MEMORANDUM

TO: Our Advanced Underwriting Advice Clients

FROM: Lawrence Brody
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Bryan Cave LLP

DATE: August 16, 2002

RE: Highlights of and Comments on the Proposed Regulations on Split-Dollar Life Insurance Arrangements

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Effective Date

As expected, the proposed Regulations will apply only to split-dollar life insurance arrangements entered into after the date the Regulations become final, and as was also anticipated, an arrangement entered into before the date of the final Regulations which is "materially modified" (a phrase that is not defined) after that date will be treated as a new arrangement entered into on the date of that modification. The preamble to proposed Regulations requests comments on whether any material modifications should be disregarded in treating a pre-final Regulation arrangement as a new arrangement, including for example, a Section 1035 exchange of the policy (without distinguishing between exchanges that involve increases in face amount and those that don't).[1/]

As also expected, Notice 2002-8 will continue to provide guidance with respect to arrangements entered into before the Regulations are adopted; accordingly, all existing arrangements and any new arrangements entered into before the final Regulations are adopted (assuming, in either case, no material modifications are made after the final Regulations) will continue to be governed by current law (as provided in

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1/ It's possible that a 1035 exchange involving an increase in face amount would be considered a material modification, but one that didn't would not; until the final Regulations are adopted, however, that isn't clear.

Notice 2002-8). However, if they wish, taxpayers can rely on the proposed Regulations for the treatment of any split-dollar arrangement entered into before the date of adoption of the final Regulations, but only if all parties to the split-dollar arrangement treat the arrangement consistently; specifically, parties to an equity split-dollar arrangement can rely on the proposed Regulations only if the value of "all benefits" taken into account by the parties exceeds the value of the economic benefits based on the life insurance protection provided under the arrangement "reflecting the fact that … [an equity] arrangement provides the [insured/owner] with economic benefits that are more valuable than current life insurance protection."

<u>Taxation of Equity Under Section 61</u>

That concept—that equity split-dollar arrangements are intrinsically more valuable to the insured/owner than non-equity arrangements—is relied on in the preamble to the proposed Regulations to require that the employee in an equity split-dollar arrangement include in gross income the value of any interest in the cash value provided to the employee "during a taxable year," presumably on an annual basis (as it increases) during the arrangement.

The preamble to the Regulations indicates that this result is consistent with the conclusion of Revenue Ruling 66-110, which requires the inclusion in current income of all "other benefits" provided under a split-dollar arrangement. The preamble also indicates that this result is consistent with the fact that an employee who has an interest in the cash surrender value of a policy under an equity split-dollar arrangement is in a "better economic position" than an employee who has no such interest in the policy. The preamble distinguishes the employee's rights in an equity split-dollar arrangement from a participant's rights in a standard nonqualified deferred compensation arrangement, since in an equity split-dollar arrangement, the preamble says that the employee is obtaining an interest in a specific asset of the employer (the policy).[2/] Finally, the preamble to the proposed Regulations indicates that the employer's right to have its premiums returned affects only the value of the employee's interest in the arrangement—and therefore the amount of the employee's current income—not whether an interest in the policy equity is an "other benefit."

Despite that, the proposed Regulations themselves reserve the issue of providing guidance on the value of the benefits provided under an equity split-dollar arrangement, as the preamble states: "pending comments … concerning an appropriate valuation methodology and views on whether such a methodology should be adopted as a substantive rule or as a safe-harbor."[3/] The preamble to the proposed Regulations indicates that one potential approach for valuing those benefits might involve subtracting from the current premiums paid by the contract owner the net present value of the amount to be repaid to the owner in the future (apparently, something like the valuation of the benefit provided under a term interest-free loan).[4/]

This result is a major change in the focus of the taxation of policy equity, away from taxing it under Section 83 (as in the equity TAM and both Notices) and to

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2/ Although note that in an endorsement arrangement, the policy and any equity developed would be subject to claims of employer creditors, preventing the employee from being treated as having an interest in the policy or its equity under traditional tax concepts, such as economic benefit or constructive receipt.

3/ The comments which will be made in response to the proposed Regulations on how to measure the annual benefit derived from an interest in policy equity will be interesting, especially those on how to measure an interest in the equity created in variable policies, where policy cash values change every day (and can become negative).

4/ How that concept could reasonably be used to measure future equity in anything other than a whole life policy isn't clear and Notice 2002-8 will (and presumably its concept for taxing equity will apply to pre-final Regulation arrangements.

taxing it under Section 61 and the "other benefit" language of Revenue Ruling 66-110.[5/] Reflecting that change, all of the traditional (economic benefit) split-dollar measurement rules provided under the Regulations are in the form of proposed Regulations under Section 61 (not, as discussed in Notice 2002-8, Section 83). Note that the rules of the 2002 Notice on the timing of the taxation of policy equity—delaying it until policy roll-out, foregoing taxation if there never was a roll-out or forgiving taxation if the arrangement qualified for the Notice's safe harbors—were clearly stated to be interim rules, pending the adoption of further guidance; the proposed Regulations apparently will not continue that approach.[6/]

Economic Benefit Measure

Surprisingly, the proposed Regulations do not appear to deal with the measure of the economic benefit provided under either equity or non-equity split-dollar arrangements, but appear to contemplate separately published guidance on the point—perhaps to be updated periodically, in Internal Revenue Bulletins. Presumably, Table 2001 and the use of alternative term rates as provided in (and limited by) Notice 2002-8 will continue, in the interim, to be used to measure those benefits. The proposed Regulations suggest, however, that further guidance on the measure of the economic benefit will be based on a "uniform term factor" to be provided in future

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5/ This change in focus will have other consequences—for example, taxing the equity under Section 83 could be helpful for employees of tax-exempt employers subject to Section 457, and might have been difficult to "translate" into gift scenarios.

6/ The safe harbors and the "solely" provision of Notice 2002-8 (taxing equity in an arrangement subject to its rules only on termination of the arrangement during the insured's lifetime) should not be effected by the change in concept for taxing equity in the proposed Regulations, since the rules of the proposed Regulations are prospective in nature—applying only to post-final regulation arrangements—and Notice 2002-8 (presumably including its concept for taxing equity) will apply to pre-final Regulation arrangements.

guidance, possibly foreshadowing the elimination of the ability to use alternative term rates;[7/] how that will be coordinated with the apparent grandfathering of the use of these rates for pre-January 28, 2002 arrangements in Notice 2002-8 isn't discussed.

Footnote 1 to the preamble to the proposed Regulations indicates that Notice 2002-8 provided that an employer and employee could continue to use PS 58 rates with respect to split-dollar arrangements entered into before January 28, 2002, to measure the benefit provided "to the employee." That footnote specifically states that taxpayers may not use the PS 58 rates for "reverse" split-dollar insurance arrangements, or split-dollar arrangements outside of the compensatory context (such as private split-dollar arrangements), confirming many commentators' interpretation of this point in the 2002 Notice.

<u>Split-Dollar Defined</u>

For the first time, the proposed regulations attempt a global definition of split-dollar arrangements, providing a general rule that a split-dollar arrangement is one between an owner and a non-owner of a life insurance contract, pursuant to which either party pays all or a part of the premiums and at least one party is entitled to recover all or a portion of those premiums and that recovery is to be made from or is secured by the proceeds of a policy. Loans used to pay premiums that are secured by the policy (premium financing arrangements) are included in this broad definition, although the effect of including premium financing arrangements in that definition isn't clear, unless the parties have a compensatory or gift relationship and the interest rate is less than the AFR. The preamble to the proposed Regulations state that the definition is intended to

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[7/] Note that, as discussed below, once these Regulations are adopted, Rev. Rul. 66-110, which authorizes the use of alternative term rates, will be revoked.

apply broadly and, while perhaps not apparent from the text of the proposed Regulations, the amount recovered by the party paying premiums "need not be determined by reference to the amount of those premiums."[8/]

The proposed Regulations also include within the definition of split-dollar arrangements certain compensatory and corporate-shareholder arrangements, where the beneficiary of the employee's or shareholder's share of the death benefit is someone whom would reasonably be expected to be named by the employee or shareholder, even if those arrangements don't meet the general definition (to include, for instance, such arrangements where the policy isn't used as security—undocumented arrangements).

The Mutually Exclusive Regimes

As expected, the proposed Regulations will provide two mutually exclusive regimes for taxing split-dollar arrangements entered into (or materially modified) after they are finally adopted—either the so-called economic benefit regime (found generally in proposed Regulations under Section 61 of the Code) or the so-called loan regime (found generally in Regulations under Section 7872 of the Code).

As also expected, the proposed Regulations provide guidance on the taxation of both equity and non-equity split-dollar arrangements and will apply (once adopted as final Regulations) for federal income, employment and gift taxes. The proposed Regulations specifically analyze three types of split-dollar arrangements:

8/ This definition is apparently broad enough to apply to reverse split-dollar arrangements; how those arrangements would be treated under the proposed Regulations, isn't, however, clear - it doesn't appear to be a split-dollar loan, nor does it seem to fit the economic benefit regime; perhaps it will be treated under the catch-all category of arrangements governed by general tax principles, depending on the relationship of the parties.

employment-related; corporate-shareholder; and (apparently for the first time outside of private letter rulings) donor/donee.[9/]

Policy Ownership

As anticipated by Notice 2002-8, which regime will apply to an arrangement will be dependent solely on which party owns the policy (with some specific exceptions); accordingly, the proposed Regulations provide detailed guidance on how to determine which party owns the life insurance contract. In general, the person named as owner in the contract is treated as the "owner" for these purposes. If there are true co-owners of a policy (as shown on the policy), then if each holds all of the rights in its undivided interest in the policy, each is essentially treated as owning a separate policy (which would not be treated as subject to a split-dollar arrangement); otherwise the first listed party is the owner.[10/] Under a special rule, any non-equity arrangement involving either employment split-dollar or donor/donee split-dollar, will treat the employer or the donor (as the case may be) as the policy owner for these purposes, regardless of actual policy ownership. Accordingly, employment-related or donor/donee non-equity split-dollar will always be governed by the so-called economic benefit regime.

The loan regime (described below) generally applies when, under a split-dollar arrangement, the non-owner makes a payment directly or indirectly to the owner that a "reasonable person" would expect to be repaid and which is to be made from or secured by a policy, and accordingly, would typically apply to collateral assignment

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9/ Partner/partnership split-dollar and other variations of split-dollar are not specifically discussed, but the Regulations appear to be drafted to include all types of arrangements which meet their broad definition within their guidance.

10/ For shared ownership arrangements, would the order of listing of the owners give the parties a choice of which regime to use?

arrangements. The economic benefit regime—the traditional split-dollar concept regime—(also described below) applies to a split-dollar arrangement that is not a split-dollar loan, and will generally govern the taxation of endorsement arrangements. In addition, a special rule requires the economic benefit regime to apply to an employment-related arrangement if the employee is not the owner (or treated as the owner) of the policy, or a donor/donee arrangement if the donee is not the owner (or treated as the owner) of the policy.[11/]

The preamble to the proposed Regulations recognize that this is a major change to the basic split-dollar concepts, because the proposed Regulations provide substantially different tax consequences, depending exclusively on which party owns (or is treated as owning) the policy.[12/] The preamble also requires all parties to a split-dollar arrangement "to fully and consistently account for all amounts under the arrangement" under either the economic benefit or the loan regime.

Economic Benefit Regime—Endorsement Arrangements

For a split-dollar arrangement taxed under the economic benefit regime, the owner (employer/corporation/donor) will be treated as providing an annual benefit to the non-owner (employee/shareholder/donee) in an amount equal to the "value of the economic benefits" provided under the arrangement. As noted above, the proposed Regulations have largely reserved the issue of how these benefits will be valued. In a non-equity situation, the calculation will be essentially the same as under current law—

11/ It isn't clear what this special rule adds to the general rule, unless it applies to third party (non-employer or non-donor) ownership.

12/ Under Rev. Rul. 64-328, an underlying principle of present law has been that the documentation method used (policy ownership) wasn't relevant in determining the tax consequences of a split-dollar arrangement.

the non-owner's portion of the death benefit will be multiplied by a term factor (presumably Table 2001, until further guidance is provided) to arrive at the value of the benefit. For an equity arrangement, then, as discussed, the proposed Regulations provide that any right in the policy, including an interest in the cash surrender value, "provided" during a year is an "economic benefit" and will be taxed "when provided (again, presumably on a current basis)."

Unlike prior law, under this regime the proposed Regulations provide that any amount received under the life insurance contract subject to the split-dollar arrangement, other than by reason of death of the insured, and provided directly or indirectly to the non-owner, is treated as though paid by the insurer to the owner and then by the owner to non-owner. The owner would be taxed on the amount of the distribution in accordance with the rules of Section 72 and the non-owner would have to take into account the payment treated as received from the owner as compensation, as a dividend, as a gift, or other transfer, depending upon the relationship of the parties. Section 72 would not normally treat a policy loan as a policy distribution. However, the proposed Regulations apply this rule not only to traditionally recognized policy distributions (dividends, withdrawals and surrenders), but also to a new concept, known as a "specified policy loan." Presumably, if loan proceeds received by a non-owner were not received in conjunction with a "specified policy loan," they would not be treated as an "amount received under a life insurance contract" and therefore would not be treated as having been transferred first to the policy owner.

In addressing the "other tax consequences" of a split-dollar arrangement under this regime, the proposed Regulations provide guidance on each party's "investment in the contract" in split-dollar arrangements under Section 72(e). Generally, the proposed Regulations indicate that no amount paid by the non-owner of the policy (and no amount included in the non-owner's gross income as an economic benefit) will be treated as an investment in the contract by the non-owner; on the other hand, any premium paid by the owner is included in the owner's investment in the contract. In addition, the proposed Regulations also indicate that the Section 101 death benefit exclusion from income will not apply to any policy equity received by the non-owner of a policy.[13/]

As the prior split-dollar rulings have held, the proposed Regulations provide that no premium payment and no economic benefit includable in the non-owner's gross income is deductible by the owner (unless the policy is transferred and the policy cash value is includable in the transferee's income). Surprisingly, however, the proposed Regulations take the position that under this regime, any amount paid by a non-owner to the owner for any economic benefit (that is, any contributory amount) will be includable in the owner's gross income.[14/] Accordingly, for the first time, in contributory, employment-related endorsement split-dollar arrangements, the employer will have income as a result of the contribution. That rule is even stated to apply to contributory, endorsement donor/donee split-dollar arrangements; even if this rule were to apply in a donor/donee situation (which would seem hard to justify, since there is no compensatory relationship), if, under general tax rules, the relationship of the parties would otherwise

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[13/] The proposed Regulations do not, however, purport to amend the Section 101 Regulations.

[14/] The combination of a contribution not giving the contributor basis and being includible in the owner's income (apparently even in a gift scenario) changes the economics of contributory arrangements, which are the preferred arrangements in a number of planning scenarios, including corporate-shareholder (especially S Corporation) arrangements and in trust-owned arrangements using Crummey withdrawal powers to qualify gifts to the trust resulting from the arrangement for the annual exclusion.

preclude the recognition of income, such as if the donee were a grantor trust from the point of view of the donor, presumably the income would go unrecognized.[15]

The proposed Regulations indicate that under this regime, a transfer of a life insurance policy, or an undivided interest therein, from the owner to the non-owner occurs only when the non-owner becomes the owner of the contract or that interest. Unless and until ownership of the contract is formally changed, the initial owner will continue to be treated as the owner for all tax purposes. The proposed Regulations also provide that after the transfer of an entire life insurance contract, the transferee will become the owner for federal tax purposes, including for purposes of the proposed Regulations. At the time of the transfer, the transferee has to take into account, for all tax purposes, the excess of the fair market value of the life insurance policy (determined by its cash surrender value plus the value of all other rights under the policy, other than current protection, not reflected in the cash value) over the transferee's basis in the policy.[16] In addition, if such a transfer is subject to Section 83, the fair market value of the policy is determined disregarding any lapse restrictions and the timing of the transferee's income inclusion is determined under the general rules of Section 83 (depending upon vesting).

<u>Loan Regime—Collateral Assignment Arrangements</u>

Under the loan regime, the owner (employee/shareholder/donee) is treated as the borrower and the non-owner (employer/corporation/donor) is treated as the lender

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15 See Revenue Ruling 85-13, 85-1 C.B. 184.

16 This provision is an amendment to Section 83 regulations, and is effective for transfers after the regulations are adopted in final form. It isn't clear what "other rights" are intended to be valued nor how to value them.

under a split-dollar loan. If a payment is made directly or indirectly by the non-owner to the owner, and if the payment is a loan under general principles of federal tax law (or even if it's not, if a reasonable person would expect the payment to be repaid in full to the non-owner) and the repayment is to be made from or secured by either the policy's death benefit or its cash surrender value, then the payment creates a split-dollar loan. The proposed Regulations specifically provide that even if, in the early years of the arrangement, the cash value of the policy is less than the cumulative loans, so long as a reasonable person would expect the payment to be repaid in full, the non-owner's payment creates a split-dollar loan.

If a payment made under a split-dollar loan is non-recourse (as most would be), the proposed Regulations will treat the loan as a loan that provides for contingent payments (increasing the complexity of calculating the tax consequences and testing for the adequacy of interest), unless the parties to the arrangement provide a written representation with respect to the loan that indicates that a reasonable person would expect all payments under the loan will be made.[17/]

With some exceptions, the below-market interest provisions of the proposed Regulations applicable to split-dollar loans are consistent with the general understanding of how Section 7872 operates.[18/] In particular, the proposed Regulations make it clear that if the effect of a split-dollar loan is attributable to the relationship between either the lender or the borrower and a third party (the example given is a split-dollar loan made from an employer to the child of an employee), the below-market split-dollar loan will be

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17/ As an aside, a representation of that kind could be suggested in comments as the basis for allowing parties to a post-final Regulation arrangement to choose which regime under which it will be taxed.

18/ Although the compensation and gift loan de minimus rules apparently will not apply.

structured as two or more successive (back-to-back) below-market loans, each with its own tax (income or gift) consequences. In addition, the proposed Regulations make it clear that a loan repayable at the death of the insured is treated as a term loan, based on the insured's life expectancy (as is true under the temporary Regulations issued under Section 7872).

Unlike the usual below-market loan rules, however, split-dollar term loans payable on the death of an individual, those that are conditioned on the performance of future services, as well as gift split-dollar terms loans are treated as split-dollar term loans for purposes of determining whether the loan provides for a sufficient interest; however, if it does not, the foregone interest is determined on the loan annually, similar to a split-dollar demand loan.[19/] The rate used to determine the amount of foregone interest on such a loan each year is the AFR, based on the term of the loan, rather than the blended annual short-term rate. This is a hybrid system of treating these types of below-market rate loans—using the demand loan rules to determine timing of the income and the term loan rules to determine how to fix the rate.

Transfer Tax Issues

The preamble to the proposed Regulations indicates that the Regulations will apply for gift tax purposes involving "private" split-dollar life insurance arrangements.[20/] As an example, the preamble indicates that if an irrevocable insurance trust is the owner of a policy and a reasonable person would expect that the donor or the donor's estate will recover an amount equal to the donor's premium payments, those premium payments will

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19/ It isn't clear if this rule applies for gift tax purposes or only for income tax purposes.

20/ Interestingly, the proposed Regulations do not purport to amend any provisions of the gift tax regulations.

be treated as loans subject to these rules; if there is no reasonable expectation of repayment, the entire premium would be a gift.

However, if the donor is treated under the proposed Regulations as the owner of the policy (in a non-equity arrangement) and the donor is entitled to recover all or any portion of the premium payments and that recovery is made from or secured by the proceeds of the policy, the donor will be treated as making a gift of the economic benefit amounts to the irrevocable trust—a re-statement the rule described above regarding donor/donee non-equity arrangements. On the other hand, if the donor or the donor's estate is entitled to receive <u>the lesser of</u> the premiums paid or the cash value (an equity arrangement, as presumably one that limited the donor to recover the premiums paid would be), the amount of the donor's gifts to the trust will equal the value of <u>all</u> economic benefits attributable to the trust's entire interest in the contract. These provisions of the proposed Regulations indicate again that any amount paid by a donee to the donor would be includable in the donor's gross income (apparently despite the fact that there is no compensatory relationship). In addition, if the donor is the owner of the contract, any amounts received by the donee under the contract (by withdrawal, distribution, or otherwise) during the arrangement are treated as gifts by the donor to the donee.

Finally, the preamble to the proposed Regulations indicates that the gift tax consequences of a transfer of a policy or an undivided interest in a policy to a "third party" will continue to be determined under established gift tax principles (based on fair market value concepts), notwithstanding who is treated as the owner of the contract under the proposed Regulations, citing Rev. Rul. 81-198.[21/] Similarly, for estate tax purposes, regardless of who is treated as the owner of a life insurance contract under the proposed Regulations, the inclusion of policy proceeds in the insured's gross estate will continue to be determined under Section 2042.

Revocation of Prior Rulings

Once the proposed Regulations become final, the income tax provisions of the basic rulings on split-dollar will become obsolete[22/]; however, taxpayers entering into split-dollar arrangements on or before the date of publication of the final regulations can continue to rely on those rulings, to the extent described in Notice 2002-8. Again, the proposed Regulations do not appear to effect the rules of the prior Notices for arrangements entered into before the Regulations become final, and, as noted above, the measure of the economic benefit will continue to be determined under them even thereafter (pending the issuance of further guidance).

Comments Requested

Comments are requested on the proposed Regulations, which are due by October 9, 2002; a public hearing has been scheduled for October 23, 2002. Given that timing and the proposed Regulation's reservation of how to tax the increases in cash value in an equity arrangement (discussed above) and other similarly controversial provisions of the proposed Regulations which are likely to result in numerous comments

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21/ On the other hand, for transfers of the policy or an undivided interest in it to the non-owner, (changing a non-equity to an equity arrangement, for example), the policy cash value, as determined under the proposed Regulations, will be the measure of the gift.

22/ Note again the possible effect of the revocation of Rev. Rul. 66-110 on the use of alternative term rates thereafter.

and presentations at the scheduled hearings, it seems unlikely final Regulations could be adopted this year.