

# The Washington Report

## Business Uses Edition

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### 409A Traps for the Unwary: Split-Dollar Life Insurance

**MARKET TREND:** Regulations and other IRS guidance under Internal Revenue Code section 409A explain how certain types of compensatory split-dollar life insurance programs may be subject to 409A's strict design requirements.

**SYNOPSIS:** This article provides a refresher on the potential applicability of the deferred compensation rules under 409A to compensatory split-dollar life insurance programs. Certain types of split-dollar programs, especially employer-owned (endorsement) programs in which the employee may have access to policy cash value, may be considered deferred compensation under 409A. If 409A applies, the split-dollar program must comply with 409A's rules regarding the timing of income inclusion based on permitted 409A payment events, and that income inclusion generally cannot be accelerated or further deferred. It is also possible that the split-dollar program could be exempt from 409A, such as under the short-term deferral exception or death benefit only exception. If, however, 409A applies but the program fails to comply, significant adverse 409A tax costs will apply, mainly for the employee.

**TAKE-AWAYS:** Given the potential for significant adverse tax results, compensatory split-dollar programs should be reviewed by a 409A tax expert for compliance. That review should occur not only when the program is first designed, but also any time the program is modified.

## Overview

This article explores the ways in which section 409A (“409A”) of the Internal Revenue Code of 1986, as amended (the “Code”), impacts the design and administration of compensatory split-dollar life insurance programs provided by employers to employees. We will explain the key requirements of 409A, the key tax considerations for split-dollar programs, and the ways in which split-dollar programs, depending on their design, may be either exempt from, or subject to, 409A.

For purposes of this article, we will keep it simple. By “compensatory split-dollar life insurance program,” we mean an arrangement between an employer and employee in which a life insurance policy on the life of the employee is issued by an insurance company, with the employer paying all or some of the premiums and the employer and employee splitting the rights to the death benefit.<sup>1</sup> The policy may either be owned by the employer (“endorsement” split-dollar) or by the employee (“collateral assignment” split-dollar), and the allocation of other policy ownership rights, such as access to policy loans or cash value withdrawals, are as specified in the split-dollar agreement between the employer and employee. As we discuss below, who owns the policy and how these various ownership rights are allocated will largely determine the 409A outcome.

Both 409A and the tax rules for split-dollar life insurance include certain grandfather rules for arrangements predating specified dates in 2004 (for 409A) or 2003 (for the split-dollar tax rules). This article does not address those grandfather rules and assumes the split-dollar arrangement is not grandfathered under 409A and is subject to the post-2003 split-dollar tax rules.

## General Structure of 409A

409A is incredibly broad. 409A was originally adopted in part to address perceived abuses in high-profile corporate scandals in which executives took in-service withdrawals of their nonqualified deferred compensation benefits while employees saw their 401(k) plans locked into company stock investments that vanished. But as adopted and implemented, 409A applies to much more than executive compensation.

409A creates rigid rules as to the timing and form of payment for compensation earned under a “nonqualified deferred compensation plan” as defined by IRS regulations.<sup>2</sup> With limited exceptions, a “nonqualified deferred compensation plan” arises any time a “service provider” (including employees, non-employee directors, and certain independent contractors) obtains a “legally binding right” to compensation that may become vested in one year but payable in a later year. This broad definition can pick up unexpected arrangements, such as annual bonus plans, severance arrangements, and, as we discuss below, certain compensatory split-dollar life insurance programs.

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<sup>1</sup>Split-dollar programs do not include key man life insurance or other types of corporate-owned life insurance (COLI) in which the employer is both the owner of the policy and the sole beneficiary of the policy cash value and death benefits. Such COLI arrangements may be used for various business purposes such as funding the ownership buyout of a key owner on death, otherwise providing economic assistance to the employer in case of a key employee's death, informally funding nonqualified deferred compensation benefits, etc.

<sup>2</sup>See Treas. Reg. §1.409A-1(a).



The IRS regulations include several exceptions to this broad definition. The two most important when analyzing split-dollar programs apply to “short-term deferrals” and “death benefit only” plans.<sup>3</sup> A “short-term deferral” refers to a legally binding right to compensation that is subject to a “substantial risk of forfeiture” and which, by its terms, must in all cases be paid no later than March 15 of the year after the year in which the substantial risk of forfeiture lapses. We sometimes refer to this as a “vest-and-pay” program. A substantial risk of forfeiture for this purpose may include a requirement to remain in service through a specified vesting date (i.e., “time-based” vesting) or a requirement that a specified performance condition or milestone be achieved (i.e., “performance-based” vesting).<sup>4</sup> A “death benefit only” plan, as the name implies, is an arrangement in which the benefits are payable only upon the service provider’s death.

For a compensation program that is subject to 409A, the program must comply with detailed rules related primarily to how and when the compensation is paid. The compensation can only be payable as of one of six permitted payment events – death, disability, separation from service, a fixed date or schedule, a change in control, or an unforeseeable emergency.<sup>5</sup> Payment events may be expressed as an “earlier of” or “later of” rule, such as payment upon the earlier of death, disability or separation from service. The payment rule may provide the form of payment as a lump sum, fixed installments, or a lifetime annuity triggered by the applicable payment event. Importantly, the applicable payment events and form of payment must be specified at the front end when the legally binding right first arises. Once the payment rules are set, they generally cannot be changed to accelerate or further defer payments, with limited exceptions specified in the 409A regulations. For nonqualified deferred compensation plans that include a service provider election to defer, the 409A regulations specify the deadlines by which any such deferral election must be made.<sup>6</sup> 409A nonqualified deferred compensation plans must comply with the applicable requirements both in operation and form.

When analyzing the potential 409A impacts on a compensation program in which payments may be made over more than one year, there are three possible results:

- The program is not subject to 409A (e.g., because one of the exceptions applies);
- The program is subject to 409A and complies with all applicable requirements; or
- The program is subject to 409A but fails to comply with any one of the applicable requirements.

The first two results mean that the compensation should be subject to income tax only as and when paid. The third result, however, triggers significant adverse taxes under 409A, mainly for the service provider. As we discuss in more detail below, those adverse 409A taxes include immediate recognition of income by the service provider (even if amounts have not been paid to the service provider) and a 20% additional tax.

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<sup>3</sup>See Treas. Reg. §1.409A-1(b)(4) for the definition of “short-term deferrals” and Treas. Reg. §1.409A-1(a)(5) for the exception related to “death benefit only” plans.

<sup>4</sup>See Treas. Reg. §1.409A-1(d).

<sup>5</sup>See Treas. Reg. §1.409A-3. Each of these payment events (other than death) has a specific definition under the 409A regulations.

<sup>6</sup>See Treas. Reg. §1.409A-2.



## Split-Dollar Tax Treatment: Economic Benefit v. Loan Regime

The applicable tax treatment for compensatory split-dollar programs depends primarily on whether the program is employer-owned endorsement split-dollar or employee-owned collateral assignment split-dollar. Endorsement split-dollar is taxable based on the “economic benefit regime” covered by IRS regulations under section 61 of the Code, while collateral assignment split-dollar is usually taxable based on the “loan regime” described in IRS regulations under section 7872 of the Code.<sup>7</sup>

**Economic Benefit Regime.** The economic benefit regime applicable to employer-owned endorsement split-dollar considers two potential economic benefits provided by the life insurance coverage that are taxable to the employee: (1) the cost of current life insurance protection, and (2) if applicable, the portion of policy cash value that the employee may currently access. In each case, the amount included in the employee’s income is reduced by any amount the employee pays under the arrangement for that economic benefit.

Every split-dollar arrangement covered by the economic benefit regime, including an arrangement providing only death benefit protection for the employee, economic benefit associated with the cost of current life insurance protection. The cost of current life insurance protection represents the value associated with having a death benefit that will be paid to the employee’s beneficiary in case of death. The value for this economic benefit is based on the amount of the employee’s portion of the death benefit and either (i) term life insurance rates specified in IRS Notice 2002-8, often referred to as “Table 2001 rates,” or (ii) if lower, published insurer term rates that meet certain additional requirements.<sup>8</sup> The value of this economic benefit will increase each year, which makes sense given that term insurance rates increase with the insured’s age. There will be a taxable cost of current life protection in a year even if the employer was not required to pay a premium to the insurer for the year (e.g., for a policy with premiums required for only a fixed period).

**Example 1:** Employer owns a life insurance policy on the life of Executive A with a total death benefit of \$1 million. Under the split-dollar agreement between Employer and Executive A, the portion of the death benefit payable to Executive A’s beneficiary is \$700,000, and Executive A is 55 years old. If the cost of current life insurance protection is determined using the Table 2001 rates, that table states the cost of term insurance for a person with an attained age of 55 is \$4.15 per \$1,000 of death benefit. As a result, the economic benefit doctrine value of \$700,000 of life insurance protection that will be taxable to Executive A is \$2,905 (i.e., \$4.15 x 700), unless a lower rate per \$1,000 of coverage is available using published insurer rates that meet the requirements of IRS Notice 2002-8.

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<sup>7</sup>See Treas. Reg. §1.61-22 and Treas. Reg. §1.7872-15. The economic benefit regime also applies to a compensatory split-dollar arrangement in which the policy is owned by the employee if the employee’s only economic interest in the policy is the policy’s life insurance death benefit protection. See Treas. Reg. §1.61-22(c)(1)(ii)(1).

<sup>8</sup>See IRS Notice 2002-8, 2002-4 I.R.B. 398 (1/28/2002).



In Addition, the underlying cash value in a policy may trigger immediate taxation to an employee under the economic benefit regime if the employee has “current access” to that cash value. The employee is considered to have “current access” to the policy cash value if:

- the employee has a current or future right to any portion of the cash value, and
- any of the following are true: (i) the employee has current access (directly or indirectly) to the cash value, such as through direct withdrawals, policy loans, or otherwise; (ii) the employer does not have access to the cash value; or (iii) the cash value is not accessible by the owner’s general creditors in case of the employer’s insolvency.

If the split-dollar arrangement includes current access by the employee to any portion of the cash value, the employee will be taxed on that portion of the cash value to which the employee has current access, less any portion that was treated as income to the employee in a prior year.

**Example 2:** Employer owns a life insurance policy on the life of Executive A. Employer is entitled to receive from the death benefit the lesser of total premiums paid or the policy cash value. Executive A has the right to borrow against the cash value to the extent the cash value exceeds the amount to be paid to Employer from the death benefit. Assume for year 4, the total premiums paid by Employer are \$100,000 and the policy cash value is \$120,000 (and this is the first year that the cash value exceeded the total premiums paid). Executive A will have taxable income for year 4 under the economic benefit regime equal to \$20,000 based on the portion of the cash value against which Executive A may borrow in year 4 (in addition to the income based on the cost of current life insurance protection for year 4). Assume for year 5, the total premiums paid are \$125,000 and the cash value is \$175,000. The taxable income to be recognized by Executive A in year 5 based on current access to a portion of the cash value will equal \$30,000 – i.e., the \$50,000 of excess cash value against which Executive A may borrow less than \$20,000 portion of that excess that was included in Executive A’s income in year 4.

Employer-owned endorsement split-dollar arrangements that include an element of current access by the employee to the policy cash value are sometimes called “equity” arrangements. It is these equity arrangements that especially raise potential issues under 409A, as discussed below.

Sometimes, the employee may want to become the owner of the employer-owned insurance policy. If ownership is transferred to the employee, the employee will recognize income under the economic benefit regime equal to the policy cash value, less any portion of the cash value previously included in the employee’s income (such as under Example 2 above) and any amount the employee pays for the policy transfer.

**Example 3:** In Example 2 above, assume Employer transfers ownership of the policy to Executive A, with no payment required by Executive A, at a time when the policy cash value is \$175,000 and the total premiums paid are \$125,000. Executive A has previously included \$50,000 in income based on current access to the portion of the policy cash value that exceeds total premiums paid. The transfer of policy ownership will trigger an additional \$125,000 of income to Executive A – i.e., the \$175,000 of total cash value less than \$50,000 previously included in Executive A’s income based on current access to the cash value. If Executive A had been required to pay Employer \$125,000 for the transfer, there would have been no additional income recognized by Executive A.



**Loan Regime.** For employee-owned collateral assignment split-dollar arrangements in which the employee has greater rights in the policy than just a portion of the death benefit, the premium payments by the employer/non-owner may be treated as loans to the employee, assuming the arrangement includes a reasonable expectation that the employer will be repaid those premiums.<sup>9</sup> The repayment of the premiums must be paid from, or secured by, the policy death benefits and/or cash value.

Taxation under the loan regime follows general tax principles associated with loans. For example, if the loan includes no interest, or interest at less than the applicable federal rate, the employee will recognize income each year for the below-market portion of the interest. In addition, if the employer forgives any portion of the loan, such as by waiving a requirement that all or any portion of the premiums that have been advanced must be repaid, the repayment amount that has been waived will be income to the employee. The IRS regulations include technical rules as to how the loan regime applies depending on whether the arrangement is treated as a demand loan, term loan, or hybrid arrangement.

**Example 4:** Assume Executive A acquires a life insurance policy on Executive A's life and Employer pays the premiums. The premiums are repayable to the Employer, without interest, from the policy cash value upon Executive A's termination of employment. The loan is non-recourse, secured by the policy cash value, and the parties properly file nonrecourse representations with their tax returns for the year of the loan. Assume the market annual interest rate applicable to the loan is 5% (calculated under the applicable IRS regulations for hybrid loans). In year 1, the Employer pays a premium of \$100,000 treated as a loan under the loan regime. The foregone interest for the year is \$5,000 (i.e., 5% of \$100,000), which will be imputed income for Executive A, reported on Executive A's W-2 for the year and subject to applicable income and payroll tax withholding requirements. Assume that Executive A then terminates employment, and that Employer in its discretion releases Executive A from having to repay the loan. Executive A will then have an additional \$100,000 in imputed income.

As discussed below, employee-owned collateral assignment split-dollar arrangements subject to the loan regime rarely raise concerns under 409A, unless the parties to the arrangement create legal entitlements related to loan forgiveness.

## When Does 409A Potentially Apply to Split-Dollar Programs?

When the IRS completed its comprehensive final regulations covering 409A, it realized that there was still uncertainty as to the application of 409A to split-dollar arrangements. To help reduce the uncertainty, the IRS issued Notice 2007-34 (the "Notice").<sup>10</sup>

Under the Notice, a split-dollar arrangement taxed under the loan regime generally will not be subject to 409A. As noted above, the loan regime requires annual inclusion of income for any below-market interest on each premium payment by the employer treated as loan, which the IRS does not consider a type of deferred compensation. However, the loan regime can also trigger compensatory income recognition if the employer waives or otherwise forgives the employee's obligations to repay the loan – such as by foregoing all or a portion of the death benefit that the employer is otherwise entitled to receive at death from the policy.

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<sup>9</sup>Under Treas. Reg. §1.7872-15(d)(2), the parties can file with their tax returns a one-time written representation (often referred to as a "nonrecourse representation") to the effect that the parties reasonably expect the loan to be repaid, as a means to establish the reasonable expectation of repayment.

<sup>10</sup>IRS Notice 2007-34, 2007-1 C.B. 1279.



If the employee obtains a legally binding right in one year to such a repayment waiver in a later year, then that legal entitlement could be considered nonqualified deferred compensation under 409A.<sup>11</sup> In that case, the legal entitlement will need to be designed in a manner that is either exempt from 409A or complies with 409A. The legal entitlement to loan forgiveness could be structured as exempt from 409A using the short-term deferral rule, such as if the loan forgiveness will occur on a specified future date conditioned on the employee's continued service through that date. To structure the legal entitlement as compliant with 409A, the loan forgiveness would need to occur only as of a permitted 409A payment event (such as separation from service after attaining a specified retirement age), with the payment rules fixed at the time the legal entitlement is created.

A split-dollar arrangement taxed under the economic benefit regime poses greater potential concerns under 409A, especially for an equity endorsement split-dollar program. A non-equity endorsement split-dollar program (i.e., one in which the employee's only interest is in a portion of the death benefit payable to the employee's beneficiary) should be considered a "death benefit only" arrangement under 409A.<sup>12</sup> As the Notice confirms, a death benefit only split-dollar arrangement should be exempt from 409A.

An equity endorsement split-dollar arrangement (i.e., one in which the employee may obtain access to the policy cash value), however, may represent a legal entitlement that is subject to 409A, as the Notice confirms. The 409A analysis depends on the details of the arrangement. If the employee's access to cash value (which triggers the income inclusion under the economic benefit regime) occurs at a fixed future date and is conditioned on the employee's continued employment through that date, the arrangement should be exempt from 409A under the short-term deferral exception. This is because the income inclusion occurs immediately upon the vesting condition being fulfilled. If, however, the employee will have future access to the cash value without any applicable vesting conditions, then the event giving rise to the access to cash value (and thus the taxable income) needs to be a permitted 409A payment event, and that payment event cannot be subsequently accelerated or further deferred unless permissible under one of the narrow 409A exceptions.

### **Caution When Setting Up or Making Changes: Key 409A Questions to Consider**

Given the potential applicability of 409A to compensatory split-dollar programs, the parties to the split-dollar program should complete a thorough 409A analysis when the program is first established or anytime it is materially amended.

For an employer-owned endorsement split-dollar program, the key 409A questions on set-up will be:

- Is this a non-equity, death benefit only arrangement? If so, there should be no 409A concerns.

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<sup>11</sup>A truly discretionary, unilateral decision by the employer to forego repayment of the loan, not based on any prior formal or informal agreement with the employee, should also not be subject to 409A. In this case, the legal entitlement to the income under 409A does not arise until the employer takes its discretionary action to forego repayment, at which time the income is immediately recognized by the employee. The arrangement does not meet the basic definition of a "nonqualified deferred compensation plan" under 409A because taxation occurs coincident with creation of the legal entitlement to the compensation. Taxpayers should be careful in this case to ensure that the employer's discretion is truly unilateral and not based on any prior understanding with the employee.

<sup>12</sup>See Treas. Reg. §1.409A-5.



- If not, when does the employee obtain current access to the cash value, and are there any vesting conditions to the employee's access to the cash value that count as a "substantial risk of forfeiture" under 409A? If so, is the arrangement exempt from 409A as a short-term deferral?
- If this is an equity arrangement and the employee's access to the cash value will not qualify as a short-term deferral, are the events giving rise to the employee's access to cash value structured as a permissible 409A payment rule (i.e., based on one or more 409A permitted payment events)?

For an employer-owned endorsement split-dollar program, the key 409A questions on set-up will be:

- Is there any agreement (formal or informal) between the employer and employee as to events under which the employer's loan for the premiums will be forgiven?
  - If no, then there should be no 409A concerns unless the arrangement is later modified to provide loan forgiveness.
  - If yes, does the legal entitlement to loan forgiveness depend on the employee satisfying conditions that count as a "substantial risk of forfeiture" under 409A? If so, the arrangement may be exempt from 409A as a short-term deferral.
  - If yes and the arrangement is not a 409A short-term deferral, do the events giving rise to loan forgiveness qualify as a permitted payment rule under 409A (i.e., based on one or more 409A permitted payment events)?

The 409A analysis also should be considered any time a split-dollar arrangement is modified. For example, if a non-equity endorsement split-dollar arrangement is changed to be an equity arrangement (i.e., by providing the employee with potential access to the cash value in the policy before death), or if ownership of the policy is transferred from the employer to the employee, the 409A analysis should be reconsidered. Similarly, if a collateral assignment split-dollar arrangement is modified to add a loan forgiveness feature, the 409A analysis will need to be applied at the time the action is taken to create that feature.

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<sup>13</sup>It should be possible for the employer to transfer ownership of a non-equity endorsement split-dollar arrangement to the employee for a payment by the employee equal to the cash value of the policy without triggering 409A. In that case, the employee would not recognize any income upon the policy transfer under Treas. Reg. §1.61-22(g). If the employer, however, transfers ownership of the policy to the employee for no payment, or for a payment that is less than the cash value, the employee will have income equal to the spread between the policy cash value and the amount paid by the employee. In this case, the policy ownership transfer could be subject to 409A, particularly if the policy ownership transfer occurs based on any formal or informal understanding of the parties reached in a prior year.



## What Happens if there is a 409A Failure?

As noted above, the 409A analysis is economically consequential, especially for the employee. If a split-dollar program is subject to 409A but fails to comply with 409A, the employee will be subject to significant adverse tax consequences, especially:

- Accelerated Income Recognition: The value of the economic benefit not yet included in income, valued as of the end of the year of the 409A failure, must be included in the employee's income for that year.
- 20% Additional Tax: The employee also owes an additional tax in the year of the 409A failure equal to 20% of the accelerated income amount. This is an "additional tax," not a penalty or excise tax, and cannot be avoided by obtaining a tax opinion.
- "Penalty Interest" Additional Tax: 409A includes another "additional tax" that may apply based on the amount of underpayment interest the employee would have owed if the deferred amount had been included in income at the original deferral date, calculated at a "penalty interest" rate.

The employer also bears some tax risk for a 409A failure, but the economic burden for that risk should be less than the employee's economic risk. The employer is supposed to report the failure on the employee's W-2 for the year of failure with a specific code indicating the failure. If the employer does not do so, there may be penalties for failing to properly report. Also, the employer is secondarily on the hook for any income taxes that should have been withheld from the accelerated income amount, as well as the employer portion of any Social Security or Medicare taxes on those amounts. Apart from tax risk, the employer will likely have a very unhappy employee, especially if blame for the 409A failure falls primarily on the employer's decisions.

As a result, employers with split-dollar programs should ensure the program has been reviewed by a 409A tax expert, both when the program is originally designed and anytime the program is modified.

