The Fox in the SOX

The Application of Sarbanes-Oxley to Split-Dollar Life Insurance Arrangements*

Introduction

At the peak of its anti-business peak last summer, Congress passed the Sarbanes-Oxley Act of 2002.[1] Section 402 of SOX prohibits "personal loans" to certain executives but due, in part, at least, to the speed with which the legislation was enacted, Congress failed to provide meaningful guidance as to the reach of these prohibitions to many common forms of executive compensation including, in particular, split-dollar life insurance arrangements.[2] This lack of Congressional directive, coupled with the problematic wording of the statute itself, has created an enormous analytical and practical problem for many corporations and executives. Further, the absence of any meaningful transition rules has left many corporations trapped between criminal and contractual violations.

Three alternatives appear possible. SOX may apply to all forms of split-dollar life insurance arrangements, essentially criminalizing any further action on existing split-dollar arrangements. Alternatively, it may only apply to certain forms of split-dollar life insurance, in which case some companies may have fortuitously arranged this form of executive compensation in an acceptable manner. Finally, it is quite possible that the statute does not apply to split-dollar arrangements at all, regardless of what some senators and congressmen may now believe to be the case. In the current state of affairs, definitive answers to any of these possibilities is impossible but the factors influencing each possible interpretation should be considered.

Background

Split-Dollar Insurance

In its broadest sense, split-dollar life insurance (hereinafter referred to as "split-dollar") is an arrangement based upon a form of whole life insurance policy (e.g., whole life, universal life or variable life, in which the policy rights are divided between two or more parties. Usually one party primarily finances the purchase of the policy, i.e., pays the premiums, with the policy rights arranged to secure that financing, and the other party primarily benefits from the policy, at least to the extent of the death benefit coverage.

In the context of this paper, the split-dollar arrangements that will be considered are those between a corporation and an executive of that company. In this type of arrangement, the proposed split dollar regulations contain a definition of compensatory split-dollar arrangements that is helpful. Under this definition, three requirements must be satisfied:

1. the arrangement must be entered into in connection with the performance of services but is not part of a group-term life insurance plan described in section 79 of the Code;[3]

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3. the employer or service-recipient pays directly or indirectly all or any portion of the premium; and

5. the beneficiary of all or any portion of the death benefit is designated by the employee or service-provider or is any person whom the employee or service-provider would reasonably be expected to designate as the beneficiary.[4]

As so defined, split-dollar is an executive compensation technique used by corporations to provide life insurance and other benefits to their executives. The life insurance policy used to finance this benefit will typically develop a cash surrender value over time. The cash surrender value is generally the amount that the owner of the contract can receive back from the insurance company on cancellation of the policy (less any applicable surrender charges). If the split-dollar arrangement entered into between the corporation and the executive provides that the corporation will receive back the *greater* of the premiums it paid or the cash surrender value, then the split-dollar arrangement is typically referred to as nonequity split-dollar. That is, the corporation retains the equity build-up (i.e., cash surrender value) in the life insurance policy. If, however, the corporation receives back the *lesser* of the cash surrender value or the premiums it paid, then the arrangement is commonly referred to as an equity split-dollar arrangement. That is, the equity or cash surrender value in the policy belongs to the executive on termination of the policy.

Split DollarÂ–Taxation

The formal income tax treatment of split-dollar began in 1955 with Rev. Rul. 55-713.[5] Rev. Rul. 55-713 held that endorsement split-dollar[6] was in "all essential respects" the same as an interest-free loan from the employer and therefore not taxable.[7] Rev. Rul. 55-713 also held that the employer was not entitled to a deduction for the premiums paid because of Code section 264 but that the death benefits, both to the employer and the employee, were tax-free under section 101(a) of the Code.

The Internal Revenue Service subsequently changed its position, at least with respect to the interest-free loan portion of Rev. Rul. 55-713, and argued that employees had income under the loan theory set forth in Rev. Rul. 55-713. That position, however, was rejected by the Tax Court in *Dean v. Commissioner*.[8] Congress at that time also refused to enact legislation statutorily incorporating the IRS position that the loan was taxable[9] but Congress did refer the matter to the Treasury Department for further study.[10] In 1984 Congress enacted legislation providing for authority in section 7872 of the Code[11] to tax no-interest loans. However, the legislative history of section 7872 does not contain any indication that section 7872 was directed at split-dollar.

The 1963 Congressional direction to the Treasury Department to study split-dollar further led to the development of a general counsel memorandum[12] that paved the way for the release of the seminal ruling on the taxation of split-dollar life insurance, Rev. Rul. 64-328.[13] Rev. Rul. 64-328 revoked Rev. Rul. 55-713 (while grandfathering both endorsement and collateral assignment policies then in existence) and established a new theory of taxation, the economic benefit theory. Rev. Rul. 64-328 held that the executive is taxed on the economic benefit provided by the arrangement and that both endorsement and collateral assignment split-dollar arrangements are taxed in the same manner. Rev. Rul. 64-328 also held that the economic benefit from the arrangement was measured by a formula valuation set forth in Rev. Rul. 55-747.[14] The ruling also continued the IRS's position that the employer is not entitled to a deduction (due to section 264 of the Code) but that the death benefit is tax-free under section 101(a) of the Code.

For over 37 years, Rev. Rul. 64-328 remained the only formal guidance on the taxation of split-dollar. It did not, however, resolve all the issues concerning the taxation of split-dollar. The unresolved issue of greatest significance for purposes of this paper is the question whether Rev. Rul. 64-328 applied to both equity and nonequity split-dollar arrangements. Without a doubt it applied to nonequity split-dollar arrangements and also without a doubt it was widely interpreted to apply to equity split-dollar arrangements as well. The uncertainty stems in large part from the terms of the ruling itself. The ruling describes a fact pattern that is a nonequity arrangement, which suggests it was only intended to apply to

nonequity arrangements. However, the ruling itself states that the factual situation described is an "illustration" of the application of Rev. Rul. 64-328. Further, in describing split-dollar arrangements, the ruling states that a split-dollar arrangement is one in which the employer is entitled to receive back the cash surrender value or "at least a sufficient" part thereof to equal the funds it has provided for premium payments. This latter description is a description of equity split-dollar and therefore, it has long been maintained that the revenue ruling, by its own terms, is applicable to both nonequity and equity split-dollar arrangements. Whatever the Internal Revenue Service's intention, it is undeniable that the Revenue Service left undisturbed for 37 years a widely applied interpretation of Rev. Rul. 64-328 that indicated that it applied to both equity and nonequity split-dollar arrangements.[15]

The first formal deviation from Rev. Rul. 64-328 came in the form of a private letter ruling (which is not precedent to anyone other than the taxpayer that received it).[16] Technical Advice Memorandum 9604001[17] held that the cash surrender value build-up in a split-dollar arrangement was annually taxed to the employee once it exceeded the amount due back to the employer. Thus, in an equity split-dollar arrangement, once the cash surrender value accumulated to a sufficient level to pay back the employer, all further increases in that cash surrender value were taxable to the employee under section 83 of the Code. If the arrangement was subject to a substantial risk of forfeiture, the taxation would be postponed until the employee vested under section 83 but otherwise, each annual increment would be taxable income to the employee under this theory. Numerous questions were raised concerning the analysis in TAM 9604001. For example, the regulations under section 83 defined "property" and "transfer" (two requirements requisite to taxation under section 83) in a way that indicates taxation only occurs when the cash surrender value of a policy is transferred from the employer to an executive, not when there is a build-up in that cash surrender value in a policy already owned by the executive.[18] Thus, if incremental build-ups in cash surrender value are not "transfers" of "property" then they would not be taxed under section 83 as suggested by the TAM. The analytical correctness of TAM 9604001 was never formally resolved but it is notable that the Internal Revenue Service appears to not have ever applied the rationale in the technical advice memorandum again and currently appears to have abandoned it altogether.

On January 9, 2001, the IRS announced its first formal change in the taxation of split-dollar since 1964. Notice 2001-10[19] "clarifies" prior rulings and suggests future methods of taxation, while at the same time providing interim guidance. In Notice 2001-10, the IRS indicated that neither Rev. Rul. 64-328 nor Rev. Rul. 66-110 addressed equity split-dollar arrangements (only nonequity split-dollar arrangements) and that under those revenue rulings, the economic benefit of the equity build-up should be includable in the employee's gross income. Notice 2001-10 effectively allowed the parties to a split-dollar arrangement to choose whether to have that arrangement taxed as a loan taxable under section 7872 of the Code or as an economic benefit taxable under section 61 (not section 83) of the Code. The Notice explicitly disavowed the treatment in TAM 9604001 and provided that the new rules would be applicable prospectively. The tax principles set forth in Notice 2001-10 were relatively short-lived, however, since they were replaced a year later by Notice 2002-8.[20] Notice 2002-8 also subscribed to a two-regime method of taxation, loan treatment under section 7872 and economic benefit treatment under section 61, but no longer gave the employer the explicit choice as to how to be taxed. Instead, it indicated that proposed regulations would be promulgated providing different regimes based on who owned the policy. It also stated that "no inference should be drawn" from this Notice regarding the tax treatment of any split-dollar arrangements entered into before the date of final regulations. Notice 2002-8 remains the last formal IRS statement of position on existing arrangements.

Approximately six months later the Internal Revenue Service issued proposed regulations that would prospectively establish the two regimes of taxation described above. Under these proposed regulations, if the company owns the policy (endorsement split-dollar) then the executive is taxed under an economic benefit theory based on section 61 (not section 83) of the Code.[21] On the other hand, if the formal owner of the policy is the executive (collateral

assignment split-dollar), then the premium payments by the company are treated as loans that are potentially taxable under section 7872 of the Code (or under original issue discount rules).[22]

Thus, at this juncture, it appears that there are three potential tax regimes applicable to split-dollar. Endorsement split-dollar arrangements (after the date of the final regulations) would be taxed as a compensatory economic benefit to the executive; collateral assignment split-dollar arrangements (after the date of the final regulations) would be taxed to an executive as compensatory loans; and arrangements entered into before the regulations are finalized could be taxed under a different regime that may be different from either loan or economic benefit regime or might not be taxed at all (with respect to the cash surrender value build-up while the policy is in force).

Split-DollarÂ–Bank Regulation

The Internal Revenue Service is not the only federal agency to consider split-dollar, although it is the federal agency that, at least at this point, has the most extensive background on the subject. The Federal Reserve has a history with split-dollar that extends back almost as long as that of the Internal Revenue Service.

Section 375a of the Federal Reserve Act prohibits a member bank from extending "credit in any manner to any of its own executive officers." Certain exceptions are provided that are not relevant for purposes of this analysis. The Federal Reserve has interpreted the application of this statutory prohibition to split-dollar on three occasions. On none of those occasions did the Federal Reserve find split-dollar arrangements to bank executives to necessarily be in violation of this prohibition.

On March 28, 1961, a member bank asked the Federal Reserve whether a split-dollar arrangement for its managerial employees would violate the statutory and regulatory prohibitions against extending credit to executives. In the Federal Reserve response[23] it was noted that split-dollar is used to recruit and retain employees and it then analyzed the nature of split-dollar arrangements. The letter concludes that since the arrangement was nonrecourse (that is, the bank had to look solely to the cash surrender value of the policy for reimbursement of its premiums), the statute was not violated. It further noted that the purpose of the statutory prohibition was not to "discourage banks from providing their employees with various forms of fringe benefits, including programs for life insurance." The Federal Reserve concluded that split-dollar was an acceptable benefit to be provided to bank executives, notwithstanding that at this time the Internal Revenue Service considered split-dollar to be a loan for income tax purposes.[24]

In 1981 the Federal Reserve was again faced with this issue. Again it held that the purchase of split-dollar insurance for a member bank's executive officer did not violate the prohibition contained in the predecessor of section 375a. Also again, it based its conclusion on what appears to be two independent holdings. First, as in the 1963 letter, the Federal Reserve concluded that the arrangement did not involve an extension of credit because there was no obligation on behalf of the executive to repay the bank's premiums. The obligation arose entirely from the policy itself. In addition, the letter noted that the Internal Revenue Service, under Rev. Rul. 64-328, treated split-dollar arrangements as taxable income and therefore split-dollar should not be considered an extension of credit.[25]

The final letter was issued in 1995 and reaffirms the position of the two earlier letters while refusing to extend it to additional factual situations that were raised. The additional factual situations involved situations in which the member bank would receive interest on its premium payments or on which the executive would be independently obligated to repay the loan outside the proceeds of the insurance policy itself. In this letter the Federal Reserve reiterates the importance of the federal income tax treatment: "Staff continues to believe that the tax treatment of these arrangements is instructive, although not determinative, as to the appropriate treatment of such transactions."[26]

SOX

Unfortunately, due in large part to the speed with which it was enacted, very little background is available for SOX. Clearly Congress was motivated by the accounting and

financial problems at Enron, WorldCom and a number of other well-known corporations. However, very little legislative guidance was provided during the enactment of SOX, which has further handicapped the ability to meaningfully apply it to a variety of situations including split-dollar.

Section 402 of SOX originated in the House of Representatives as part of H.R. 3763. As its title ("Enhanced Conflict of Interest Provisions") suggests, the provision originally only required disclosure for executive loans. In the Senate, Senators Feinstein and Schumer proposed an amendment to prohibit personal loans.[27] This amendment ultimately became the final language of section 402.

The limited legislative history of SOX indicates that Congress had concerns about protecting shareholders from financial harm such as occurred from certain high profile loans that had been discussed in the national media, none of which referred to split-dollar.[28] One well-publicized loan that may have been the focus of Congressional intention was the loan from WorldCom to Bernie Ebbers in the amount of $408.2 million at a low rate of interest. The legislative history does not, however, articulate other more indirect forms of loans that the statute would encompass, notwithstanding the broad language of the statutory provision itself.

Notwithstanding the absence of any legislative history or statutory language concerning the application of section 402 to split dollar, some efforts have been made to create post-enactment legislative history. For example, the Permanent Subcommittee on Investments of the House of Representatives sent a letter to the SEC arguing for a strict application of section 402. Further, Senator Schumer, one of the authors of the current version of section 402, in remarks to the press indicated that split dollar was "the type of thing we wanted to eliminate."[29]

Section 402 of SOX is further notable for two features that it lacks. First, it does not provide for any transition treatment but instead was effective immediately upon enactment on July 30, 2002. Thus, no opportunity to appropriately transition out of existing arrangements is provided by the law. Second, while Congress provided directives to the SEC to develop rules on many aspects of SOX, it did not provide any such directive to the SEC with respect to section 402. Based on informal remarks from SEC staff personnel, this is likely to mean the SEC will not provide any interpretative guidance in the near future.[30]

As a result of the foregoing, companies subject to section 402 of SOX are unfortunately in the position of having to rely almost exclusively on a careful analysis of one sentence in section 402 in order to determine whether split-dollar arrangements are criminal violations. This difficulty is particularly acute for companies that had existing split-dollar arrangements on July 30 and are now in the very untenable position of deciding what course of action to take with respect to those split-dollar arrangements without violating SOX.

Analysis

Section 402 of SOX amends section 13 of the Securities Exchange Act of 1934 (the 1934 Act) to add subsection (k). As so revised, section 13(k)(1) of the 1934 Act provides that "It shall be unlawful for any issuer..., directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer." The remaining sentence in section 13(k)(1) provides that extensions of credit on the date of enactment are not subject to this prohibition provided there is no material modification to any term of any such extension of credit or the renewal of any such extension of credit on or after the date of enactment.

Before analyzing the statutory language itself, it may be helpful to look at other areas of the law for any assistance that they may provide in analyzing these statutory provisions. Five other areas of the law will be considered.

Factors

1. *State Law*

The question presented is whether the form of the transaction under state law is relevant in determining whether section 13(k) of the 1934 Act is violated. By analogy, the Federal Reserve, in analyzing section 375a of the Federal Reserve Act, looked in large part to state law regarding the repayment obligation, e.g., recourse or nonrecourse, in determining whether an extension of credit existed. Further, as a practical matter, some split-dollar arrangements are, by contract, designated in the form of loans where others are not. Should this contractual designation have any relevance and if so, would it mean that split-dollar arrangements that are contractually designated as loans run afoul of SOX whereas other split-dollar arrangements do not? In effect, is the determination of what is an extension of credit or a personal loan ultimately be a matter of state law since SOX does not provide any definitional guidance for these terms?

At present there are no answers to these questions. Certainly a substantial argument can be made that since SOX did not define the terms, the terms must find their underlying meaning under normal usage, which may implicate state law or contract law. However, it seems unlikely that state law would be fully determinative because such an approach could potentially lead to inconsistent results in different states or inconsistent results based on different contractual provisions. Thus, while state and contractual law principles might be invoked in interpreting section 13(k), use of these principles as an absolute interpretative technique seems implausible.

1. *Tax Law*

The most extensive body of law on the treatment of split-dollar is found in the tax laws, as discussed previously. Further, the tax law treatment of split-dollar was relevant to the Federal Reserve in interpreting section 375a of the Federal Reserve Act. Perhaps the SEC should likewise consider the tax law treatment in analyzing section 13(k) of the 1934 Act.

The problem is that the tax law does not provide a single definitive answer to the question. As previously noted, at the present time the tax law appears to provide three different taxing regimes for split-dollar based on the timing and the form of the transaction. Arrangements that are entered into before the proposed regulations are finalized may be treated differently from those arrangements entered into after the proposed regulations are finalized. Post-regulatory arrangements will be further taxed under either a loan regime or an economic benefit regime, depending upon the form of the transaction.

If, therefore, the SEC were to rely on the tax treatment of split-dollar in analyzing section 13(k), it would be left with a situation in which post-regulatory endorsement split-dollar does not violate section 13(k) (because it is not treated as a loan but instead as an economic benefit provided from the employer to the executive) and collateral assignment split-dollar might be treated as a violation of section 13(k) (because the tax rules would treat collateral assignment split-dollar as a loan).[31] While the characterization for tax law purposes of pre-regulatory split-dollar arrangements is less certain, it seems unlikely that these arrangements would be treated for tax law purposes as loans[32] and therefore those arrangements may well be exempt from section 13(k) if the tax law characterization controls.

It should be noted that from 1964 (beginning with Rev. Rul. 64-328) until 2001 (ending with Notice 2001-10), the Internal Revenue Service's explicit position was that there was no difference between collateral assignment and endorsement split-dollar and that they would both be taxed the same. Because the IRS now explicitly rejects this position, if the tax law is relied upon, some differentiation based on the form of the split-dollar arrangement would be required.

Further, many companies have nonequity split-dollar arrangements in effect. Since such arrangements do not transfer any equity (cash surrender value) to the executive and do not contemplate any repayment by the executive, a strong case can be made that section 13(k) should not apply to these arrangements because there is no "loan" involved. These arrangements are more analogous to pure straight life insurance benefits and therefore seem to be exclusively in the nature of a compensatory benefit and not a loan.

Notwithstanding the complexity of these tax rules, a strong argument can be made that the Securities and Exchange Commission should place considerable reliance on these rules, just as the Federal Reserve has historically done. The characterization of split-dollar for tax purposes (and for banking purposes as discussed herein) are the two most relevant areas of law that the SEC has available to it in interpreting SOX. Instead of trying to invent a new interpretative approach, reliance on these established benchmarks may be the most appropriate analogy for the SEC to use.

1. *Banking Law*

   The similarity between the statutory prohibition in section 375a of the Federal Reserve Act and the prohibition in section 13(k) of the 1934 Act is striking. It strongly suggests that the drafters of SOX used section 375a as a starting point in drafting. Both statutes prohibit an extension of credit to executive officers. SOX modeled the statutory language in section 375a in a number of ways, most importantly by adding that the extension of credit must be "in the form of a personal loan." That additional phrase, as discussed below, appears to narrow, not expand, the statutory reach in that SOX requires that the extension of credit be in the form of a personal loan whereas the banking law applies to all extensions of credit, whether in the form of a personal loan or otherwise.

Given this similarity, the long-standing (since 1963) Federal Reserve interpretation of its statute would appear to have substantial importance. As previously discussed, the Federal Reserve has concluded that nonrecourse split-dollar arrangements are not an extension of credit at all and further, that the tax law treatment of these arrangements is at least relevant in this analysis. In fact, it seems difficult to understand how the Federal Reserve could consistently treat its statute as not applying to split-dollar and the SEC could interpret a narrower statute to reach the opposite result in the context of a criminal statute.

1. *Securities Law*

The provisions of section 13(k) of the 1934 Act are, in their most important aspects, new to the securities laws and therefore, existing securities law does not appear to offer a great deal of help in interpreting these rules. Further, as noted previously, it presently seems unlikely that guidance on this will be forthcoming in the near future from the Securities and Exchange Commission.

1. *Criminal Law*

While criminal law may not provide any direct analogies useful to interpreting section 13(k), it does provide some useful principles of statutory construction that must be considered. Section 13(k) is a criminal statute and must be interpreted as such.

As a first principle, criminal statutes must be sufficiently clear in their meaning that people can clearly understand what is prohibited. The courts have frequently struck down as vague criminal statutes or the application of criminal statutes in situations where the prohibited action is not clearly articulated.[33]

A second critical principle is that criminal statutes must be interpreted to ensure "fair warning"[34] and that Congress must speak in language that is "clear and definite."[35]

The Statute Itself

With this background, the only analytical step left is to parse the statutory provisions themselves to try to determine the meaning of section 13(k) of the 1934 Act. Following are some of the key terms and phrases used in this sentence and some considerations that may be applicable to their interpretation.

1. ***Issuer.*** The term "issuer" is explicitly defined by reference to section 2 of SOX itself and basically means a public company. Section 2(a)(7) of SOX indicates that an "issuer" means an issuer of securities registered under section 12 of the 1934 Act, an issuer that is required to file reports under section 15(d) of the 1934 Act or an issuer that files or has filed a registration statement that has not yet become effective under the 1934 Act and that it has not withdrawn.

3. ***Director.*** The term "director" is presently defined in Rule 3a-7 of the 1934 Act as "any director of a corporation or any person performing similar functions with respect to any organization." This definition is reasonably certain although the status of certain nonvoting directors of a corporation may be less clear.

5. ***Executive Officer (or Equivalent Thereof)."*** As previously noted, the term "executive officer" (without the equivalency parenthetical) appears to have been taken directly from the Federal Reserve Act. The term is also used under rule 3b-7 of the 1934 Act as follows:
   "The term 'executive officer,' when used with reference to a registrant, means its president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function or any other person who performs similar policy-making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of a publicly held company if they perform policy-making functions for the publicly held company."

Given the existence of a definition of "executive officer," it seems likely that the SEC will apply that definition for purposes of section 13(k). It is less certain what the parenthetical "(or equivalent thereof)" will do to this definition since the definition in rule 3b-7 already defines the term by reference to certain policy-making functions and not by title alone. Regardless of the existence of a definition that may be applied, it should be noted that there is in practice considerable uncertainty as to the breadth of the definition and exactly to which executives it applies. Without a more precise standard, companies will be forced to assume that many executives who might not otherwise be executive officers are covered by the prohibition.

7. ***"Directly or Indirectly, Including Through Any Subsidiary."*** This language clearly evidences an intent by Congress to be expansive in the reach of section 13(k). Not only does it explicitly prohibit extensions of credit through a subsidiary, it prohibits any extensions of credit in any other indirect form. In analyzing section 13(k) therefore, it must be kept in mind that any device that ultimately flows from the issuer, no matter how obliquely, is probably caught up within its prohibitions.

9. ***Extend or Maintain Credit."*** Sections 7 and 11(d) of the 1934 Act deal with the concept of an "extension of credit." These provisions relate to margin activities and other types of credit extensions that do not appear to be particularly relevant to SOX. Based on the SEC's approach to these existing provisions, it seems likely that it will take an expansive approach to the concepts of extending or maintaining credit.[36] This may implicate such normal executive transactions as providing travel advances to executives or providing the use of company credit cards.

11. ***"Arrange for the Extension of Credit."*** This phrase seems to clearly suggest that facilitating credit through a third party, even though the issuer does not itself extend the credit, would also be a violation of SOX. This concept may be particularly important for certain types of executive compensation transactions such as providing cashless exercises of stock options, which may be "arranged" through a broker relationship with the issuer.

13. ***"Renew an Extension of Credit."*** This phrase makes it clear that even though an extension of credit may have occurred before the effective date of SOX (July 30, 2002), a renewal of that credit would still be a violation of SOX. The easiest example would appear to be a term loan that is extended after the effective date of SOX. A demand loan, however, is daily renewed and extended.
    This has particular implications for split-dollar which, for tax purposes, is generally treated (in the case of collateral assignment split-dollar) as a demand loan. As a consequence, this provision suggests that if collateral assignment split-dollar is prohibited by section 13(k), then unless the loan was closed out no later than July 30, 2002, section 13(k) has already been violated even if the company has not paid any further premiums since July 30.

15. ***In the Form of a Personal Loan."*** This is the key phrase in analyzing whether section 13(k) applies to split-dollar. As previously noted, not only must there be an extension of credit but that extension of credit must be in the form of a personal loan. In order for this latter phrase to have meaning, it seemingly must narrow the concept of extension of credit because extensions of credit that are not in the form of a personal loan are not violative of section 13(k). Since the term "personal loan" is not defined in the statute or any other relevant body of law, the term must be interpreted *ab initio*.
    The first aspect of this phrase is the term "loan" itself. A good example of this differential may be travel advances. While it can be argued that travel advances are within the realm of being an extension of credit, it would be beyond normal usage to

> consider a travel advance a loan.
>
> Of greater relevance is the application of these terms to split-dollar. As noted in the Federal Reserve letters discussed above, the Federal Reserve views nonrecourse split-dollar as not even involving an extension of credit because there is no personal obligation to repay. This rationale would appear to be even stronger in the case of an extension of credit that has to be in the form of a personal loan. If there is no obligation on the executive to repay, i.e., the funds are recovered from another source, it seems difficult to characterize the transaction as a loan.
>
> The other key term in this phrase is the word "personal." That is, not only must the extension of credit be in the form of a loan, but the loan must be a "personal" loan. Thus, certain types of loans are permitted and other types of not. (Unless the word "personal" is superfluous). The question then becomes what meaning to give the word "personal." The most likely meaning is personal as opposed to business. Under this interpretation, a business loan to an executive would not be violative of SOX, whereas a loan made for non-business reasons, i.e., personal reasons, would.
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> This characterization takes on particular importance in the case of split-dollar. Split-dollar has always been considered a form of executive compensation, although the exact taxation of that executive compensation has been the subject of considerable debate. What has not been the subject of debate is that split-dollar is not a personal transaction but is instead a business or compensatory transaction between the company and the executive.

This analysis suggests that regardless of what various members of Congress may individually now believe, section 13(k), when properly interpreted, should not apply to split-dollar arrangements for the reasons suggested above, the most significant of which is that it is extremely difficult, especially in the context of a criminal statute, to characterize split-dollar as a personal loan.

Practical Considerations

Notwithstanding the foregoing analysis, public companies that have existing split-dollar arrangements feel trapped by SOX. These companies may be subject to contractual obligations that require them to continue the split-dollar arrangement with the executive. While violation of a criminal statute may be an adequate defense against contractual obligations, if the company fails to honor its contractual commitments and it turns out that SOX does not prohibit the action in question, the company may be liable civilly. This situation is not likely to be remedied soon, as previously noted, because authoritative guidance from the SEC is not likely to be available in the near future.

Many, if not most, large insurance carriers that have sold split-dollar to public companies have provided temporary premium holidays on these arrangements. These premium holidays are subject to deadlines in the relatively near future and it seems unlikely that they will be continued indefinitely. Thus, these premium holidays may, to some extent, defer the problem but will not ultimately solve the dilemma that the companies are in. In fact, if the arrangements in question are treated as loans, then under the language in SOX, it may be that the premium holidays do not avoid a violation of section 13(k) at all because an extension of credit may have already been "renewed" by reason of the continuation of split-dollar arrangements that are deemed to be demand loans.

SOX has, in practice, totally eliminated sales of split-dollar to public companies and has probably caused an over-reaction by public companies in limiting the use of split-dollar to individuals who may not even be covered by section 13(k), i.e., employees who are not directors or executive officers. Nevertheless, without authoritative guidance on which to rely, companies have little choice but to be very conservative in the face of the criminal prohibitions contained in SOX.

Conclusion

SOX has had a swift and dramatic effect on the use of split-dollar among public companies. Whether that reaction has been appropriate or not will probably remain unanswered for a considerable period of time as it is unlikely that authoritative guidance will be issued in the near future. Nevertheless, as this paper suggests, a very substantial argument can be made that the prohibitions in section 402 of SOX do not apply to split-dollar arrangements based on a variety of factors, including analogous areas of law, and careful statutory interpretation, particularly the statutory requirement that the prohibited extension of credit must be in the form of a "personal loan." It is difficult to comprehend how a long-standing executive compensation technique such as split-dollar can be construed to be a personal loan.

[*] The warning provided by Dr. Seuss in his book of a similar name also applies to this subject: "Take it slowly. This book is dangerous!"

[1] P.L. 107-204 (hereinafter referred to as "SOX").

[2] As Ogden Nash once wrote, "God in his wisdom gave us the fly, and then forgot to tell us why."

[3] References herein to the Code are references to the Internal Revenue Code of 1986, as amended.

[4] Proposed Treas. Regs. §1.61-22(b)(2)(ii).

[5] 1955-2 C.B. 23.

[6] Endorsement split-dollar is a form of split-dollar in which the formal owner of the policy is the company and collateral split-dollar is a form of split-dollar in which the formal owner of the policy is the executive.

[7] This holding was later referred to by the Internal Revenue Service as "embarrassing" in GCM 32941 (November 20, 1964).

[8] 35 T.C. 1083 (1961).

[9] See, e.g., Summary of the President's 1963 Tax Message, 23-24, JCS-263 (April 1963).

[10] See H. Rep. No. 749, 88th Cong. (1963), 1964-1 C.B. (Part II), 125, 186; S. Rep. No. 830, 88th Cong. (1963), 1964-1 C.B. (Part II) 505, 582.

[11] P.L. 98-369, the Deficit Reduction Act of 1984.

[12] GCM 32941 (November 20, 1964).

[13] 1964-2 C.B. 11.

[14] 1955-2 C.B. 228. The economic measure is commonly referred to as the PS-58 cost.

[15] Rev. Rul. 66-110, 1966-1 C.B. 12, modified Rev. Rul. 64-328 to state that an employee was taxed on "other benefits" provided to the employee. However, Rev. Rul. 66-110 only referenced policy dividends as an instance of "other benefits" that were taxable. By negative inference, many have argued that Rev. Rul. 66-110 further endorsed the principle that equity build-up was not taxable due to the statutory protections of §72 of the Code.

[16] Code §6110(k)(3).

[17] January 26, 1996.

[18] See Treas. Regs. §1.83-(a)(1); §1.83-3(e). In collateral assignment arrangements the policy is formally owned by the executive.

[19] 2001-1 C.B. 818.

[20] I.R.B. 2002-4, 398 (January 28, 2002).

[21] See Prop. Treas. Regs. §1.61-22.

[22] See Prop. Treas. Regs. §7872-15.

[23] FRRS 3-1044 (August 27, 1963).

[24] Rev. Rul. 55-713.

[25] Unpublished interpretative letter to Gene Mathews (March 10, 1981).

[26] F.R.B. Interpretative Letter to Jeffery S. Kane (April 13, 1995).

[27] Amendment No. 4295 to H.R. 3763, 107th Cong., 2nd Sess. (2002).

[28] S. Rep. No. 107-205 at 30 (2002).

[29] See Tracie Rozhon and Joseph B. Treaster, "Insurance Plans of Top Executives Might Violate the Law," New York Times (August 29, 2002).

[30] See Joseph B. Treaster and Tracie Rozhon, "Another Blow to Executives on Stock Options," New York Times (August 15, 2002).

[31] While collateral assignment split-dollar is treated as a loan (under section 7872 of the Code), under the proposed regulations on split-dollar, the SEC would still have to determine whether collateral assignment split-dollar is a "personal" loan.

[32] Note, e.g., that Rev. Rul. 64-328 expressly rejected loan treatment.

[33] See, e.g., Kolender v. Lawson, 461 U.S. 352 (1983) (California loitering statute was unconstitutionally vague); Lanzetla v. New Jersey, 306 U.S. 451 (1939) (New Jersey gangster statute was unconstitutionally vague); Connally v. General Construction Co., 269 U.S. 385 (1926) (Oklahoma wage statute was unconstitutionally uncertain).

[34] U.S. v. Lanier, 520 U.S. 259 (1977).

[35] U.S. v. Bass, 404 U.S. 336 (1971).

[36] See Liazos and Murphy, "The Metaphysics of §402 of the Sarbanes-Oxley Act and Its Implications for Executive Compensation," draft paper presented to the Tax Management Compensation Planning Advisory Board, November 21, 2002 (expected to be published as a future Tax Management Memorandum).

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