



Income and Gift Tax Planning Experts' Critical Analysis of Split-Dollar Proposed Regulations

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In this timely interview, Messrs. Brody and Weinberg discuss the proposed split-dollar life insurance regulations issued on July 3, 2002, as well as the interim guidance provided in IRS Notice 2002-8, issued on January 3, 2002. The interviewer is our executive editor, Myron Kove, Esq.

Q. In January 2002, the IRS issued Notice 2002-8 which revoked the previous guidance issued in Notice 2001-10, and it has now issued proposed split-dollar regulations. With all this guidance, how should practitioners prepare themselves for the future?

Weinberg: Practitioners must now be concerned about several things. The Notice and the proposed regulations (if adopted in their current form) totally change the taxation of split-dollar plans. One set of rules, based on the Notice, governs the taxation of split-dollar until the proposed regulations become final. At that time a different set of rules will govern. The practitioner must be able to guide clients through the interim period and prepare them for the new split-dollar regime that will be in effect when final regulations are adopted. Practitioners must resign themselves to the fact, however, that the net effect of the new regulations, once finalized, will probably mean the end of equity split-dollar, as we have known it. However, I wish to emphasize that this is not the end of split-dollar planning. Such planning will continue in new directions, notably the use of split-dollar loans, and these new plans will be

structured to comply with the final regulations. (The final regs. may take effect as early as the end of this year.)

Q. Before we review the interim guidance and the proposed regulations, why is the IRS concerned about equity split-dollar?

Brody: In a typical equity split-dollar arrangement, the employer advances the premiums for a life insurance policy owned by the employee or an irrevocable life insurance trust (ILIT) created by the employee. The employee's (or ILIT's) obligation is to reimburse the employer for the employer's cumulative premium advances, or in some plans, the lesser of the employer's cumulative premium advances or the policy cash value. To secure the employer's advances, the policy is collaterally assigned to the employer. On termination of the arrangement, any cash value in excess of employer premium advances, the policy "equity," is the property of the employee (or ILIT).

In TAM 9604001, the IRS first advanced the position that this equity was taxable to the employee under Section 83, and this position was confirmed in subsequent IRS Notices 2001-10 and 2002-8. As discussed below (and except as otherwise provided by the 2002 Notice grandfather provisions), under the rules in existence now, the policy equity will be treated by the IRS as taxable compensation to the employee when "transferred" to the employee on termination during the employee's lifetime, unless the employer premium payments are treated as a series of loans by the employer to the employee.

Q. Does Notice 2002-8 provide any grandfather rules for equity split-dollar plans?

Weinberg: Yes, limited grandfather protection is provided by the Notice. If a split-dollar plan was entered into before January 28, 2002, and the plan is terminated before January 1, 2004, by repayment of the employer's premium advances (i.e., a "rollout"), the employee will not be taxed on any then existing policy equity. Although this appears to be a big break, the option to terminate the plan before January 1, 2004, will be most meaningful for mature equity split-dollar plans but it probably will not be beneficial for immature plans.

Q. What is the difference between mature and immature existing plans (pre-Jan. 28, 2002 plans)?

Brody: A "mature" existing plan is a plan that before January 1, 2004, will have arrived at its time for a rollout (termination during the employee's lifetime). Such a plan will have substantial policy equity after repaying the employer, and the termination safe harbor in the Notice will avoid taxation of that equity at the time of plan termination. An "immature" plan is a plan where future premium payments will be required after January 1, 2004. If the immature plan is terminated by January 1, 2004, the employee would be faced with the prospect of paying the full amount of future premiums with after-tax dollars, and those same amounts would also be subject to gift taxation if the policy were owned by an ILIT.

Q. What if an "immature" existing plan continues after January 1, 2004?

Weinberg: Alternatively, for existing split-dollar plans (pre-Jan. 28, 2002 plans), the plan may continue in split-dollar mode until January 1, 2004. Then, before January 1, 2004, the plan may be switched to a loan from the employer to the employee. Conversion to a loan before January 1, 2004 will avoid taxation to the employee of policy equity existing at the time of the switch. This loan safe harbor requires that all pre-2004 employer premium payments be picked up as the beginning loan balance (although interest does not retroactively accrue on these prior employer payments), and that subsequent employer premium payments be treated as additional loans. This is the safe harbor that will likely be used by most immature existing split-dollar plans.

Q. What is a split-dollar arrangement under the proposed regulations?

Brody: Effective for arrangements entered into, or materially modified, after the regulations become final, the proposed regs. broadly define a split-dollar arrangement as any arrangement between an owner of a life insurance policy and a non-owner under which either party pays part or all of the premiums, and the party paying the premiums is entitled to recover all or part of the premiums from the proceeds of the life insurance contract or such recovery is secured by the contract. As defined, the regulations will apply to split-dollar arrangements between an employer and employee, a corporation and a shareholder, and to private split-dollar plans between a donor and donee. A special rule also applies to arrangements entered into for the performance of

services and arrangements between a corporation and its shareholders. Under this special rule, the arrangement will be treated as split-dollar regardless of whether the premium payer is entitled to recover from, or is secured by, the policy.

The only arrangements excluded from the definition of split-dollar are group term life insurance plans under Code Sec. 79 and the purchase of life insurance between the policy owner and the life insurance company issuing the policy. Any plan under which there is no expectation of reimbursing the party advancing the premiums is not a split-dollar plan; in such situations, the premium payments will be treated as taxable income, a dividend, or a gift, depending on the relationship between the parties.

Q. What types of split-dollar plans are provided for under the proposed regulations?

Weinberg: The proposed regulations create two mutually exclusive regimes for the taxation of split-dollar plans. These are the economic benefit regime and the loan regime. Under the economic benefit regime, the owner of the policy is treated as providing economic benefits to the non-owner. All endorsement arrangements, where the non-owner has the right to designate the beneficiary, will be governed by the economic benefit regime. The economic benefit regime will also apply if the arrangement is entered into in connection with the performance of services and the employee or service provider is not the owner of the policy. A similar rule applies in the case of private split-dollar where the donee (e.g., an ILIT) is not the policy owner.

Under the loan regime, the non-owner of the life insurance is treated as loaning the premiums to the policy owner. All collateral assignment arrangements will be governed by the loan regime, except that a collateral assignment plan in which the employee or donee has no equity in the policy (i.e., a “non-equity” plan) will be treated as an endorsement plan and taxed under the economic benefit regime, regardless of who owns the policy. Presumably, this exception will allow for a non-equity corporate controlling stockholder or insured private split-dollar arrangement that will avoid incidents of ownership in the insured for estate tax purposes.

Q. What are the income tax consequences of the economic benefit or endorsement regime under the proposed regulations?

Brody: The traditional economic benefit taxation of a split-dollar arrangement will be mandated for any arrangement subject to the regulations in which the employer is formally designated as the owner of the life insurance contract, the typical endorsement arrangement. The employee will be deemed to receive income in an amount equal to the current life insurance protection and any other benefit provided under the arrangement while the arrangement is in force. Surprisingly, “any other benefit” apparently includes the annual increase in employee equity in an endorsement policy as it accrues, and the IRS asks for comments on how to value this equity. If the non-owner is an employee, the annual economic benefit, or “AEB,” is taxed as compensation; if a shareholder, it is taxed as a dividend; and if a donee (or an ILIT), this amount is treated as a gift.

Q. What are the tax consequences of any amounts paid by the non-owner under an endorsement split-dollar plan subject to the regulations?

Weinberg: Since the non-owner does not have an ownership interest in the life insurance policy, any non-owner premium contributions and any amount taxable to the non-owner as AEB are not included in the non-owner’s basis or investment in the contract. An additional surprise is that any amount paid by the non-owner to the owner for any economic benefit (i.e., a contributory split-dollar plan) is included in the owner’s gross income. Furthermore, the owner is not entitled to deduct any AEB included in the non-owner’s income.

Q. What if the policy is transferred to the non-owner?

Brody: If under the endorsement regime, the policy is transferred to the non-owner/employee, then the employee will be taxed on the cash surrender value of the policy less any consideration paid by the employee for the policy and, presumably, less any amounts previously taxed to the employee on a current basis. Such amounts do not include annual term costs previously taxed to or contributed by the employee. Moreover, as I previously indicated, the employee is taxed on the equity build-up in the policy prior to the transfer, but the proposed regulations reserve the issue of how to do that.

Q. Are there any income tax consequences to the

employer or the employee in an endorsement split-dollar plan when the death benefit is received?

Brody: With regard to the employer, the amount, if any, received by the employer in excess of its aggregate premium advances is taxable to the employer, although that provision of the proposed regs. is inconsistent with the Section 101(a) death benefit exclusion.

With regard to the employee, another surprise is that the proposed regs. appear to subject to income tax the portion of the policy death benefit equal to the employee equity under an equity endorsement plan. These apparent erosions of the Section 101(a) death benefit exclusion will no doubt be negatively commented upon to the IRS.

Q. Turning now to the loan regime, what are the income tax consequences of a split-dollar loan?

Weinberg: Once the regs. become final, the loan regime will replace collateral assignment split-dollar. If the employee is formally designated as the owner of a life insurance contract subject to a split-dollar arrangement, then treatment of the employer's premium payments as involving a series of loans is mandated, so long as the employee is obligated to repay the employer from the policy's death benefit or cash surrender value. (The only exception, as previously noted, is for a non-equity arrangement, which is treated under the proposed regs. as an economic benefit (endorsement) plan regardless of who owns the policy.) These loans are classified as either demand loans or term loans, and they are subject to the below-market loan rules of Section 7872 and the original issue discount rules of Sections 1271-1275.

Brody: Under Section 7872, when an employer enters into a below-market or interest-free loan with its employee, an amount equal to the foregone interest is treated as having been paid by the employer to the employee as compensation and then repaid by the employee to the employer as interest. Each employer premium payment is treated as a separate loan to the employee. If the loan is a demand loan (as presumably would be the case with a loan terminable solely upon termination of employment), then the deemed transfers of the foregone interest occur annually. With a term loan (including a loan payable at an actuarially determinable future date, such as the insured's death), the foregone interest is

treated as having been transferred by the employer to the employee as income in the year when the loan is created. (A term loan's foregone interest amount is calculated as the difference between the amount loaned and the present value of all payments actually due under the loan.) This retransferred amount is then taxed to the employer as interest income under the original issue discount rules (essentially spreading the interest over the term of the loan).

Q. What if adequate interest is charged?

Weinberg: If adequate interest (based on the Applicable Federal Rate or AFR) is charged on a loan, then, in general, Section 7872 does not apply. Accordingly, especially when interest rates are low, it has been suggested that the best course of action may be to arrange the transaction as a term loan that states adequate interest. Because adequate interest is stated, it can be paid annually, or even accrued until the end of the term, instead of treated as having been transferred upon creation of the loan.

Q. What are the gift tax consequences of split-dollar arrangements under the proposed regulations?

Brody: The proposed regulations will apply for gift tax purposes to private split-dollar arrangements. In a typical private split-dollar arrangement, the donor would make premium payments on a life insurance policy owned by an ILIT. If it is reasonably expected that the donor is to be repaid the premiums, and it is an equity arrangement, then the arrangement is deemed to be a loan from the donor to the ILIT and is treated as a split-dollar loan subject to the rules under the proposed regs. If the loan is repayable upon the death of the donor, normally, the term of the loan would be the donor's life expectancy, and the value of each gift (assuming no stated interest) would be the premium payment less the present value of the donor's right to receive repayment at life expectancy. If the premium payments are not split-dollar loans, then the payments are governed by general gift tax principles.

Similar rules apply to the gift "leg" of the transaction in employer-employee equity split-dollar if the policy is owned by the employee's ILIT. This will be taxed the same as private equity split-dollar, treating the insured employee as the "donor."

In a non-equity donor/donee arrangement, the

economic benefit regime will apply, regardless of who owns the policy.

Q. How is the cost of current life insurance protection, that is, the Annual Term Cost (“ATC”), determined?

Brody: Prior to Notice 2002-8 (and its predecessor, Notice 2001-10), the ATC was measured based on the P.S. 58 table. Alternatively, if lower, the ATC could be measured by using the insurance company’s published, standard risk, one-year term rate, and this rate was always much lower than the P.S. 58 rate. Notice 2001-10 introduced Table 2001 to measure ATC. Although the rates under the 2001 table are much lower than the P.S. 58 table, they are still substantially higher than existing carrier alternative term rates. For example, the Table 2001 rate for a 55-year old is \$4.15 per \$1,000 of insurance coverage, which is lower than the P.S. 58 rate of \$13.74 per \$1,000, but higher than a typical insurance carrier’s individual alternative term rate of about \$1.10 per \$1,000 of coverage.

Weinberg: The proposed regulations provide that the cost of current life insurance protection (ATC) is to be measured by the “life insurance premium factor.” The preamble to the regulations contains the following example for computing ATC. The example is a split-dollar endorsement plan in which the employer (R) owns a \$1 million dollar policy on its employee (E) with a \$10,000 annual premium paid by R. The plan provides that R is entitled to recover the greater of its premium payments or the cash surrender value (in other words, a non-equity plan). In year 10, R has paid a total of \$100,000 in premiums, the cash surrender value is \$200,000, and the cost of term insurance for E is \$1.00 per \$1,000 of coverage. The ATC taxable as compensation to E is \$800 ($\$1,000,000 - \$200,000 = \$800,000 \times .001$ (E’s premium rate factor)). If E paid \$300 of the premium, then the ATC to E is reduced to \$500. Note that beyond these brief comments, the proposed regs. say nothing more about ATC.

Q. How is the ATC determined under Notice 2002-8?

Brody: For split-dollar arrangements entered into before Jan. 28, 2002, where required by the terms of an agreement between employer and employee, actual P.S. 58 rates can continue to be used in these plans to determine the value of current life insurance protection provided to the employee. The use of

actual P.S. 58 rates to measure ATC is relevant principally in reverse split-dollar plans. However, in reverse split-dollar, the insurance protection is provided to the employer, not to the employee, and a footnote in the preamble to the proposed regulations confirms that P.S. 58 rates may not be used in reverse split-dollar or other non-compensatory plans.

Furthermore, recent IRS Notice 2002-59 says that neither the Table 2001 rates nor the carrier’s alternative term rates can be used to measure the benefit in reverse split-dollar. The Notice doesn’t say what rates can be used to measure this benefit.

Weinberg: For split-dollar arrangements entered into before the effective date of future guidance, the IRS Table 2001 rates can be used to determine the cost of current life insurance protection. Furthermore, existing carrier alternative term rates, if lower, can continue to be used for pre-January 28, 2002 plans and these rates can also be used for plans entered into after January 28, 2002, but before future guidance, at least through 2003. In this connection, it’s not clear whether “future guidance” means final regulations, and it is possible we will have another IRS notice (perhaps before the final regs.) that will amplify how ATC is to be calculated.

It should be further noted that Table 2001 only provides individual, not survivorship, term rates, and the Notice leaves it up to taxpayers to figure out survivorship rates based on the Table 2001 individual rates. One carrier I am familiar with has calculated Table 2001-based survivorship rates by applying the “Greenberg-to-Greenberg” formula used to determine US 38 survivorship rates, which in turn are based on P.S. 58 individual rates. Of particular interest is that carrier’s observation that survivorship term rates based on Table 2001 are actually lower than the carrier’s existing alternative survivorship term rates up to ages husband 70/wife 70. Thereafter, the rates cross over so that the carrier’s alternative survivorship rates are lower than the Table 2001-based survivorship rates. Furthermore, the Table 2001-based survivorship rates will always be lower than the US 38 rates because the latter are based on the higher P.S. 58 rate table. The bottom line for survivorship split-dollar term rates is that, in many cases, we may be able to use more favorable survivorship rates that are actually lower than the survivorship rates now being used in those plans.

Brody: As Mike just indicated, for split-dollar

arrangements entered into before January 28, 2002, existing carrier alternative term rates that comply with present IRS requirements can continue to be used to measure AEB, if lower than the Table 2001 rates. The use of existing carrier alternative term rates will clearly be advantageous in single life cases and, as Mike suggested, may or may not be advantageous in survivorship cases. The combination of the ability to continue to use existing carrier alternative term rates for pre-January 28, 2002 existing plans, together with the safe harbor grandfather protections provided for such plans (discussed earlier), results in maximum future flexibility and preserves the most favorable options for these existing split-dollar plans.

Weinberg: For split-dollar arrangements entered into after Jan. 28, 2002 and before the effective date of future guidance, existing carrier alternative term rates can also continue to be used to measure ATC, but only through 2003. After 2003, carrier alternative term rates can still be used to measure ATC in such plans, but they must meet tough new standards applicable to commonly sold term policies in order for the alternative rates to be used instead of the Table 2001 rates. And, for split-dollar plans entered into after “future guidance” is issued, it is questionable whether carrier alternative term rates will be permitted at all – see the earlier discussion of the “life insurance premium factor.”

Q. Suppose a pre-final regs. equity collateral assignment split-dollar plan is continued after Jan. 1, 2004. What are the consequences insofar as taxation of the equity is concerned?

Brody: For split-dollar plans entered into before the date of publication of final regulations (including both new plans entered into after January 28, 2002 and pre-January 28, 2002 existing plans that do not elect the January 1, 2004 safe harbors), there are two other safe harbors provided by the Notice. Under the first safe harbor, the plan can continue in split-dollar mode so long as the employee continues to report the ATC, and the employee will not be taxed on any policy equity accruing during this time period. The problem for the employee is the increasing ATC costs as the employee ages. A rollout during the employee’s lifetime in order to end this continuing and increasing term cost will likely result in the taxation to the employee of the entire policy equity at the time of rollout for income tax purposes (less any employee basis in the policy) and also for gift-tax purposes if the policy is owned by an ILIT (without

reduction for basis). Consequently, continuing a split-dollar plan under this safe harbor results in a plan without an exit strategy as a practical matter. (Concerning employee basis, remember that the proposed regs. deny an employee any basis for ATC contributions in the case of economic benefit regime (endorsement) plans entered into after the regs. become final. Query whether this same rule applies to pre-final reg. plans, particularly pre-final reg. collateral assignment plans.)

Q. What is the other design for a split-dollar plan?

Weinberg: Alternatively, for split-dollar plans entered into before the date of final regulations, there is a second safe harbor. Such plans can elect to be taxed under an employer loan regime. If employer loan treatment is elected from the outset, the result seems similar to the taxation of collateral assignment plans under the proposed regulations where all employer premium payments will be treated as loans. However, it appears that for pre-final reg. plans, the plan can continue in split-dollar mode under the first safe harbor above, and it can then switch to a loan under this second safe harbor as long as all previous employer premium payments are treated as the beginning loan balance at the beginning of the taxable year in which the switch occurs. We call this favorable plan “switch-dollar.”

Brody: The purpose of continuing in split-dollar mode would be to preserve the (presumably) lower ATC cost for a period of time instead of the higher interest cost if employer loan treatment were elected at the outset of the plan. The result of a switch-dollar plan would probably be that any employee equity existing at the time of the switch to a loan (less employee basis) would be taxable. If the switch occurs just before equity appears, there would be no equity to tax. Therefore, since most split-dollar plans do not generate equity for 6-8 years after policy inception, favorable split-dollar (i.e., ATC) taxation can be preserved during this period, up to the time of the switch. Moreover, policy equity accruing after the switch to a loan would not be taxed, unless and until withdrawn from the policy in excess of basis (other than by policy loan). This switch-before-equity technique seems applicable to a new plan adopted after January 28, 2002 and before the date of final regs. It also seems to apply to an existing plan (pre-Jan. 28 plan) that will have no equity on January 1, 2004 and, therefore, does not need to elect the January 1, 2004 safe harbors.

Q. What effect does the “no inference” language in the Notice have on pre-final regulation plans?

Brody: The Notice states “no inference should be drawn from this notice regarding the appropriate Federal income, employment and gift tax treatment of split-dollar life insurance arrangements entered into before the date of publication of final regulations.” For equity split-dollar plans, commentators are taking this to mean that the parties could choose not to use any of the safe harbors and take their chances on taxation of policy equity under existing law. Since policy equity taxation has been a very controversial area, many advisers will likely not opt for this alternative.

Q. There seem to be a bewildering number of choices under Notice 2002-8 applicable to pre-January 28, 2002 existing plans, new plans entered into after January 28 and before the date of publication of final regulations, and new plans entered into after the publication of final regs. In a given situation, how can a professional adviser decide which is the optimum plan for his or her client?

Weinberg: Number crunching is part of the answer. Illustrations will have to be prepared for each alternative course of action, using computer models such as those we and other advisers have developed. I expect that some of the answers will be counter-intuitive, and you won't know which to choose until you've modeled the alternatives.

Q. What planning are you undertaking at the present time with respect to both new and existing split-dollar plans?

Weinberg: With respect to new plans, we intend to continue implementing collateral assignment split-dollar plans. The reason is that automatic employer loan treatment for collateral assignment plans does not apply to plans adopted before the date of publication of final regulations. The use of collateral assignment split-dollar at the outset, instead of an employer loan, means that the measure of employee taxation will be the ATC rather than the (presumably) higher loan interest, while the split-dollar arrangement is in effect.

As Larry previously suggested, the plan can be kept in split-dollar mode until just before policy equity appears. It can then be switched to a loan to avoid

taxation of policy equity to the employee since there will be no equity at the time of the switch. Policy equity accruing after the loan switch will not be taxed, unless and until it is withdrawn from the policy in excess of policy-owner basis (and other than by policy loan). Therefore, there appears to be a window of opportunity for new collateral assignment split-dollar plans entered into before the date final regs. are published. This window closes on that date, which could be as early as the end of this year.

Brody: With respect to existing plans, advisers should be careful not to disturb the grandfather protections provided by the Notice for split-dollar plans entered into before January 28, 2002. We are telling clients and advisers to just sit tight for now and not make any “material modifications” to these plans that would risk the loss of grandfathering. We have until January 1, 2004 to decide how to proceed with existing plans in the light of subsequent developments. While I wouldn't advise waiting until the end to analyze alternative courses of action, this grace period should provide adequate time for thoughtful decisions, and we are advising against hasty action.

Q. Do the proposed regulations affect the tax-free exchange of life insurance policies?

Weinberg: An important question for existing split-dollar plans is whether, after January 28, 2002, policies can be exchanged tax-free for new policies under Code Section 1035, without causing a material modification of the plan. Commentators have observed that since the Notice addresses the availability of the January 1, 2004 safe harbors in terms of split-dollar arrangements entered into before Jan. 28, 2002, rather than policies issued before that date, policy exchanges after January 28 should not constitute a material modification of an existing arrangement. The proposed regs. specifically request comments on this issue, so we probably won't know the answer until final regs. are issued. Incidentally, comments on the proposed regs. are due by October 7, 2002, and a public hearing will follow on October 23rd.

Q. How does passage of the Sarbanes-Oxley Corporate Responsibility Act of 2002 affect split-dollar planning for public companies?

Brody: The Sarbanes-Oxley Act prohibits a public company, either directly or indirectly, from making

personal loans to any director or executive officer. It appears that collateral assignment and perhaps endorsement split-dollar plans could fall under this Act. The SEC has refused clarification of the issue at this time. Therefore, until further guidance is provided, where premiums are payable by the company after the Act's effective date of July 30, 2002, I think directors and executive officers of a public company should be very cautious about continuing to participate in the company's split-dollar plan, unless the plan can be considered as a binding commitment entered into prior to the Act's effective date and grandfathered under the Act. Endorsement arrangements may not be subject to this prohibition, especially if they are non-equity arrangements that provide only a death benefit.

The problem for public corporation split-dollar plans is immediate because the Sarbanes-Oxley Act does not grandfather future executive loans (i.e., loans made after July 30, 2002), unless, again, the plan is considered a binding commitment entered into before the Act's effective date and is grandfathered. Severe consequences can result from violation of the Act, including the imposition of criminal penalties. This

means that paying the very next premium under a public corporation executive split-dollar plan could subject the responsible parties to criminal penalties!

Weinberg: Let's emphasize that Sarbanes-Oxley applies only to public companies. I believe that the vast majority of split-dollar plans are in closely held private companies, not in public companies. This does not diminish the problem for public companies, however, and we have developed a "rescue" program for public company executive split-dollar plans that will permit these plans to continue for the benefit of the executives who are affected by the Act.

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