MEMORANDUM

TO: Our Advanced Underwriting Advice Clients

FROM: Lawrence Brody
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Bryan Cave LLP

DATE: July 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" 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.

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) continue to be governed by current law. 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 "reflecting the fact that such an arrangement provides the [insured/owner] with economic benefits that are more valuable than current life insurance protection."

Taxation of Equity Under Section 61

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 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 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 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, they indicate that the employee is obtaining an interest in a specific asset of the employer (the policy). 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 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." The preamble to the 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).

This result appears to be 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 toward taxing it under Section 61 and the "other benefit" language of Revenue Ruling 66-110. As a part of 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 Section 83). Note that the rules of the two Notices on the timing of the taxation of policy equity—delaying it until policy roll-out or foregoing taxation if there never was a roll-out—were clearly stated to be interim rules, pending the adoption of further guidance; the proposed Regulations apparently will not continue that approach.[1/]

Economic Benefit Measure

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. 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 that further guidance on the measure of the economic benefit will be based on a "uniform term factor" to be provided in future guidance, possibly foreshadowing the elimination of alternative term rates.

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.

[1/] 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).

Split-Dollar Defined

For the first time, the 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; 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 related in a compensatory or gift context. The preamble to the Regulations state that the definition is intended to apply broadly and, while perhaps not apparent from the text of the Regulations, the amount recovered by the party paying premiums "need not be determined by reference to the amount of those premiums." The Regulations also include within the definition of split-dollar arrangements certain compensatory and corporate-shareholder arrangements, even if they don't meet the general definition.

Mutually Exclusive Regimes

As expected, the proposed Regulations will provide two mutually exclusive regimes for taxing split-dollar arrangements entered into 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: employment-related; corporate-shareholder; and (apparently for the first time outside of private letter rulings) donor/donee.[2/]

Policy Ownership

As anticipated by Notice 2002-8, which regime applies is dependent solely on which party owns the policy (with some specific exceptions); accordingly, the 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 likely not be subject to a split-dollar arrangement); otherwise the first listed party is the owner. Under 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 be governed by the so-called economic benefit regime.

The loan regime 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 arrangements. The economic benefit regime (the traditional split-dollar concept regime) applies to a split-

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2/ 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 split-dollar arrangements within their guidance.

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 of the policy, or a donor/donee arrangement if the donee is not the owner of the policy.

The preamble to the Regulations recognize that this is a major change to the basic split-dollar concepts, because the Regulations will provide substantially different tax consequences, depending exclusively on which party owns (or is treated as owning) a contract. 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

For a split-dollar arrangement taxed under the economic benefit regime, the owner will be treated as providing an annual benefit to the non-owner in an amount equal to the "value of the economic benefits." As noted above, the Service has largely reserved the issue of how these benefits will be valued. In a non-equity situation, the calculation will be essentially the same as current law—the non-owner's portion of the death benefit will be multiplied by a term factor to arrive at the value of the benefit. For an equity arrangement, then, as discussed, the 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."

Unlike prior law, 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 as compensation, as a dividend, as a gift, or another transfer, depending upon the relationship of the parties. The Regulations indicate that this provision is to be broadly interpreted and apply it to a new concept, known as a "specified policy loan," indicating perhaps (as would be supported by the preamble) that if loan proceeds received by a non-owner were not received in conjunction with a "specified policy loan," they would not be treated as having been transferred first to the policy owner.

In addressing the "other tax consequences" of a split-dollar arrangement, 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.

As the prior rulings have held, 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 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. Accordingly, for the first time, in an employment-related split-dollar arrangement, the employer will have income in a contributory arrangement. How that general rule will work in donor/donee split-dollar isn't discussed in the proposed Regulations; even if this general rule were to apply in a donor/donee situation (which would seem unlikely, since there is no compensatory relationship), if the donee were a grantor trust from the point of view of the donor, presumably the income would go unrecognized under Revenue Ruling 85-13. Assuming the proposed Regulations apply to reverse split-dollar arrangements (which is not entirely clear given that the proposed Regulations contemplate a return of premiums to one party, which doesn't occur in a reverse split-dollar arrangement), this provision makes such an arrangement much less attractive, at least in the employer/employee context.

The proposed Regulations indicate that a transfer of a life insurance policy, or an undivided interest therein, from the owner occurs only on the date that 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. At the time of the transfer, there has be taken into account, for all tax purposes, the excess of the fair market value of the life insurance policy (determined by its cash surrender value) over the transferee's basis in the policy. 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). The 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.

Loan Regime

Under the loan regime, the owner is treated as the borrower and the non-owner is treated as the lender of 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 is a split-dollar loan. The 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 is a split-dollar loan. If a payment 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 the tax consequences), 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.[3/]

With some exceptions, the below-market interest provisions of the proposed Regulations are consistent with the general understanding of how Section 7872 operates. 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 structured as two or more

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3/ 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 it will be taxed under.

successive below-market loans. 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. The rate used to determine the amount of foregone interest each year is the AFR, based on the term of the loan, rather than the blended annual short-term rate.

Transfer Tax Issues

The proposed Regulations indicate that they will apply for gift tax purposes involving "private" split-dollar life insurance arrangements. As an example, 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 (an equity arrangement), those premium payments will be treated as loans subject to these rules. 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 benefits 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 the lesser of 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 all 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 existence of a compensatory relationship). In addition, if the donor is the owner of the contract, any amounts received by the donee under the contract during the arrangement are treated as gifts by the donor to the donee.

Finally, the proposed Regulations indicate that the gift tax consequences of a transfer of an interest in a contract to a third party will continue to be determined under established gift tax principles, notwithstanding who is treated as the owner of the contract under the proposed Regulations, citing Rev. Rul. 81-198. 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; 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 and presentations at the scheduled hearings, it seems unlikely final Regulations could be adopted this year.