Reviewing In-Force (Pre-Regulation) Corporate Split Dollar Plans

In-force split dollar plans (that have been grandfathered from the 2003 split dollar regulations) may have numerous issues that need to be addressed. They may have experienced poor policy performance and thus cannot support the original needs of the insured or their poor performance may inhibit the ultimate repayment to the employer and have a negative impact on the employer's balance sheet and income statement.

Beyond the policy performance, existing plans may have been handled poorly from an administrative standpoint. The plan may not have the proper written documentation, collateral assignments or policy endorsements. The parties may not have properly reported annual taxable income resulting from the plan. Plans established prior to the 2003 regulations should have been examined at that time to determine whether their grandfathered status should have been maintained or if the terms of the agreement should have been amended to bring the plan into compliance with one of the two tax regimes established under the regulations. Old plans may have also lost their grandfathered status inadvertently. Finally, some grandfathered plans may need to be converted to a new tax regime to take advantage of continued tax savings.

Analyzing in-force split dollar plans requires a thorough fact-finding with the parties to the agreement. There may be a need to have multiple levels of questioning in order to zero-in on a proper course of action. The following list of preliminary questions should be included in any fact gathering session:

1. Does the current policy continue to support the original insurance need of the insured or policy owner?
2. Does the policy's projected performance continue to support withdrawals or loans sufficient to make the originally desired income flow, employer repayment and/or future premium/insurance costs?
3. If the policy values are less than originally illustrated, can the policy be effectively rehabilitated with additional premiums, change of investment philosophy, or an exchange of contracts?
4. Does the plan document call for the insured or third-party policy owner to access policy cash values that exceed the employer's interest in those values? If so, does the policy currently have such excess values?
5. Assuming an exchange of contracts will cause a loss of grandfathered status, are the parties willing to administrate the plan as dictated by the 2003 regulations? (E.g., dealing with loan regime interest costs or under the Economic Benefit Regime having excess equity taxable when made accessible to the insured.)
6. Assuming a policy replacement or exchange is desired, will the insured(s) still qualify for the coverage? Have the health ratings changed?
7. Is there a written plan document? Have the necessary collateral assignments or policy endorsements been filed with the carrier?

8. Has the insured or policy owner properly reported and paid tax on any annual economic benefit income or other income events triggered by the plan?
9. Has the plan been reviewed for possible compliance with new Section 409A regulations dealing with deferred compensation arrangements?
10. How many years are remaining before the policy will be able to support a rollout/repayment to the employer or a stream of income for the insured?
11. If the policy will not support a rollout, how likely is it that the arrangement can be left intact until death of the insured?
12. For grandfathered plans, have there been any material modifications to the agreement or policy changes made since September 17th, 2003?

Once the status of the plan and its policy(s) have been determined from the answers to the preliminary questions, the advisor or insurance producer may be able to place the situation into one of the categories below under the two primary split dollar types. Of course, the client situation may involve multiple categories but we may be able to piece together an appropriate course of action.

ENDORSEMENT SPLIT DOLLAR (NOW REFERRED TO AS ECONOMIC BENEFIT REGIME)

1. **Bad Administration:** The current policy is still viable for the purposes for which it was initially purchased but the plan administration has been lacking. The economic benefit reporting has not taken place in some or all years.

   COURSE OF ACTION: Begin damage control. Make sure all documents are available. Begin reporting economic benefit income. Have agreement reviewed to determine possible application of Section 409A. Plan an exit strategy. Excess Equity (if promised to the insured) will not be taxable as long as the insured is reporting the economic benefit and the employer still has an interest in the policy. Determine if the policy will support a lump sum rollout at some point in the future. If it won't, consider a "crawl-out" or partial rollout. Keep in mind that as the employer's interest is reduced, the insured's economic benefit costs will increase.

2. **Runaway Economic Benefit:** The current policy is still viable for the purposes for which it was initially purchased. All plan documentation is in place. All tax reporting is up-to-date. However, the costs associated with the economic benefit taxation are becoming prohibitive.

   COURSE OF ACTION: Determine if the lowest possible rate has been used to value the economic benefit, e.g., does the carrier have an alternative term rate available? Examine the possibility of a change to the loan regime. Compare projected loan interest rate costs to the term costs.

Remember to factor-in the cost to amend the old agreement. If the old agreement is to be maintained, assess whether it falls under Section 409A. Amending a plan to comply with 409A will not cause it to lose its grandfathered status under the split dollar regs.

3. **Policy "Underwater":** The plan documents may be solid but the policy has not performed as originally projected. The employer may never see cost recovery and there may be little or nothing left of the policy to roll out to the insured at retirement.

   COURSE OF ACTION: First, determine if the policy is still grandfathered. In other words, have there been any material modifications since 9/17/2003 that may have caused it to lose it's grandfathered status? Attempting to rehabilitate an underwater policy by changing variable sub-account strategies (variable life policies) or by paying additional premium (universal life policies) should not cause a loss of grandfathering. However, these strategies will likely take time to be effective.

   Exchanging the old contract for a new contract with better guarantees or more investment options may also be explored but will likely cause a loss of grandfather status and a need to comply with the 2003 regulations. In the case of an Economic Benefit Regime plan (the old Endorsement approach), the new regulations will not be difficult to comply with except in those cases where the insured has access to policy equity under the existing agreement. The new regulations dictate that such policy equity will be taxable as soon as it is made available to the insured. To avoid this result, the plan should be modified and access restricted. Once again, after an exchange, a new policy may take time to restore values to the point originally illustrated. If there is insufficient time to make up the difference, the parties must determine if a compromise position can be taken. Can the employer accept a partial payback? Does the insured still need coverage beyond retirement, etc.?

4. **Changed Circumstances:** The insured or premium payer has had a change of circumstance. For instance, the original need for the coverage no longer exists or the employer is being sold to a third party and the agreement will not carry over to the new business.

   COURSE OF ACTION: It is difficult to outline any standard course of action without knowing the exact circumstance. The financial advisor should be familiar with the tax consequences of a plan termination, policy surrender, a policy transfer to the insured and/or a plan or policy modification. Policy equity that is paid to or made available to the insured upon a termination of the agreement will generally be taxable income. Prior economic benefit reporting will have created basis for the insured.

Policy transfers to the insured will also result in taxable income. Any plan or policy modification may be considered a material change and may trigger a loss in the grandfather status of the policy. As stated above, the loss of grandfathering will have an impact on those Endorsement/ Economic Benefit plans that give access to policy equity.

5. **Section 409A Violation:** If an Endorsement split dollar arrangement provides for unfettered access to policy values, those values will be subject to tax under the new Split dollar regulations. Grandfathered policies avoid that treatment as long as the plan is in place and the economic benefit costs are being reported as income. However, a grandfathered plan will not avoid the reach of Section 409 A relating to deferred compensation plans. The IRS has indicated that 409A will apply to certain split dollar arrangements that allow the insured to access policy values. If a plan falls under the 409A rules, it must comply with the requirement that plan benefits be paid only upon certain triggering events. Unfettered access to values, now or in the future, would be a violation. A violation causes equity build-up credited after December 31, 2004 to be taxable to the insured with additional tax penalties applied.

   COURSE OF ACTION: Plans that violate 409A should be amended. Employee equity accrued since 2005 will have to be reported as income with penalties paid. The upside of this is the employee's basis increase due to the tax reporting. After plan amendment, the split dollar arrangement may continue as before. No loss of grandfathering will result from the plan amendment.

COLLATERAL ASSIGNMENT SPLIT DOLLAR
(NOW REFERRED TO AS LOAN REGIME SPLIT DOLLAR)

1. **Bad Administration:** The current policy is still viable for the purposes for which it was initially purchased but the plan administration has been lacking. The economic benefit reporting has not taken place in some or all years. Plan documentation may be missing. Collateral assignments may not have been filed with the insurance carrier.

   COURSE OF ACTION: Once again, if the intention is to maintain the plan, some damage control is in order. Determine if documents can be created after the fact. Collateral assignment forms may be filed with the carrier in midstream. How many years of tax reporting are missing? Determine if it makes sense to open past tax returns or just start reporting as of the current year.

As far as the long-term maintenance of the plan, review the intended exit strategy in light of the 2003 regulations. Will the policy still support a straight rollout and payback of the employer? If there will be excess policy equity at the time of the rollout, is the client comfortable not reporting it as taxable income? (Remember that the IRS has not stated definitively that it will challenge this point.) Is there even a desire to repay the employer? Possibly the employer would consider bonusing its interest in the policy at plan termination. Alternative courses of actions may include (1) keeping the plan in place until death (with ongoing economic benefit costs); (2) switching to the Loan Regime (non-public companies only) and taking advantage of the current low federal interest rates; (3) Changing policies to achieve greater long term performance or guarantees; and (4) Changing the plan to the Economic Benefit Regime to take advantage of a carrier's low alternative term rates. This option is most often considered in conjunction with a policy exchange since the exchange will likely cause a loss of grandfathered status.

2. **Runaway Economic Benefit:** Many employers with grandfathered collateral assignment split dollar arrangements have been reporting economic benefit costs to plan participants using the government's Table 2001 rates since they were introduced in Notice 2001-10. While these rates are more favorable than the old P.S. 58 Table, they can still be high at older ages. Some of these employers may be feeling the pinch at this point because they know that terminating the plan will likely result in more taxable income to the participant and changing the policy to one with a carrier which has low-cost alternative term rates will result in a loss of grandfathering.

   COURSE OF ACTION: This is a situation where the various options may need to be compared to one another with the advantages and disadvantages considered. No one course of action is likely to be ideal in all cases. Factors to be considered will include, age of insured, purpose of the coverage, years to projected termination, type and age of policy and the tax brackets and resources of the parties to the agreement.

   If the primary focus of the arrangement is to provide death protection (as opposed to a stream of retirement income), the parties may benefit from an exchange of contract to a carrier with low alternative term rates and a simultaneous switch to the Economic Benefit Regime. The loss of grandfathering will not be disadvantageous if the insured is not looking to the policy for retirement income and expects the arrangement to stay in-place until death.

A second option is to change to the Loan Regime. Closely held companies can choose this route but public companies would be barred from making loans to officers and directors under the Sarbanes-Oxley Act. For those exploring this choice, low current interest rates on split dollar loans maybe an attractive alternative to the high economic benefit costs. Of course, if the policy has equity in excess of the employer's share of the cash value, the parties will have to determine if they should report that excess as income at the time of the conversion. Remember that we are past the window of opportunity allowed for tax-free conversions to the Loan Regime of plans existing at the time of the final regulations.

A third option is to terminate the arrangement and deal with the possible tax consequences. A plan termination with no employer payback will result in taxable income of at least the employer's interest. A plan termination with an employer payback may still result in taxable income if there is excess equity. We still don't know if the IRS will challenge these old equity split dollar plans when they are terminated. In addition, the ability to repay the employer may depend upon the resources at hand. Will the policy values be sufficient? Are there sufficient outside sources available? If the policy is owned by an irrevocable trust can sufficient gifts be made to the trust to cover the payback?

3. **Policy "Underwater":** As with the grandfathered endorsement plans, collateral assignment plans whose policies are underperforming provide the most difficult challenge. In addition, the loss of grandfathered status is an even bigger issue with collateral assignment plans since it forces these plans into following the Loan Regime rules. While the interest rates for policy loans may be currently low, the parties to the agreement may not wish to take on the added plan administration.

   COURSE OF ACTION: Some advisors are quick to recommend a new updated policy with greater guarantees or lower fees and costs of insurance. However, a policy exchange will likely be considered a material change to the plan. The employer's interest in the policy will now be considered an outstanding loan. Excess equity may not be the issue in some of these "underwater" situations but there may be policies that have lost dramatic amounts of value and yet still have cash values exceeding premiums paid. For these, there will likely be some immediate taxation as a result of the switch to the Loan Regime. Remember that for ILIT owned policies, the insured may be considered to be making a gift to the trust for any amounts included in income.

For those employers who wish to see the plan participant made "whole," a plan termination may be in order. If the employer bonuses its interest or a portion of its interest, the employee's policy values may be back to the originally promised levels. Future policy premiums could be also bonused if the employer does not wish to continue with a Loan Regime plan. If an employer decides to forgo repayment but wishes to maintain the current collateral assignment plan into the future, it should not change the plan document. A desire to forgo repayment, if promised in writing, may cause the employer's interest to be immediately taxable. Even if the employer's interest were not immediately taxable, such an arrangement would likely be viewed as deferred compensation with no risk of forfeiture.

4. **Changed Circumstances:** As with endorsement plans, the employer or the employee may have changed circumstances that result in the desire to change or terminate the existing agreement. The company may be in the process of being sold. The employee may be leaving the company. The need for the coverage may have changed.

   COURSE OF ACTION: Advisors and producers should be able to communicate the implications of a plan termination, a policy rollout (with payback), a policy rollout (with no payback) and a surrender of the policy.
   Policy equity in excess of the employer's interest will likely be subject to tax once the plan is terminated. The employer's interest, if not repaid, will also be taxable to the insured. As stated above, these income taxable events become potential gift tax problems if the primary owner of the policy is an irrevocable insurance trust or some other third-party.

   Remember that if a policy is surrendered the carrier will report the gain in the contact as taxable income to the policy owner. However, that amount may not reflect the total taxable income resulting from the plan termination. The carrier's Form 1099 may only be part of the story.

5. **Section 409A Violation:** In April of 2007, the IRS released Notice 2007-34 which addressed the issue of the application of Section 409A (deferred compensation rules) to split dollar plans. Based on the Notice, most split dollar plans will not fall under these rules. Those that do tend to be equity endorsement type arrangements (as discussed above). In regard to collateral assignment agreements written prior to the split dollar regulations, Notice 2007-34 indicated that there would be no application of Section 409A as long as the agreement was active and the employer was charging out the annual economic benefit to the insured.

6. A plan termination, however, could trigger the 409A rules if it was recast in such a way as to delay taxation of equity. In addition, if the split dollar plan has been lacking in its administration and economic benefits have not been reported, it is possible that the IRS could apply the 409A rules to the plan.

   COURSE OF ACTION: Most of these plans will require no changes to avoid the application of Section 409A. If all tax reporting is handled properly while the plan is in-force and all taxation of equity is properly reported in the year of plan termination, there should be no issue. If, however, plan administration has been lacking and economic benefit reporting has been missing, the parties to the agreement should begin the tax reporting ASAP and consider the possibility of paying past years' taxes. Plan termination and recasting under the Loan Regime would also solve the problem.