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Federal Tax ADVISORY ■

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# Splitting the Difference: IRS Applies Exempt Organization Excise Tax to Split-Dollar Life Insurance Policies

The Tax Cuts and Jobs Act added a new excise tax under Section 4960 imposed on excess compensation paid by certain exempt organizations. On June 11, 2020, Treasury published proposed regulations addressing various aspects of this new excise tax. As anticipated, the proposed regulations clarify that when interest income is imputed to employees from an exempt organization's below-market loan used to pay for split-dollar life insurance premiums, such imputed income is treated as remuneration included in the organization's Section 4960 excise tax liability calculation.

The excise tax under Section 4960 generally applies to remuneration exceeding $1 million and excess parachute payments by certain tax-exempt organizations (including any organization exempt from tax under Section 501(a)) or a related organization to any "covered employee." A covered employee is any employee (or former employee) who was among the organization's five highest compensated employees in any year starting after December 31, 2016.

For purposes of the Section 4960 excise tax, remuneration generally includes all cash and non-cash compensation, including benefits. The definition is broad but excludes payments to a tax-qualified pension or profit-sharing plan and payments for certain medical services.

Split-dollar life insurance arrangements have long been offered as a fringe benefit to executives in all sectors but have become an increasingly popular offering for highly compensated employees of tax-exempt organizations since the introduction of the Section 4960 excise tax. Notably, such arrangements were recently included in the compensation packages of top coaches at universities with leading athletic programs such as LSU, Michigan, Clemson, and South Carolina.

Under the type of split-dollar life insurance arrangement typically used in this setting, an employer makes premium payments on a high-death-benefit, universal life insurance policy owned by the employee. The premium payments are treated as a loan to the employee, and the employee agrees to a collateral assignment of the policy's death benefit to the employer in an amount sufficient to repay the loan and any accrued interest. The employee's family will receive the remaining benefit upon the employee's death, and in some cases, the employee may be able to borrow against the accumulated cash value of the policy upon retirement.

The split-dollar life insurance arrangement structured as a policy loan has always been beneficial to both the employer and employee. The employer can offer a significant benefit to its employee and later recover much of its cost, and the employee does not pay tax on the value of the benefit because the premium payments are respected as loans. This loan characterization became even more beneficial for tax-exempt organization employers after the introduction of Section 4960 because loans are not considered remuneration and are excluded from the organization's Section 4960 excise tax liability calculation.

Even though premium payments treated as loans are not taxable as compensation, "below-market" split-dollar life insurance arrangements can result in imputed taxable income to the employee. If the policy loan is interest-free or at a rate below the applicable federal rate (AFR) when the premium payment is made, the difference in accrued interest between the AFR and the policy loan's actual rate will be considered imputed taxable income to the employee each year the policy loan is outstanding. In line with the general treatment of this imputed interest income as taxable compensation to an employee under Section 7872 (although exempt from federal income tax withholding under Section 7872(f)(9)), the proposed regulations provide that such imputed interest income will be considered remuneration when calculating the organization's Section 4960 excise tax liability.

Imputed income can be avoided by using the AFR (currently at historic lows) at the time of payment as the loan's interest rate. This will eliminate both the excise tax liability for the organization and the income tax liability for the employee. Of course, this reduction in tax cost will reduce the benefit to the employee because accrued interest at this higher rate will need to be repaid. Any reduction in tax cost should be weighed against the reduced benefit to the employee when determining how to structure split-dollar life insurance arrangements.

For more information, please contact George Abney at 404.881.7980, Mark Williamson at 404.881.7993, Danny Reach at 704.444.1272, or April McLeod at 212.210.9487.

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