AALU's Washington Report

Premier analysis of federal legislative and regulatory developments for the nation's 2000 most advanced life insurance planners, focusing on business, estate, qualified and nonqualified retirement planning.

Counsel	1776 K Street, N.W.	*Executive Vice President*	2901 Telestar Court
Gerald H. Sherman	Washington, D.C. 20006	David J. Stertzer	Falls Church, VA 22042
Stuart M. Lewis	(202) 452-7900		(703) 641-9400
Deborah M. Beers	(fax) (202) 452-7989		(fax) (703) 641-9885
Norma Sharara			

AALU Bulletin No: 03-96 **September 15, 2003**

Subject: **Split-Dollar and the Tax-Exempt Organization**

Prior AALU Washington Reports: *03-94; 03-95*

MDRT Information Retrieval Index Nos.: *2500.00;6800.00; 7400.021*

The preamble to the split-dollar regulations that were recently finalized (see our Bulletins Nos.03-94 and 03-95) contains a specific reference to the taxation of split-dollar life insurance arrangements by tax-exempt organizations. That sentence indicates that, at least in some circumstances, split-dollar arrangements may be taxed under section 457, i.e., at an earlier time, than they would be taxed under the normal split-dollar regime.

Section 457 of the Code provides two distinct rules of taxation for tax-exempt organizations with respect to deferred compensation arrangements. Under so-called "eligible" plans (which are highly limited in the amount of deferred compensation that can be provided), the taxation does not occur until payments are actually made. Under all other arrangements (which are governed by section 457(f) of the Code), the arrangement is taxed when it is no longer subject to a substantial risk of forfeiture, i.e., when it is vested.

In the past, a number of tax-exempt organizations have set up split-dollar arrangements on the theory that they are not subject to section 457(f) of the Code. One argument that has been considered in these situations is that under Rev. Rul. 64-328, for example, it does not appear that there is any ***deferred*** compensation in the taxation of split-dollar arrangements and therefore, section 457(f) would not apply because it only applies to arrangements for ***deferred*** compensation. The Internal Revenue Service has never spoken directly to this issue, however, so notwithstanding that this practice has gone on for many years, there has at least been a degree of uncertainty whether the IRS would accept or challenge these arrangements under section 457(f).

Over the last several years, as the Internal Revenue Service has actively considered the tax treatment of split-dollar life insurance, it has not explicitly raised the application of section 457 to split-dollar arrangements, at least not until now. In the preamble to the regulations (but not in the regulations themselves) the IRS indicates that in some cases separate tax rules may require the nonowner of the policy to include an amount in gross income under an equity split-dollar insurance arrangement at a time earlier than would be required under the split-dollar regulations. It then goes on to say, "An equity split-dollar insurance arrangement ***governed by the economic benefit regime*** constitutes a deferred compensation arrangement." In short, what the IRS literally says is that if the split-dollar arrangement is governed by the economic benefit regime, then it is deferred compensation and section 457(f) would tax it at an earlier date than would the split-dollar regulations. Keep in mind that under the split-dollar regulations, endorsement arrangements are taxed under the economic benefit regime but collateral assignments are not -- they are taxed as loans under section 7872.

The first question presented is what is the intended reach of the statement in the preamble. Based on the context of the sentence, i.e., in the preamble to the regulations describing the new rules, and based on counsel discussions with government officials, AALU believes that the sentence was intended only to address endorsement arrangements governed by the regulations themselves (i.e., arrangements entered into or materially modified after September 17, 2003 under the endorsement method). Therefore, the sentence would not apply to collateral assignment arrangements governed by these regulations because they are not "governed by the economic benefit regime." However, the more significant question is whether, since pre-existing arrangements, i.e., arrangements entered into before September 18, 2003 and not materially modified thereafter (which are presumably subject to an economic benefit regime taxation under Notice 2002-8) are intended to be within the scope of this sentence or not.

The Internal Revenue Service may take the same position with respect to these pre-existing arrangements. However, the preamble sentence itself does not appear to be (for the reasons indicated above) directed at those types of arrangements. Notice 2002-8 explicitly says that no inference is to be drawn regarding the taxation of split-dollar life insurance arrangements entered into before the date of the publication of the final regulations. The IRS and the Treasury Department have been very careful in the ensuing activity with respect to these regulations to avoid commenting on the law concerning pre-existing arrangements and therefore it seems likely that this sentence was not directed at those arrangements. That, however, would not preclude the IRS from taking such a position on a pre-existing arrangement.

The next question is what is the effect of a statement in the preamble. Since there is no accompanying regulation provision, the statement in the preamble should be viewed as a statement of policy position by the government but probably has no weight beyond that. It does not have the force of a regulation or law but merely represents the IRS views on this particular issue. A court may give credence to the IRS view on the subject but certainly should not treat it as an authoritative statement of the law.

The final question is whether action should be taken immediately with respect to arrangements entered into by tax-exempt organizations in view of the September 17, 2003 effective date. If a tax-exempt organization has an existing split-dollar arrangement, it should consider what the effect of this preamble language is on the taxation of that arrangement. That question may be sharpened by the effective date of these regulations (September 17, 2003) and whether any action should be taken immediately to try to effect a change in the arrangement in response to this preamble without losing grandfathered status for the arrangement. In order to avoid the risk of it being a material modification after September 17, the modification would have to be undertaken no later than September 17.

One course of action that has been suggested by at least one AALU member is that the parties should consider postponing or eliminating vesting in the arrangement in order to avoid adverse taxation under section 457(f). Undertaking that action on short notice will involve a number of considerations that will be difficult to work out in such a short period of time. For example, such a modification may require the employee to give up certain contractual rights that he or she has and the employee must be properly advised concerning that surrender of rights. In addition, Notice 2002-8 provides for special rules for arrangements entered into before January 28, 2002 that could be adversely affected if modification are made at this time even if the modifications are made before the effective date of the new regulations. Finally, there are questions whether such a modification would actually be effective in accomplishing the result that is intended.

Another possibility is that the statement in the preamble may cause the parties to assess the risks of adverse taxation differently than they have in the past. If this is the case, the parties might want to consider the use of the safe harbors in Notice 2002-8. Because those safe harbors are available until the end of the year, action would not necessarily be required on such an immediate basis but could be considered over the balance of the calendar year.

This issue is a highly complex one that only formally surfaced at the last minute as part of the preamble to these regulations. Because the legal issues are far from certain and because of the complexity of any action that might be undertaken, it is difficult to say with any degree of certainty whether any action should be taken by parties in this context and if so, what. AALU members, however, are being advised of this concern as promptly as possible so that you can at least be alert to this issue.