AALU's Washington Report

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AALU Bulletin No. 02-90 July 15, 2002

Subject: **Initial AALU Analysis of Split-Dollar Proposed Regulations**

Prior AALU Washington Reports: 02-84; *02-1; 01-9; 96-9*

MDRT Information Retrieval Index Nos.: *2500.00; 6800.00; 7400.021*

Last week the Treasury and the Internal Revenue Service released the proposed regulations on split-dollar life insurance arrangements. (See our Bulletin No. 02-84.) The regulations adopt the basic approach of Notice 2002-8 (see our Bulletin No. 02-1) but with a number of adjustments and additions.

In general, where the employer (or donor in a private split-dollar arrangement) owns the insurance contract, the employee (or donee) will be taxable annually on the value of life insurance protection provided to him or her either as compensation or as a gift. The value of the employee's equity in the contract will also be taxable annually (not just on "rollout"), but no definitive measure of the value of the equity is provided in the regulations. Lastly, transfers of the entire contract (or an undivided interest therein) from one party to another will be taxed to the recipient at the time of transfer.

If the employee (or donee) owns the contract, the transaction will be treated as a loan and deemed transfers of interest will be taxable to the employee (or donee) under Internal Revenue Code Sections 7872 (below market interest rate loans) and/or 1271 - 1275 (the "OID" rules).

Significantly, the regulations are prospective, and will take effect after the date of publication of final regulations. This date will be no earlier, and probably considerably later, than October 23, 2002, when a hearing will be held by the government on the proposed regulations. In the meantime, taxpayers can rely on Notice 2002-8, including the grandfathering protection set forth in that Notice.

While the proposed regulations answer a number of questions (unfortunately, some negatively) they also leave a number unanswered, notably with respect to (i) the valuation of the economic benefit referable, as characterized by the regulations, to the equity portion of a life insurance contract, and (ii) the effect of a modification of an existing split-dollar arrangement, such as by a Section 1035 exchange.

The proposed regulations effectively will revoke Revenue Rulings 64-328 and 66-110 with respect to split-dollar arrangements entered into after the date of publication of final regulations. These rulings have governed the taxation of split-dollar arrangements for over 35 years, but, in the Revenue Service's view as expressed in Notices 2001-10 (*see* our Bulletin No. 01-09) and 2002-8, have failed to account for (and tax) the equity aspects of split-dollar arrangements in those cases where the employer (or donor in the case of a private split-dollar arrangement) reserves the right to recover the ***lesser*** of its premium payments or the cash surrender value of the life insurance policy that is the subject of the arrangement.

The regulations provide guidance on the income, employment and gift (but not estate) tax treatments of split-dollar life insurance arrangements of both the equity and nonequity types. The estate tax treatment of split-dollar life insurance arrangements will continue to be determined under the principles of Section 2042 of the Revenue Code.

The guidance may be generally divided into three parts: (i) the definition of a split-dollar life insurance arrangement; (ii) the division, on the basis of formal policy ownership, of such arrangements into "economic benefit" and "loan" segments; and (iii) the tax consequences flowing from the division.

SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENT

Under Revenue Rulings 64-328 and 66-110 split-dollar arrangements are viewed as a form of contractual agreement between an employer and employee to "join in the purchase of a life insurance contract" for which the premiums and the policy benefits are allocated between the employer and employee. The employee receives current life insurance protection and is taxed on the economic value of that protection to the extent that it exceeds the employee's share (if any) of the premium payments.

Although Rev. Rul. 64-328 describes 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 is the same under either form.

Under the proposed regulations, 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 life insurance contract. However, in the context of employer/employee split-dollar and corporation/shareholder split-dollar, the arrangement will be 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 regulations. They also presumably cover "reverse" split-dollar arrangements, although, in a footnote to the proposed regulations' preamble, the Revenue Service states that the P.S. 58 rates may not be used for such non-compensatory arrangements (such as private reverse split-dollar) entered into prior to January 28, 2002, (thus clarifying one of the unanswered questions left over from Notice 2002-8).

However, 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 will be taxable to the recipient under the general rules of Section 61 of the Code, or, in a non-compensatory context, as a gift. The new rules also will apply to situations where the policy is owned jointly. (*See* below for further development of joint ownership rules.)

OWNER AND NONOWNER DEFINED

Notice 2001-10 offered the taxpayer 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) under section 83 (the approach originally adopted in TAM 9604001, discussed in our Bulletin No. 96-9).

Notice 2002-8 and the proposed regulations, in contrast, mandate that 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 will be 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 will be treated as loans subject to the rules of Section 7872 (and the OID provisions).

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 will be treated as the owner of the contract. (*Query* whether naming the employer in an equity split-dollar plan as the first owner on the contract, but limiting its interest to bare legal title, while reserving all other incidents of ownership to the second owner - the employee's life insurance trust - would permit the use of the economic benefit regime in majority shareholder equity split-dollar arrangements?)

Exceptions. Notwithstanding the formal designation of ownership, the employer in an employer/employee arrangement and the donor in a private split-dollar arrangement will be 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.

ECONOMIC BENEFIT PLANS

Where the employer or donor is the owner of the contract, the following results 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) will be taxable - as compensation, dividend or gift, as the case may be - on an annual basis. The value of current life insurance protection will be measured by reference to a premium factor (currently Table 2001) that will change from time to time in accordance with published guidance. The proposed regulations say nothing about the ability to continue to value the cost of insurance protection by reference to the insurer’s lower term insurance rates, although grandfathering under existing plans would not appear to be affected. That grandfathering permits, as set forth in Notice 2002-8, use of the insurer's lower term rates under certain circumstances for arrangements entered into before the effective date of the final regulations.

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 will be required to take into income (or the donor will be required to report as a gift) the value of the current life insurance protection, as described above respecting non-equity arrangements, ***and*** the amount of the annual increase in the value of his or her interest in the policy's equity. This increase must be taken into account on a current basis, and not just upon “rollout” of the policy. The treatment of the increase is a significant change from details previously set forth in Notices 2001-10 and 2002-8, but cannot be deemed to be totally unexpected given the broad "economic benefit" language used in Notice 2002-8.

The measure of the value of annual increases in the equity of the policy is not defined in the regulations, and the Revenue Service has asked for suggestions on how to compute this amount each year. It offers, as a possibility, the difference in the cash surrender value's annual growth over the present value of the employer/donor’s right to repayment of that amount on termination of the arrangement.

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 distributed directly to the owner (employer, corporation or donor) and transferred to the nonowner. This approach as applied to withdrawals and dividends could be reasonably anticipated. The treatment of policy loans comes as somewhat of a surprise, particularly since most, perhaps all, split-dollar arrangements do not involve MECs.

The proposed regulations posit a constructive distribution to the owner (reportable under the rules of Section 72 of the Code) and a subsequent transfer of the amount to the nonowner as compensation, dividend or gift as the case may be. However, the amount of compensation, dividend or gift reportable by the nonowner will be reduced by the amount previously taken into taxable income by the nonowner as economic benefit or paid by the nonowner for the economic benefit. There can be no reduction however to reflect the term value taken into income by the nonowner or paid for by the nonowner. In effect, there is no offsetting credit for the term value charged to, or paid for by, the nonowner.

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 will in part be 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 will be taxable, under Section 83 of the Code, 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, will be able to deduct the amount included in income by the employee as a result of the transfer of the contract to the employee.

Contributory Arrangements. The proposed regulations include a new - and highly questionable - rule to the effect that any payment for life insurance protection made by the nonowner of a contract will be treated as income to the policy owner. This will be the case even in a private split-dollar arrangement, where any contribution by the donee will be taxable - ***as income*** - to the donor, a rule that would appear to make little sense.

Death Benefits. 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 of the Code to the extent attributable to amounts previously paid or taken into account for tax purposes by the nonowner for life insurance protection. This would seem to remove the protection of Section 101 from any amount distributed at death which represents the equity piece of the cash surrender value to the extent that such amount is in excess of the nonowner's cost for that amount.

In addition, 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. (We note, however, that the repayment of a loan usually does not result in tax consequences to the lender, unless the repayment includes accrued interest not previously taxed.) This provision appears to be an attempt to re-write Section 101 and the regulations thereunder without actually doing so - the regulations under Section 101 are not explicitly revised.

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 will be treated as a series of loans to the owner - *i.e.*, each premium payment will be a separate loan. Under this régime, such loans will be 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 will be 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) the Section 7872 rules will apply whether or not the $10,000 threshold is exceeded (as it almost certainly will be in most cases in any event).

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 structured, 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 will be 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 will be determined in accordance with the relationship of the parties.

Nonrecourse Loans/Written Representation. Where, as is typical, a split-dollar loan is nonrecourse to the borrower, the payment will be 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 (i) must provide for adequate stated interest, and (ii) 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.

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 will be tested for adequate stated interest under Section 7872. A split-dollar demand loan will be 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 2002 is 2.78%

If a split-dollar demand loan does not have adequate stated interest, the foregone interest will be 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 will be 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 will be 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 July 2002 are 2.84%, 4.6%, and 5.69%, 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. (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 will be 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 will be 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.

- ***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. If the individual outlives his or her life expectancy, the split-dollar term loan is treated as retired and reissued on that date, using the AFR on the day the loan was originally made as the new "test rate" for determining adequate stated interest. 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) is intended to facilitate split-dollar arrangements that are, in essence, estate planning transactions, rather than deferred compensation arrangements.

- ***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. The proposed regulations, however, limit the application of the demand loan rules to gift loans to the Federal income tax consequences of the loan. The gift tax consequences are determined in accordance with the rules relating to term loans. These rules normally would require the difference between the face amount of the loan and the imputed loan amount to be taken into account as a gift to the donee in the year the loan is made. [*See* Code Sections 7872(d)(2) and (b)(1).] The regulations are unclear, however, concerning whether a gift loan that is payable on the death of an individual is subject to the gift loan rules (which may result in an upfront gift) or the rules, summarized above, applicable to life expectancy loans. However, the preamble to the proposed regulations suggests that there will always be an immediate gift in the case of a below-market rate gift term loan, regardless of whether the term is measured by life expectancy.

- ***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. If there is not a stated maturity date, the term is 7 years. As in the life expectancy situation, if the term of the loan extends beyond either the stated or deemed maturity date, the loan is treated as retired and reissued on that date for the loan's adjusted issue price on that date.

Effect of OID Rules. The original issue discount (OID) rules of Section 1271-1275 of the Code are immensely complicated and clearly will require further study. However, these rules (which are income tax rules, and not gift tax rules) would, in general, appear to 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.

MODIFICATIONS

Although, as stated above, the regulations will not be effective until the date that they are published as final regulations, an arrangement which is entered into prior to that date and is materially modified after that date will be treated as a new arrangement entered into on the date of the material modification. Comments are requested concerning whether a material modification should be disregarded in determining whether an arrangement should be treated as a new arrangement for purposes of the effective date rule, and particularly whether a Section 1035 exchange of policies should be viewed as a new arrangement.

CONCLUSION

The proposed regulations, as issued, are not radically different from what was outlined in Notice 2002-8. However, given the number of negative changes and amendments in the "going forward" rules, as contrasted to the approach of Notice 2002-8, they appear to be designed to restrict the use of split-dollar in many contexts. These restrictions are particularly applicable to the use of split dollar as a retirement planning vehicle. For example, the regulations tax the full value of any lifetime transfers from the policy on a current basis under either the economic benefit or loan régime. The restrictions on the use of the technique in a purely estate-planning context seems to be somewhat less burdensome, especially when dealing with a non-contributory non-equity arrangement.

On balance, the proposed regulations present a series of challenges which AALU expects fully to meet. Counsel will be working closely with AALU's split-dollar committee towards discharging the multiple goals of:

(i) convincing the Treasury and the Internal Revenue Service to improve the proposed regulations before they are finalized so that they will better respond to taxpayers' legitimate needs;

(ii) developing split-dollar marketing techniques that, in light of the new regulations, can be used to the best advantage of the AALU membership and its clientele; and

(iii) structuring strategies to assist AALU members in responding appropriately to marketing needs during the interim period prior to the finalization of the regulations.

Counsel and the committee have been instructed to respond promptly and aggressively.

From a broader perspective, we find ourselves in a situation where there is an almost never-ending stream of legislative developments as life insurance gets swept up in post Enron Congressional activity. In addition, we are required to be ever vigilant with respect to the estate tax repeal proposals that, in the judgment of AALU, are simply ill advised and are misleading to the extent they promise an estate tax free world that, as a practical matter, they will not be able permanently to deliver. Finally, there is the stream of less radical, but nevertheless important, issues that arise out of the federal judicial and administrative systems and that need constant attention on behalf of AALU members. AALU is committed to responding to all of those problems, without in any way lessening its efforts with respect to split-dollar life insurance and the issues raised by the new regulations.

We welcome the comments, suggestions and questions of members so that we may be responsive to your real needs with respect to this subject. We will be keeping you informed of the split-dollar committee's progress in general and particularly as respects the development of our response to the Treasury and the Revenue Service. The next few months for AALU regarding split dollar will be extremely active.

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