party to the split-dollar arrangement pays for the entire economic benefit received in any tax year, this issue may be obviated. PLR 9331009, 9413023, 9651017.

When the agreements were between the S corporation and life insurance trusts created by its shareholders, and the trusts (or the trust grantors) or the beneficiaries were required to reimburse the S corporation to the extent of the economic benefit to the trusts, no second class of stock was found to exist. PLRs 9709027 and 9735006. If the shareholder/employee’s policy is owned by a trust so that the life insurance proceeds would not be included in the shareholder/employee’s estate, the transfer of the funds necessary to pay the annual premium to the trust by the shareholder/employee/insured would generate a taxable gift if in excess of the annual gift exclusion. The S corporation split-dollar arrangement could substantially reduce or eliminate that potentially negative gift tax consequence.

In a closely held business organized as an S corporation a split-dollar arrangement can be used to fund insurance for succession planning and estate tax purposes. This can be illustrated in an example.

Example. Mother and Father own the stock in a family business organized as an S corporation and both are employees (if not, the arrangement illustrated will have a different result). They have utilized their lifetime $1 million gift exclusion. Assume further, that the annual premium for a $12 million survivorship policy is $94,000/year. There would be a substantial gift tax cost incurred for them to make cash gifts to an irrevocable life insurance trust (“ILIT”) to pay for the premiums. Instead the ILIT and Corporation enter into a non-equity split-dollar arrangement. Pursuant to this arrangement, on termination, Corporation will receive the greater of the aggregate premiums paid or the policy cash surrender value. Although Corporation does not own the policy, this arrangement is taxed under the economic benefit paradigm of the 2003 Regulations. The payment of the insurance policy premiums in this example consists of two components: Corporation pays for the value of a joint and survivor term insurance policy under Table 2001 that is about $850.00. This amount is treated as taxable income to Mother and Father, perhaps as a dividend distribution from Corporation. Then this amount would be a deemed gift by Mother and Father to the ILIT. Corporation pays the balance of the premium $93,250, to the ILIT directly as an investment in the policy. Because the corporation is entitled to receive back the premiums paid or cash value in the policy, there is no indirect gift to the ILIT by the Mother or Father as a result of this payment.

Corporation/Family Trust-Loan Regime

In a closely held business organized as a corporation a split-dollar loan arrangement can be used to fund insurance for succession planning and estate tax purposes (compare to the example above of the application of the economic benefit regime to a family succession planning situation).

Example. Mother owns the stock in a family business organized as a corporation. Mother has utilized all of her lifetime $1 million gift exclusion so further taxable gifts would generate a significant gift tax. Assume further, that the annual premium for a $10 million insurance policy is $200,000/year. There would be a substantial gift tax cost incurred for her to make cash gifts to an irrevocable life insurance trust (“ILIT”) to pay for the premiums. Instead the ILIT and the Corporation enter into a loan split-dollar arrangement. Pursuant to this arrangement, the premium payments by the Corporation to/for the benefit of the ILIT will be for a 12 year term. The applicable federal long term interest rate applies. Assume that the applicable federal rate is 5%. Interest will be due the first year is $10,000 ($200,000 x 5%). If Mother gifts the $10,000 to the ILIT which in turn pays it to the corporation, the transaction will be disregarded and treated as an interest-free loan. If instead Mother makes gifts to the ILIT over the course of the year of varying amounts, and the ILIT uses $10,000 of those gifts to pay the interest due to the corporation, that arguably, according to some practitioners, should not trigger the same consequences. However, there is no authority for this conclusion.

Key Employee/Employer Loan Regime Post-2003 Regulations

If a key employee owns the life insurance policy that is subject to a split-dollar arrangement, and the employer pays for any portion of the premiums on the policy, and the arrangement is not an economic benefit arrangement, the loan regime will govern. As the premiums (or a portion of them) are paid by the employer, they will be treated as a series of loans to the employee. These loans will be tested under the below market loan rules to determine if the interest charged is adequate. There is no de minimus exception for the imputation of interest under these rules. If the employee is either not obligated to repay the premiums advanced by the employer, or this obligation is terminated, the amount forgiven must be treated as compensation income to the employee. This might be a hybrid loan under IRC Sec. 7872.

Code Section 409A and Split-Dollar

Code Section 409A was enacted in 2004 to provide strict rules governing nonqualified deferred compensation. Generally, if the requirements of Code Section 409A are not satisfied any compensation otherwise deferred will be taxable to the participant if not subject to a substantial risk of forfeiture. Split-dollar life insurance arrangements are not subject to the reach of Code Section 409A if:

- They only provide death benefits for an employee. Notice 2007-34
- Loan split-dollar arrangements if there is no agreement for the employer to forgive the loan. However, if there is an arrangement to forgive the loan, Notice 2007-34 provides that the split dollar loan can be subject to Code Section 409A. Note that the proposed Regulations provide that the corporation can continue to advance premiums without charging a market rate of interest.
- Split-dollar arrangements wherein the employer owns the policy and endorses a portion of the death proceeds in excess of the premiums advanced to the employee (the “endorsement method) may be subject to Code Section 409A if the employee has a legally enforceable right to

compensation that will be included in the employee's income in a tax year after the substantial risk of forfeiture lapses.

- Modifications of a pre-2003 Regulation split-dollar arrangement to comply with Code Section 409A may not constitute a material modification that would subject an otherwise grandfathered arrangement to the 2003 Regulations.

In most split-dollar situations the employer entity is a beneficiary of the life insurance policy subject to the split-dollar arrangement. Therefore, the employer entity is generally not entitled to an income tax deduction for the portion of premiums it pays on the policy. This result occurs even if the employee has to report some portion of the payments as income. IRC Sec. 264(a); Rev. Rul. 64-328.

Split-Dollar and Corporate Owned Life Insurance and Code Section 101(j)

Business owned life insurance contracts issued after August 17, 2006 must meet certain requirements to exclude the proceeds of an employer-owned life insurance contract from income. Employer-owned life insurance is a policy of life insurance on the life of certain employees that are owned by the employer (or a party related to the employer). An "employee" includes an officer, director, and highly compensated employee. See IRC Sec. 414(q). The employer (or the related party) is directly or indirectly, a beneficiary.

The IRC Sec. 101(j) rules are not applicable if the individual employee involved is not a U.S. citizen or resident. The rules affect businesses that enter into redemption agreements (where the business itself buys the interest of a former owner) and purchase insurance on the owners' lives to fund its obligation under the agreement. If the 101(j) requirements for tax free treatment are not met only that portion of the life insurance proceeds from an employer-owned life insurance policy equal to premiums and other amounts paid for the policy can be excluded from income. Proceeds above this amount are taxable. If the IRC Sec. 101(j) requirements are met, then the entire proceeds from the employer-owned life insurance will be excluded from income.

The employee must be notified in writing of the employer's plans to insure the employee's life and of the maximum face value of the policy's when it is issued. The employee must be informed in writing that the employer will be a beneficiary of any death proceeds. The employee must consent in writing to be insured, and to the coverage continuing after termination of the employment arrangement. A statement on Form 8925 "Report of Employer-owned Life Insurance Contracts" must be filed with the income tax return for each year that policies subject to IRC Sec. 101(j) are owned. IRC Sec. 6039I(a). This filing must report the total number of employees at the end of the year, the number of employees insured under employer-owned life insurance ("EOLI"), the face amount of life insurance in force under EOLI contracts at the end of the year, the name, address, and taxpayer identification number of the policyholder, the type of business of the policyholder, and a statement that the business has a valid consent for each insured employee, or the number of insured employees for which the proper consent has not been obtained.

If the notices and consents are provided, the death benefit will not be taxable if the insured was an employee at any time during the 12-month period before his or her death. At the time the contract was issued, the employee was a director, a highly compensated employee under IRC Sec. 414(q), or a highly compensated individual under IRC Sec. 105(h)(5) (except that 35% under IRC Sec. 105(h)(5)(C)).

If the notice and consent requirements are complied with, the life insurance proceeds will be tax free if it is paid to a member of the insured's family, any individual other than the employer (or a related party to the employer) who is the designated beneficiary of the policy, the estate of the insured, or a trust established for the benefit of a family member. It is also tax free if it is used to purchase equity in the employer from a family member, estate, or trust.

Mere administrative changes won't cause an insurance policy issued prior to the effective date to be subject to the IRC Sec. 101((j) rules. Unfortunately, there is little latitude in what is considered administrative (e.g.,, changes from a general to a separate account). A policy issued after August 17, 2006 as a result of a Section 1035 exchange for a policy issued on or before that date is not considered a material modification.

Employer-owned life insurance ("EOLI") is subject to stringent rules for death benefit proceeds payable to the entity. The overlay of a split-dollar regime on the insurance does not necessarily avoid the applicability of the EOLI rules. A split-dollar arrangement may provide that if the employee dies while the split-dollar agreement is in effect the employer will be repaid the premiums advanced or cash value. This payment of a portion of insurance proceeds might be subject to the IRC Sec. 101(j) rules, although, it is not fully clear that this situation is intended to be covered by EOLI.

If any one of the following requirements are met the corporation can avoid the taxable income re-characterization of 101(j):

- The insured had to be an employee of the corporation during the 12 month period prior to death.
- The insured was a highly compensated employee or director when the insurance contract was issued.
- The insurance proceeds are payable to the insured's family, a designated beneficiary of the insured, a trust for the benefit of the family of the insured, or to the insured's estate. In a split-dollar arrangement a portion of the proceeds are in fact payable to the insured's family, etc. However, a portion is also payable to the employer so that it would appear that this could be at most a partial exclusion. However, if the portion payable to the employer only equals the premiums paid the issues sought to be addressed by IRC Sec. 101(j) don't seem to be applicable to a split-dollar arrangement. However, what if the employer receives the cash surrender value which exceeds the amount of premiums paid? This could be viewed as insurance proceeds under a IRC Sec. 101(j) paradigm.
- The proceeds are part of a buyout used to purchase the equity interests of the insured's estate, a family member or trust.

Income Tax Treatment of Employee

Employees are generally taxed, as compensation income, on the value of what would be current term life insurance protection in the amount of coverage provided, to the extent that value exceeds payments made by the employee. Rev. Rul 64-328; Rev. Rul. 66-110.

The measure of this value that is taxable to the employee was determined:

- Pre-2001 using the PS 58 table rates, Rev. Rul 55-747, or the insurance company rates for a standard risk one year term policy if lower.
- 2001 and forward Table 2001 rates had to be used instead of the PS 58 rates or lower insurance company rates for new arrangements or materially modified existing ones.
- In 2002 Notice 2002-8 was issued which provided rules for determining the value to an employee. Under this paradigm the employer/employee can treat the insurance arrangement as either a loan to the employee or an economic benefit to the employee. If loan treatment is used then the tax consequences of a low or below market interest loan may apply. Below market interest loans are addressed in IRC Sec. 7872. If economic benefit regime is chosen the employee treats the value of the term insurance coverage generally determined under Table 2001, or qualifying alternative

term rates, in excess of any payments, as income in the year of payment and the value of any cash surrender value of the policy as income in the year it becomes available to the employee.

- Post-2003 Regulations, the provisions in the Regulations should be used to determine the amount taxable to the employee. These rules generally apply to policies issued after September 17, 2003, or policies issued earlier that were materially modified.

Payroll Tax Treatment of Split-Dollar Arrangements

To the extent that a split-dollar arrangement results in taxable compensation income to an employee that amount is also subject to federal withholding tax. Rev. Rul. 64-328; Rev. Rul 66-110. The compensation component is not subject to FICA or FUTA taxes. IRC Sec. 3121(a)(2)(C).

Conclusion

Split-dollar arrangements can offer a valuable planning technique to address a number of different aspects of succession planning for the closely held business. Creatively applied split-dollar can address gift tax issues, asset protection concerns, provide a means of motivating a key employee and more. There are a range of complications and ancillary issues to address in this type of planning including transfer tax issues, income and payroll tax issues, and more.