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TAX TRAPS IN SPLIT-DOLLAR LIFE INSURANCE

— by Neil E. Harl*

Split-dollar life insurance has become a popular insurance arrangement in recent years.¹ Under a split-dollar policy, an employer and an employee agree to share the costs and benefits of a permanent life insurance contract providing both a death benefit and cash value. The employer provides the funds to pay part of the annual premium to the extent of the increase in the cash surrender value each year; the employee pays the balance of the annual premium. The employer is typically entitled to receive, out of the proceeds of the policy, an amount equal to the cash surrender value or at least the amount of the premiums paid. The employee has the right to name the beneficiary of the balance of proceeds payable at death.

As a practical matter, the employee pays a substantial part of the premiums in the early years of the policy but the employee's share of the premium decreases rapidly and often reaches zero after a few years.

An employee is taxable on the value of the cost of the insurance protection benefit provided to the employee under the arrangement.² The benefit is defined by using the tabular P.S. No. 58 term rate or the insurer's one-year term rates available for all standard risks.³ That amount equals the one-year term cost of the declining life insurance protection to which the employee is entitled from year to year, less the portion provided by the employee, if any.⁴ The Internal Revenue Service has determined that a split-dollar insurance arrangement should not be treated as an interest-free loan by the employer to the employee.⁵ Originally, IRS had determined that these arrangements could be treated as interest-free loans.⁶ However, IRS later concluded that position was incorrect.⁷

Worrisome 1995 ruling

In a 1995 technical advice memorandum, IRS determined that an employee has reportable income "...to the extent that the cash surrender values of the policies exceed the premiums paid ..." by the employer.⁸ The position of the Service was that the income was properly reportable under I.R.C. § 83.⁹ The employee must include in income each year the arrangement is in force — (1) an amount equal to the one-year term cost of declining life

insurance and (2) any cash surrender buildup in the policies exceeding the amount returnable to the employer when the arrangement is discontinued.¹⁰ Under the facts of the 1995 ruling, the policies were owned by a trust and the employee was considered to have made a gift to the trust each year equal to the amount included in the employee's income each year under the split-dollar arrangement.¹¹

Critique of the 1995 ruling

The storm of protest over the issuance of the 1995 ruling has focused principally upon the fact that earlier revenue rulings had not provided a basis for taxing, and did not contemplate taxing, employees on the cash surrender values in split-dollar contracts in excess of the employer's premium payments.¹² Also, objection has been voiced on the grounds that I.R.C. § 83 only applies where substantial vesting has occurred. However, the ruling recites that "the cost of life insurance protection under a life insurance contract is taxable generally under section 61 of the Code during the period the contract remains substantially unvested."¹³

Under the statute, I.R.C. § 83, if property is transferred in connection with the performance of services to any person other than the person for whom the services were performed, the excess of the fair market value of the property over the amount paid for the property is included in the service provider's gross income in the first taxable year in which the rights of the service provider in the property are transferable or are not subject to a substantial risk of forfeiture.¹⁴ The ruling points out that, under the regulations, the term "property" for purposes of I.R.C. § 83 includes a beneficial interest in assets (including money) which is transferred or set aside from the claims of creditors of the transferor such as in a trust or escrow account.¹⁵

In the 1995 ruling, while the employer had a collateral security interest in the policies to assure repayment of the employer's premium payments, there had arguably not been a transfer of beneficial ownership in the property from the employer to the employee within the meaning of I.R.C. § 83.

Planning suggestions

Although there remains the possibility that the Internal Revenue Service may reconsider the position taken in the 1995 ruling,¹⁶ it seems prudent to review split-dollar arrangements that have progressed to the point of producing

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tax consequences under the 1995 ruling. Specifically, it may be wise to consider slowing the increase in cash value so that it accrues over a longer term. That postpones equity attainment. Also, it may be possible to avoid a taxable transfer under I.R.C. § 83 by providing for a substantial risk of forfeiture on the part of the employee. A taxable transfer does not occur if the interest has not vested.¹⁷ Vesting could be tied to attainment of performance objectives by the employee (or reaching a specified number of years' service).

In conclusion...

The last word has clearly not been written on the tax treatment of split-dollar life insurance contracts. Further guidance from the Internal Revenue Service is to be expected. Moreover, the Service position is likely to be challenged in court.

FOOTNOTES

¹ For a discussion of the taxation of life insurance generally, see 5 Harl, *Agricultural Law* § 43.02[2] (1996); Harl, *Agricultural Law Manual* § 5.01[4] (1996).

² Rev. Rul. 64-328, 1964-2 C.B. 11.

³ *Id.* See Rev. Rul. 55-747, 1955-2 C.B. 228.

⁴ *Id.*

⁵ *Id.*

⁶ Rev. Rul. 55-713, 1955-2 C.B. 23.

⁷ Rev. Rul. 64-328, 1964-2 C.B. 11.

⁸ Ltr. Rul. 9604001, Sept. 8, 1995.

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² See, e.g., Rev. Rul. 64-328, 1964-2 C.B. 11. See also Rev. Rul. 55-747, 1955-2 C.B. 228.

¹³ Ltr. Rul. 9604001, Sept. 8, 1995.

¹⁴ I.R.C. § 83(a).

¹⁵ Treas. Reg. § 1.83-3(e).

¹⁶ Ltr. Rul. 9604001, Sept. 8, 1995.

¹⁷ I.R.C. § 83(a).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ANIMALS

HORSES. The plaintiff was a contestant in a horse show and had ridden her horse up to the arena entrance but was prevented from entering by a mass of people. The defendant was also an entrant and had stopped nearby for the same reason. A horse exiting the arena was forced to walk close to the defendant's horse and bumped the defendant's horse, causing it to rear and kick the plaintiff. The plaintiff sued for damages under negligence and strict liability theories. The defendant argued that La. Rev. Stat. § 9:2795.1 provided immunity from the suit. The statute provided immunity from liability for an "equine activity sponsor, an equine professional, or any other person." The court held that the defendant was within the class of persons provided with immunity from liability. The plaintiff argued that the exception in the statute for willful or wanton disregard for the safety of others applied because the defendant should have known that the defendant's horse would kick if bumped. The defendant testified that the horse had not kicked anyone before but that it was common knowledge that horses could become frightened if their "comfort zone" was invaded. The court held that the incident was within the range of dangers associated with equine activities and held that the defendant did not commit willful or wanton disregard for the plaintiff's safety. **Gautreau v. Washington, 672 So.2d 262 (La. Ct. App. 1996).**

BANKRUPTCY

GENERAL-ALM § 13.03.*

EXEMPTIONS

HOMESTEAD. The debtors owned 78 acres of rural land. The debtors' home was situated on 2 acres, 76 acres

were contiguous woodlands, and 3.5 acres of the woodland were used as a residence by the debtors' adult daughter and her children. The home site and woodlands were assessed together for property taxes but the 3.5 acres were assessed separately. The 3.5 acres were not included as security for a loan used to buy the entire 78 acres. The court held that the debtors were entitled to a rural homestead exemption for their home site and the woodlands but not for the 3.5 acres used as a residence by the daughter. The court noted that the woodlands qualified as rural property even though the debtors did not use the land for agricultural purposes, because the land was clearly rural in nature and the state exemption statute did not require that a rural homestead property be actively used for farming or other agricultural purposes. **In re McCall, 195 B.R. 911 (Bankr. E.D. Ark. 1995).**

PRIORITY. During the debtor's Chapter 12 case, the county assessed property taxes against the debtor's property. The debtor converted the case to Chapter 7. The county sought seventh priority status for the tax claim under Section 507(a)(7). The court held that when the taxes were assessed a lien was automatically created by Ark. Code § 26-34-101 and the taxes became a secured claim. The court held that Section 507(a)(7) allowed a priority only for unsecured governmental claims; therefore, the county's claim would have to be paid from its security and could not receive priority. **In re Wrigley, 195 B.R. 914 (Bankr. E.D. Ark. 1996).**

CHAPTER 12-ALM § 13.03[8].*

VALUATION. The issue in this case was the valuation of the debtors' farm real and personal property to determine the amount of the FmHA (now FSA) secured claim in the property. The court discredited both the FmHA in-house appraisal and the debtor's personal appraisal of the property