# *AALU's Washington Report*

***Premier analysis of federal legislative and regulatory developments for the nation's 2000 most advanced life insurance planners, focusing on business, estate, qualified and nonqualified retirement planning.***

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Subject: **Analysis of Final Split-Dollar Regulations**

Major References: ***T.D. 9092, ___ Fed. Reg. ___ (Sept. 17, 2003); Rev. Rul. 2003-105, I.R.B. 2003-40, ___; Treasury September 11, 2003 Press Release***

Prior AALU Washington Reports: *03-94; 03-80; 03-51; 03-50; 03-16; 02-90; 02-1;01-09; 96-9*

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***As stated in our Bulletin No. 03-94, the Treasury, on September 11, 2003, released the final version - differing little from the July 2002 and May 2003 proposed versions - of regulations governing the taxation of split-dollar life insurance arrangements. The final regulations are generally effective for arrangements entered into after Wednesday, September 17, 2003, and for arrangements entered into on or before that date that are thereafter "materially modified." The rules, including transition safe harbors, announced in Notice 2002-8 (see our Bulletin No. 02-1) will continue to govern existing arrangements that are not materially modified. The availability of any such transition rules will, however, for the most part expire on December 31, 2003, without extension.***

***As in the2002 proposed regulations, the taxation of a split-dollar arrangement flows from the formal ownership of the life insurance contract; in consequence, a nonowner is taxed annually on increases in the cash value of a life insurance***

***contract to which he or she has "current access," to the extent that such amount was not actually taken into account for a prior taxable year. The concept of "current access" to policy cash value is based on a broad interpretation of the income tax doctrine of "constructive receipt," pursuant to section 61 (not section 83) of the Internal Revenue Code.***

The following is a detailed analysis of the final regulations, including the details in which they differ from the 2002 and 2003 proposed regulations.

## *BACKGROUND*

The final regulations are the culmination of a series of (sometimes contradictory) rulings, notices and regulations issued by the Internal Revenue Service over the last 8 years that cumulatively have modified the tax treatment of split-dollar life insurance arrangements under Rev. Rul. 64-328 (and Rev. Rul. 66-110). Although Rev. Rul. 64-328 described two contractual forms - *i.e.,* the endorsement method (under which the employer is formally designated as the owner of the contract), and the collateral assignment method (under which the employee is formally designated as the owner of the contract) - the taxation of the arrangement was the same under either form. Prior to the publication of Rev. Rul. 64-328, the Revenue Service had characterized split-dollar arrangements as interest-free loans.

Recent guidance, foreshadowing the final regulations, may be summarized as follows:

- ***TAM 9604001*** applied for the first time the concept that increases in the cash surrender value of an equity split-dollar arrangement, *i.e.,* an arrangement in which an employer's interest in the cash surrender value of a life insurance contract is limited to the aggregate amount of its premium payments - are taxable annually under Section 83 of the Internal Revenue Code. (*See* our Bulletin No. 96-9.)

- ***Notice 2001-10*** provided "interim guidance" pursuant to which the taxpayer is offered a choice, "pending consideration of public comments and the publication of further guidance," of treating the equity split-dollar arrangement either as a loan, taxable under Section 7872, or as a transfer of property (cash value build-up) upon "rollout" under Section 83. ***Notice 2001-10*** also promulgated Table 2001, based on the mortality experience reflected in Table (i) under Section 79 of the Internal Revenue Code, with (importantly) extensions for ages below 25 and above 70, and the elimination of the five-year age brackets. The Table 2001 rates replace the P.S. 58 rates set forth in Rev. Rul. 55-747, and are materially lower than the P.S. 58 rates at all ages. (*See* our Bulletin No. 01-09.)

- ***Notice 2002-8*** revoked ***Notice 2001-10***, and announced the government's intention to publish regulations providing comprehensive guidance concerning split-dollar life insurance arrangements under which the taxation of the arrangement would depend on the parties' designation of the formal ownership of the insurance contract. ***Notice 2002-8*** also provided interim guidance regarding the valuation of current life insurance protection and stated certain effective date and safe harbor rules with respect to existing arrangements. One of these safe harbors allowed (without the recognition of income) arrangements entered into prior to January 28, 2002 to be terminated or converted to a loan prior to January 1, 2004. This date has not been extended by the final regulations. (*See* our Bulletin No. 02-01.)

- ***2002 Proposed Regulations*** (the "2002 Prop. Regs."), published on July 9, 2002, provided comprehensive proposed guidance, based generally on the principles announced in ***Notice 2002-8***, for the income, gift, and employment taxation of both equity and nonequity split-dollar life insurance arrangements. (*See* our Bulletin No. 2002-90.)

- ***2003 Proposed Regulations*** (the 2003 "Prop. Regs."), published on May 9, 2003, proposed rules for the valuation of the economic benefits provided under an endorsement equity split-dollar life insurance arrangement. The 2003 Prop. Regs. rejected what many viewed as the implied promise of ***Notice 2002-8*** to tax equity - under Section 83 of the Code - only on "rollout" of the contract, and instead adopted a régime for current (annual) taxation of equity under Section 61. (*See* our Bulletin No. 03-51.)

AALU, NAIFA and other interested parties (including ACLI) submitted comments to Treasury concerning all of the foregoing pronouncements. Unfortunately, as illustrated below, few of these comments are reflected in the final regulations.

## *SCOPE OF FINAL REGULATIONS*

The final regulations adopt the 2002 and 2003 Prop. Regs. virtually intact. In our discussion below, we have noted such variations as were incorporated in the final regulations.

As noted in our Bulletin No. 03-94, concurrently with the publication of the final regulations in the Federal Register, the IRS and Treasury will formally issue Rev. Rul. 2003-105, obsoleting Rev. Rul. 79-50, 1979-1 C.B. 139, Rev. Rul. 78-420, 1978-2 C.B. 67, Rev. Rul. 66-110, 1966-1 C.B. 12 (except as provided in Section III, Paragraph 3 of Notice 2002-8, 2002-1 C.B. 398, regarding the permitted use of the insurer's alternative term rates - as modified in some cases - for arrangements in existence prior to September 17, 2003, and Notice 2002-59, 2002-36 I.R.B. 481, to the same effect, except with regard to certain "reverse" split-dollar arrangements), and Rev. Rul. 64-328, 1964-2 C.B. 11.

The preface to the final regulations states specifically that they do not address:

(i) The issues arising out of Section 402 of the Sarbanes Oxley Act, which, the Treasury notes, falls within the jurisdiction of another government agency, the SEC; and

(ii) The estate taxation of split-dollar life insurance arrangements, which will continue to be governed by Section 2042. Future guidance may be issued on the estate tax implications of "co-owned" policies.

### FINAL REGULATIONS

## *SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENT*

A split-dollar life insurance arrangement is defined as ***any*** arrangement (other than a group-term life insurance plan) between an "owner" and a "nonowner" of a life insurance contract, under which either party to the arrangement pays all or part of the premiums and one of the parties paying the premiums is entitled to recover all or any part of those premiums from the proceeds or cash surrender value of the contract. However, in the context of employer/employee split-dollar and corporation/shareholder split-dollar, the arrangement is subject to the regulations even where the obligation of repayment is not secured by the policy or its proceeds, so long as the beneficiary of all or part of the death benefit is designated by the employee or shareholder or is someone whom the employee or shareholder would be reasonably expected to designate as a beneficiary.

Employer/employee arrangements, corporation/shareholder arrangements and private (*i.e.,* donor/donee) arrangements are covered in the final regulations. "Reverse" split-dollar arrangements are not discussed, as these presumably have been dealt with in ***Notice 2002-59.*** (*See* our Bulletin No. 02-103.)

The regulations do not include among split-dollar life insurance arrangements one under which one party to the transaction pays the premiums for the benefit of another party without expectation of repayment. In that case, the payment is taxable to the recipient under the general rules of Section 61 of the Code, or, in a non-compensatory context, as a gift.

The preamble to the final regulations makes clear that definition of "arrangement" does not cover the purchase of an insurance contract in which the only parties to the arrangement are the policy owner and the life insurance company acting only in its capacity as issuer of the contract. The final regulations also make clear that "key man" insurance, where the employer or corporation owns the policy and all of its benefits, is outside the scope of the regulations. The regulations do, however, cover loans used to pay premiums that are secured by the policy, including, presumably, at least in theory, third-party (*e.g.* bank) premium financing arrangements. However, the effect of including premium financing arrangements in the definition isn't clear, unless the parties have an employment, shareholder or gift relationship and the interest rate is less than the AFR (or issues of OID are involved). The final regulations also are silent on the effect of a guarantee of a third-party loan by a related party (employer or donor) who may later step into the original lender's position with respect to the collateral.

## *OWNER AND NONOWNER DEFINED*

As under the 2002 Prop. Regs., the income and gift tax consequences of a split-dollar arrangement follow (with two exceptions) the formal ownership of the policy, thus making the definition of "owner" and "nonowner" key to the new rules. In general, payments made by an "owner" of the policy for the benefit of a nonowner in a split-dollar life insurance arrangement (typically an endorsement arrangement) are taxed to the parties through the use of an "economic benefit" analysis, while payments made by a "nonowner" of the policy for the benefit of the owner (typically a collateral assignment arrangement) are treated as loans subject to the rules of Section 7872 (and the OID provisions).

The request, by AALU and others, that the taxation régime be dependent, at least in part, on an election by the parties was rejected by the government, which noted that "in the view of the IRS and the Treasury, taxpayers effectively have the ability to elect which regime will apply by designating one party or the other as the owner of the life insurance contract."

***General Rule***. The "owner" of the policy is defined as the person who is named as the owner of the policy. A nonowner is anyone (other than the owner) who has a direct or indirect interest in the policy.

***Joint Ownership***. If two or more persons are named as policy owners (*i.e.,* the joint ownership situation) ***and*** each person has all of the incidents of ownership with respect to an undivided interest in the contract, each is treated as the owner of a separate contract to the extent of the undivided interest. However, if two or more persons are named as policy owners and each person does ***not*** have all of the incidents of ownership with respect to an undivided interest in the contract, the person who is first named as the owner is treated as the owner of the contract.

***Exceptions***. Notwithstanding the formal designation of ownership, the employer in an employer/employee arrangement and the donor in a private split-dollar arrangement is treated as the owner of the contract where the arrangement is not of the "equity" variety. The purpose of these exceptions appears to be aimed, at least in part, at allowing the use of the restricted collateral assignment method for estate planning purposes in a controlling (more than 50%) shareholder situation without requiring that the arrangement be reported as a loan.

***Attribution***. The final regulations provide attribution rules (not present in the 2002 Prop. Regs.) for compensatory split-dollar life insurance arrangements. Under these rules, the employer is treated as the owner of a life insurance contract owned by (i) a member of the employer's "controlled group," (ii) a § 403(b) secular trust, (iii) a grantor trust (such as a "rabbi" trust) of which the employer is treated as the owner, or (iv) a § 419(e)(1) welfare benefit fund.

## *ECONOMIC BENEFIT PLANS*

Where the employer or donor is the owner of the contract, the following results, essentially the same as under the 2002 and 2003Prop. Regs., are prescribed:

***Nonequity Arrangements***. The value of current life insurance protection paid for by an employer, corporation, or donor (reduced by any amount contributed by an employee, shareholder or donee) is taxable - as compensation, dividend or gift, as the case may be - on an annual basis. The value of current life insurance protection is measured by reference to a premium factor (currently Table 2001) that will change from time to time in accordance with published guidance. The final regulations do not allow the continued use of the insurer's alternative term rates for arrangements entered into after September 17, 2003.

The timing of the measurement of current life insurance protection value is changed under the final regulations. The 2002 Prop. Regs. provided that the "average death benefit" during the taxable year be used to compute the value of current life insurance protection, while the final regulations, subject to an anti-abuse rule, permit the value to be determined on the last day of the nonowner's taxable year, unless the parties agree to use the policy anniversary date. The valuation date may be changed with the consent of the Commissioner of Internal Revenue.

***Equity Arrangements***. Where the employer, corporation or donor is entitled to recover from the employee, shareholder or donee the lesser of its premium advances or the cash surrender value of the policy, the benefited party is required to take into income (or the donor is required to report as a gift) the value of the current life insurance protection, as described above respecting nonequity arrangements, ***and*** the amount of the annual increase in the value of his or her interest in the policy's equity to which the nonowner has "current access" (as described below). This increase must be taken into account on a current basis, and not just upon "rollout" of the policy. The nonowner also must take into account any other economic benefit provided by the owner.

***Modifications***. This topic was reserved in the 2002 Prop. Regs. The final regulations provide that a nonequity arrangement that becomes an equity arrangement will result (in the case of an existing endorsement arrangement) in the continued taxation of the arrangement under the economic benefit régime. Where the existing arrangement was a collateral assignment arrangement, the conversion to an equity arrangement will be treated as a transfer of the contract from the employer or donor to the employee or donee as of the date of the modification. At that point the loan regime kicks in.

***Loans, Withdrawals, Dividends, etc.*** The nonowner (employee, shareholder, or donee) will also be taxable on any amount received by him or her under a life insurance contract as a policy loan, a withdrawal or dividend, as if the amount had been just distributed directly to the owner (employer, corporation or donor) and then transferred to the nonowner. As we have noted in the past, this approach as applied to dividends could be reasonably anticipated. The treatment of policy loans and withdrawals, however, in AALU's judgment which has been vigorously communicated to the Treasury, is not defensible. The final regulations, like the 2002 Prop. Regs., posit a constructive distribution to the owner (reportable under the rules of Section 72 of the Code) and a subsequent taxable transfer of the amount to the nonowner as compensation, dividend or gift as the case may be. The amount of the transfer is reduced by the amount previously paid or taken into taxable income by the nonowner as the equity portion (but not the term coverage portion) of the economic benefit.

This interpretation, which we believe flies in the face of Section 72(e) of the Code, is justified by the government in the preamble to the final regulations first because, in its view, Section 72(e) applies only to the "owner" of a life insurance contract, and second because:

> ". . . [T]he rules of section 72(e) apply only if no other provision of subtitle A of the Internal Revenue Code (Code) applies. In the case of an equity arrangement subject to the economic benefit regime, the relationship between the owner and the non-owner and the terms of the arrangement between them ordinarily make other provisions of subtitle A applicable, such as section 61(a)(1)."

This statement ignores the fact that Section 61(a) also states that it applies "[e]xcept as otherwise provided in this subtitle [A] . . .," thus creating a circular reference devoid of any real meaning.

As we have stated in our prior submissions, Section 72(e) has been interpreted consistently to invalidate the application of the doctrine of "constructive receipt" (on which the government's Section 61(a)(1) equity taxation analysis is based) to taxation of the inside build-up of a life insurance policy. We continue to believe that it is not supportable to apply it here.

***Basis***. No nonowner of a policy will receive a basis in the contract for any portion of the premium paid by, or taxed to, him or her, under the split-dollar arrangement, even though, as noted above, offset against income recognition is, in part, permitted with respect to policy cash distributions.

***Transfer of the Contract***. Where a contract (or an undivided interest in a contract) is transferred by an owner to a nonowner, the nonowner is taxable under Section 83 on the fair market value of the contract (defined, in general, as its cash surrender value) reduced by any consideration paid for the transfer or previously taken into account with respect to the equity portion of the contract. As with respect to loans, withdrawals and dividends directly from the policy, no amount that was paid or previously taken into account for tax purposes by the transferee and was attributable to current life insurance protection may either (i) reduce the (former) nonowner's gain on the transfer or (ii) be added to the (former) nonowner's basis in the policy after the transfer.

***Deduction by the Employer.*** The employer, in a compensatory situation, may deduct the amount included in income by the employee as a result of the transfer of the contract to the employee.

***Contributory Arrangements***. The final regulations reaffirm that any payment for life insurance protection made by the nonowner of a contract is treated as income to the policy owner. This is the case even in a private split-dollar arrangement, where any contribution by the donee is taxable - ***as income*** - to the donor, a rule that continues to make little sense.

***Death Benefits***. The final regulations provide that any amount paid to a beneficiary (other than the owner) of a life insurance contract by reason of the death of the insured is excludable from gross income under Section 101 ***only*** to the extent attributable to amounts previously paid or taken into account for tax purposes by the nonowner for life insurance protection. While this rule would appear at first blush to present the potential for taxation of any untaxed equity component of the death benefit, under the final regulations, all transfers of economic benefit of either a nonequity or equity variety should be fully accounted for and taxed during the insured's lifetime. The split dollar import of this rule thus should in most cases be minimal. As with the 2002 Prop. Regs., the regulations under Section 101 of the Code are not amended.

The statement in the 2002 Prop. Regs. that amounts received by a nonowner in his, her or its capacity as a lender (such as the employer or donor in an equity split-dollar arrangement that is treated as a loan under the principles described below) by reason of the death of the insured will not be treated as an amount received by reason of the death of the insured for purposes of Code Section 101 is omitted (with no explanation) from the final regulations. As we noted in our Bulletin No. 02-90, however, the repayment of a loan usually does not result in tax consequences to the lender, unless the repayment includes accrued interest not previously taxed.

## ***"CURRENT ACCESS" AND CONSTRUCTIVE RECEIPT***

***"<u>Constructive Receipt, Economic Benefit, and Cash Equivalence</u>"*** The final regulations, like the 2003 Prop. Regs., provide that, in the case of an endorsement equity split-dollar life insurance arrangement, the value of the economic benefits provided to the non-owner under the arrangement for a taxable year equals (i) the cost of any current life insurance protection provided to the non-owner, (ii) ***the amount of policy cash value to which the non-owner has current access*** (to the extent that such amount was not actually taken into account for a prior taxable year), and (iii) the value of any other economic benefits provided to the non- owner (to the extent not actually taken into account for a prior taxable year).

The concept of "current access" to policy cash value is based on the income tax doctrine of "constructive receipt" – *i.e.,* income (whether or not actually received) is taxed at the time that is either credited to the taxpayer's account, set apart for him, or otherwise made available to the taxpayer so that he may draw upon it at any time.

As broadly construed in the regulations, a nonowner is deemed to have current access to "any portion of the policy cash value that is ***directly or indirectly accessible by the non-owner, inaccessible to the owner*** (an approach which, to the best of our knowledge, has never previously been used to sustain a constructive receipt result and which has been inadequately defended by the Treasury in the preface to the regulations)***, or inaccessible to the owner's general creditors***." (Emphasis supplied.) The term "access" includes any direct or indirect right of the nonowner "to obtain, use, or realize potential economic value from the policy cash value." The right to withdraw from the policy, borrow from the policy, or affect a total or partial surrender of the policy is considered "access."

***<u>Accessibility and Creditors' Rights</u>*** Policy cash value is deemed to be ***accessible to a nonowner*** if he or she can "anticipate, assign (either at law or in equity), alienate, pledge, or encumber the policy cash value," or if the policy cash value is subject to attachment, levy, or other legal or equitable process by the nonowner's creditors.

Policy cash value is deemed to be ***inaccessible to the owner*** if the owner does not have the full rights to policy cash value normally held by an owner of a life insurance contract.

Policy cash value is ***inaccessible to the owner's general creditors*** if, under the terms of the split-dollar life insurance arrangement or by operation of law or any contractual undertaking, the creditors cannot, for any reason, effectively reach the full policy cash value in the event of the owner's insolvency.

***Acceleration Rule/Section 457.*** The final regulations add an acceleration rule for those cases that may require a nonowner to include an amount in income earlier than would otherwise be required under the general split-dollar rules. The regulations state that an equity endorsement split-dollar life insurance arrangement constitutes a deferred compensation arrangement. Therefore, so the Treasury states, an employee of a tax-exempt organization or of a state or local government subject to Section 457 of the Code may have to include an amount in gross income attributable to an equity split-dollar life insurance arrangement even if the employee does not have current access to the policy cash value under these regulations.

***<u>Taxation Under Code Section 61 – Not Section 83</u>*** The final regulations, over the objections of virtually every interested party that filed comments on these regulations, ground the taxation of equity under the economic benefit régime in the constructive receipt analysis of Section 61 of the Internal Revenue Code, not Section 83.

Section 83 provides, in general, that if "property" is "transferred" to any person in connection with the performance of services, the excess of the fair market value of such property over any amount paid for such property is included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in the transferred property are transferable, or are not subject to a substantial risk of forfeiture. In the case of a life insurance contract, only the cash surrender value of the contract is considered to be "property."

By avoiding the use of Section 83, the government claims that there is no need to credit the nonowner with basis in the inside build-up in the policy for purposes of measuring future accretions of cash value and life insurance protection. Again, the preamble to the final regulations justifies this result as follows:

> "The IRS and Treasury believe that the approach set out in the 2003 proposed regulations remains appropriate and so have not followed the suggestion to adopt a section 83 approach. Section 83 applies only in connection with a transfer of property, but a non-owner may have currently includible income by reason of another rule – such as the doctrines of constructive receipt, cash equivalence, or economic benefit. It would be inappropriate to limit current taxation to circumstances that constitute transfers of property under section 83, and it would be inappropriate in this context to apply section 83 to circumstances that give rise to income under other Code provisions or judicial doctrines."

This response (or non-response) to objections with respect to the failure to adopt a Section 83 approach appears to be based solely on the inability to square the consequences of Section 83 (which, under Treas. Reg. § 1.61-2(d)(6), would appear to prevent the application of the more general provisions of Section 61) with the approaches taken in the final regulations with respect to basis, the availability and timing of an employer deduction, etc. There is an assumption in the regulations that those approaches are totally consistent with the consequences of section 61 -- an assumption which we believe is subject to direct challenge and may not withstand analysis. For example, even without the application of section 83, it can be convincingly argued that a deduction is available to the owner of an endorsement contract in the amount constructively received by the non-owner.

***Measurement of Policy Cash Value*** In a change from the 2003 Prop. Regs., the final regulations provide that, subject to an anti-abuse rule, policy cash values are to be determined on the last day of the nonowner's taxable year, unless the parties agree to use the policy anniversary date. Policy cash values are still determined, however, without regard to surrender charges or other similar charges or reductions. If any "artifice or device" is used to artificially understate the value of any economic benefit, the date on which such value is determined is the date on which the amount of policy cash value is greatest during that taxable year.

## *LOAN PLANS*

The loan régime should apply to virtually all collateral assignment equity arrangements.

If the employee, shareholder or donee is formally designated as the owner of the contract and is obligated to repay the employer, corporation or donor, whether out of contract proceeds or otherwise, the premiums paid by the nonowner for the direct or indirect benefit of the owner is treated as a series of loans to the owner - *i.e.,* each premium payment is a separate loan. Under this régime, such loans are subject to the principles, where applicable, of sections 1271-1275 (regarding the taxation of original issue discount or "OID") and section 7872 (below-market interest rate loans). If only a portion of the premium payment made by the nonowner is repayable (or is reasonably expected to be repaid), the portion that is not repayable will not be considered to be a split-dollar loan and is taxed to the owner under the general principles of Code Section 61.

***De Minimus Rules Not Applicable.*** The rules of Section 7872 are generally not applicable to "gift" loans, "compensation-related" loans, or "corporate-shareholder" loans on any day on which the aggregate amount of indebtedness outstanding does not exceed $10,000. In the split-dollar context, however, (probably in order to make certain that all split-dollar circumstances are covered by the regulations, but seemingly in defiance of the statute) the Section 7872 rules will apply whether or not the $10,000 threshold is exceeded.

***Indirect Loans.*** The regulations recognize that many split-dollar arrangements involve third parties, such as life insurance trusts, and provide that such transactions will be viewed, for purposes of Section 7872, as a series of back-to-back loans for income and gift tax purposes. Thus, where an employer/lender advances premiums to a life insurance trust/borrower of which the employee (the "indirect participant") is the insured, any foregone interest is computed as if the employer made a compensatory below-market loan to the employee (likely generating income recognition), and the employee took the loan proceeds and made a second below-market gift loan to the life insurance trust (likely generating a taxable gift). The tax results of each deemed loan are determined in accordance with the relationship of the parties. Compare this with the approach taken by the regulations in endorsement circumstances where the employer's loan from the insurance company is not considered part of a back-to-back series of loans and the passing on of loan proceeds to the employee is deemed to be a taxable policy dividend distribution rather than a loan.

***Nonrecourse Loans/Written Representation.*** Where, as is typical, a split-dollar loan is nonrecourse to the borrower, the payment is treated as a "contingent" payment. To avoid contingent payment treatment (which generally will result in the imposition of unfavorable assumptions when testing the loan for adequate stated interest), the parties to the loan must represent in writing (and must attach to the parties' returns) no later than the due date for the return of the borrower or lender for the year in which the first split-dollar loan is made that a "reasonable person" would expect that all payments under the loan will be made. The final regulations have eliminated a second requirement with respect to nonrecourse loans, - *i.e.,* that the loan bear interest at a stated rate.

Loans subject to the foregone interest rules of Section 7872 are generally classified as demand loans or term loans.

***Demand Loans.***

***Definition.*** A split-dollar demand loan is any split-dollar loan that is payable in full at any time on the demand of the lender - a circumstance that is characteristic of most split-dollar arrangements.

***Taxation and Timing.*** In each year that a split-dollar demand loan is outstanding, the loan is tested for adequate stated interest under Section 7872. A split-dollar demand loan is deemed to have adequate stated interest if the interest rate, which may be a variable rate, is no lower than the "blended annual rate" for the year (an average of the January and July short-term rates) based on annual compounding. The blended annual rate (which is published in June of each year) for 2003 is 1.52%

If a split-dollar demand loan does not have adequate stated interest, the foregone interest is deemed to be transferred by the lender to the borrower on the last day of the calendar year and will be accounted for in accordance with the parties' relationship. Therefore, in an employment context, foregone interest (recomputed each year based on the blended annual rate applicable to each year) on a split-dollar demand loan is taken into income by the employee as compensation on the last day of each calendar year that the loan is outstanding. The amount taken into income (or treated as a gift, in the case of a private split-dollar arrangement) will then be treated as retransferred at the end of each year by the borrower to the lender as (nondeductible) interest.

***Term Loans.***

***Definition.*** A split-dollar term loan is any split-dollar loan, other than a split-dollar demand loan, and thus is the default classification (as is the case for all below-market interest rate loans under Section 7872).

***Taxation and Timing.*** A split-dollar term loan is tested on the day the loan is made to determine if it has adequate stated interest. Interest is adequate if the face amount of the loan is equal to or greater than the "imputed loan amount." The "imputed loan amount" is the present value of all payments due under the loan, determined as of the date the loan is made, using the discount rate equal to the applicable federal rate (AFR) on that date. The AFR/discount rate must be appropriate to the loan's term: short-term (not over 3 years); mid-term (over 3 years, but not over 9 years); or long-term (over 9 years). The short-term, mid-term and long-term AFRs for September 2003 are 1.52%, 3.43%, and 5.08%, respectively, assuming annual compounding. A loan's term is the period from the date the loan is made to its stated maturity date.

The difference between the split-dollar term loan's face amount and the imputed loan amount is taken into income as compensation or as a dividend by the borrower in the year that the loan is made. Special rules, described below, apply to gift loans and certain other types of loans. (The required acceleration of income recognition, coupled with the higher interest rates that generally apply to term loans of any duration, will make their use unattractive in most situations.) The amount treated as income to the borrower is treated as OID to the lender, and is taken into income by the lender ratably over the term of the loan, together with any other amount of OID on the loan (determined without reference to Section 7872).

***Exceptions to Upfront Taxation of Imputed Interest on Term Loans.*** Foregone interest on split-dollar term loans payable on the death of an individual, gift term loans (which would be the norm in a private split-dollar transaction) and split-dollar term loans conditioned on the future performance of substantial services by an individual is determined annually, in a manner similar to a demand loan, but using an AFR that is appropriate for the loan's term and that is *determined when the loan is issued* (not annually, as would be the case in a true demand loan). The final regulations clarify this last point. Presumably the exception from the upfront income inclusion for term loans payable on the death of an individual (like the rule subjecting nonequity collateral assignment arrangements to the economic benefit régime) will facilitate split-dollar arrangements that are, in essence, estate planning transactions, rather than deferred compensation arrangements.

With exceptions, the terms of life expectancy loans, gift loans, and loans conditioned on the performance of future services are determined as follows:

- ***Life Expectancy Loans.*** The loan's term in the case of a split-dollar term loan payable on the death of an individual will be the individual's life expectancy determined under the appropriate table in the Section 72 regulations.

- ***Gift Loans.*** The loan's term in the case of a gift loan is the period from the date the loan is made to its stated maturity date.

- ***Loans Conditioned on the Performance of Future Services.*** The term of a split-dollar term loan that is conditioned on the future performance of future services is based on its stated maturity date.

***Effect of OID Rules.*** The original issue discount (OID) rules of Section 1271-1275 of the Code are immensely complicated. However, these rules (which are income tax rules, and not gift tax rules) will, in general, tax interest that is accrued, but unpaid, to the lender in a split-dollar transaction, even though the borrower is not entitled to a deduction for that interest. If unpaid interest is later forgiven, all or part of that interest, to the extend prescribed in the regulations (which in turn depends on whether the loan is a term or demand loan and whether the loan bears adequate stated interest) is treated as transferred to the lender by the borrower on the date the interest is forgiven, and is treated as re-transferred by the lender to the borrower on that date. The amount deemed re-transferred to the borrower is taken into income by the borrower in accordance with the relationship of the parties.

***Other.*** The proposed regulations contain other provisions with respect to split-dollar loans, including provisions for variable interest rate loans, term loans containing unconditional options and contingent payment loans. In general, these rules respecting contingent payments assume that interest rates will apply and payments will be made in a manner that ascribes the lowest possible value to a contingent payment.

## *MATERIAL MODIFICATIONS*

As stated above, the regulations are effective for arrangements entered into after September 17, 2003, and arrangements entered into prior to that date that are "materially modified" after that date. AALU and others urged the government to define "material modification," and otherwise to provide a list of actions that would not constitute material modifications under the new rules. Section 1035 exchanges of policies were of particular concern.

The final regulations provide a "non-exclusive" list of changes that are "non-material modifications," as follows:

- A change solely in the mode of premium payment (for example, a change from monthly to quarterly premiums);
- A change solely in the beneficiary of the life insurance contract, unless the beneficiary is a party to the arrangement;
- A change solely in the interest rate payable under the life insurance contract on a policy loan;
- A change solely necessary to preserve the status of the life insurance contract under section 7702;
- A change solely to the ministerial provisions of the life insurance contract (for example, a change in the address to send payment);
- A change made solely under the terms of any agreement (other than the life insurance contract) that is a part of the split-dollar life insurance arrangement if the change is non-discretionary by the parties and is made pursuant to a binding commitment (whether set forth in the agreement or otherwise) in effect on or before September 17, 2003;
- A change solely in the owner of the life insurance contract as a result of a transaction to which section 381(a) applies and in which substantially all of the former owner's assets are transferred to the new owner of the policy;

- A change to the policy solely if such change is required by a court or a state insurance commissioner as a result of the insolvency of the insurance company that issued the policy; or
- A change solely in the insurance company that administers the policy as a result of an assumption reinsurance transaction between the issuing insurance company and the new insurance company to which the owner and the non-owner were not a party.

A conversion of an existing, pre-January 28, 2002, equity split-dollar life insurance arrangement to a loan pursuant to Section IV, Par. 4 of Notice 2002-8, also will not be considered a "material modification" for purposes of these regulations. We note, however, that Section 1035 exchanges are not included among the "non-material modifications."

The final regulations state that the Commissioner of Internal Revenue, in revenue rulings, notices, and other published guidance, may provide additional guidance with respect to other modifications that are not material.

**CONCLUSION**

The final regulations must be viewed as a major disappointment in that so few of the changes requested by AALU and other members of the life insurance industry and by the legal profession were adopted in the final regulations. However, AALU continues to believe that the legal basis for a number of the approaches adopted in the final regulations, particularly as they conflict with well-established doctrines under Sections 72(e) and 101, may be open to challenge in the courts. In addition, the Treasury may be faced with expressions of substantial disfavor by Congress as the extent of anti-life insurance content reflected in the regulations becomes apparent and is understood by the general public.

The Treasury appears to have made little effort to camouflage the fact that it views split dollar life insurance with disfavor. While the power of the Treasury to issue regulations to give administrable meaning to areas that are not clearly set forth in the Revenue Code is substantial and generally recognized by the courts, it is not free to operate outside the limits of that Code. However, in this set of regulations the Treasury seems to have decided virtually every close and, to some extent, not-so-close question in a manner that undercuts life insurance generally, not merely as applicable to split dollar arrangements. In our judgment, the Treasury has moved sufficiently far in this direction that, in many instances, it has exposed the regulations to successful challenge by taxpayers and, thereby, placed the structure of these regulations in jeopardy. In any event, until and unless there are successful challenges to the regulations, the future use of split dollar life insurance appears to have been negatively impacted in a major way. Query, whether that impact can be carried further by analogy or injudicious future citation to the regulations in a way that demeans other aspects of the tax treatment of life insurance?

In the short term, taxpayers still have time (only until the end of 2003), pursuant to Notice 2002-8, to terminate existing equity arrangements without tax on accumulated equity, or to convert such arrangements to loans. For arrangements that have not yet reached the "cross-over" point - *i.e.,* there is no equity in the contract - it is at least possible that conversion to loan status may be deferred beyond December 31, 2003 without detrimental tax effect. Although it would appear that such a conversion constitutes a material modification and that such a converted arrangement will be subject to the regulations, section III, Par. 3 of Notice 2002-8 indicates "the Service will not challenge reasonable efforts to comply with" the regulations' imputed interest rules. For arrangements not susceptible to one of these options, taxpayers have recourse to the protection of the "no inference" rule that governs (if they wish to employ it) the taxation of arrangements entered into on or before September 17 of this year.

We appreciate that the final regulations have not been public long enough for us to provide a discussion that is anywhere near a definitive analysis. This is true, even given the extended length of this Washington Report. We will doubtless be providing further insights (some developed by us and some by others) over the next few weeks as this subject becomes better understood. To illustrate, the Washington Report immediately following this one is devoted entirely to an aspect of the final regulations -- their application to section 457 -- which is considered, but has not been fully developed, here.

Any AALU member who wishes to obtain a copy of the final regulations (T.D. 9092), Rev. Rul. 2003-105 and/or the Treasury press release may do so through the following means: (1) use hyperlink above next to major reference, (2) log onto the AALU website at *www.aalu.org*, enter the *Members Portal* with your social security number and select *Current Washington Report* for linkage to source material; (we are no longer utilizing the Fax-On-Demand system) or write to AALU, Attention DeLane Jones, 2901 Telestar Court, Falls Church, Virginia 22042-1205, and include a reference to this Washington Report No. 03-95.