

RA Bench

IRS EXECUTIVE COMPENSATION AUDIT INITIATIVE

Split Dollar May Not Make Final Target List

October 14, 2004

Internal Revenue Service personnel have indicated informally that the Service may not include split dollar life insurance arrangements on its final "target list" of issues to be examined during future executive compensation audits.

Last year the Revenue Service announced that it was commencing an executive compensation audit initiative to gauge the level of compliance in the following eight targeted areas: (1) split dollar life insurance arrangements; (2) loans to executives; (3) nonqualified deferred compensation; (4) golden parachutes; (5) equity compensation arrangements; (6) fringe benefits; (7) asset protection schemes such as sales of compensatory options to family limited partnerships and off-shore (so called "Irish") leasing arrangements; and (8) compliance with the one million dollar deduction limit under Code section 162(m). The Service then selected 24 companies for examination.

We understand that all 24 audits have begun and about half have been completed. The IRS has found significant noncompliance respecting the (i) deduction timing rules for nonqualified deferred compensation arrangements, (ii) \$1 million cap on deductible compensation, (iii) incentive stock option rules and (iv) fringe benefit rules (executive perquisites). One of the eight initially targeted areas was split dollar life insurance arrangements. With one exception, we understand that the IRS has found general compliance with the split dollar rules and that exception involved a company's use of insurance tables for valuing the life insurance protection. Given the lack of information that is available at this time, we can only speculate as to the specific problem that has been identified. For example, Section III of IRS Notice 2002-8 allows certain split dollar arrangements (i.e., generally those established before September 17, 2003) to use the Table 2001 rates prescribed in the notice or an insurer's alternative term rates. The notice provides that taxpayers can make appropriate adjustments to the prescribed rates to reflect insurance protection that covers more than one life (e.g., second-to-die insurance). As a result, one possible problem area may relate to companies that are making inappropriate adjustments to reflect the multiple lives.

Nevertheless, we understand that, because the Service has been finding general compliance with the split dollar rules, it is not planning to focus on split dollar arrangements for another couple of years, and therefore, split dollar will likely not be included on the final "target list" when the executive compensation audit initiative is completed and the full audit program is commenced. That commencement is expected to occur by the end of this year. With this change in focus, we understand that field agents will generally not scrutinize a taxpayer's split dollar arrangements unless there are obvious indications of non-compliance.