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Summary of Proposed Split-Dollar Regulations

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On July 3, 2002, the Internal Revenue Service published proposed regulations governing the taxation of split-dollar arrangements (the "proposed regulations"). At the outset, it is important to note that **by their own provisions the proposed regulations apply only to split-dollar arrangements entered into after the date the regulations are published in the Federal Register as final regulations**. Taxpayers may continue to rely upon the provisions of IRS Notice 2002-8 (the "Notice") for guidance in the tax treatment of split-dollar arrangements or may rely upon the provisions of the proposed regulations; however, taxpayers may rely upon the provisions of the proposed regulations with respect to equity endorsement split-dollar arrangements only if the value of economic benefits determined under the proposed regulations is greater than those produced under the Notice.

The proposed regulations were promulgated under IRC §§61, 83, 301, 1402, and 7872, and change the way split-dollar is treated by the Service in several fundamental ways. A careful and complete interpretation of the changes and their full consequences will take time and discussion within the community. This memorandum is an initial outline and summary of the proposed regulations; when we have had the benefit of more time and discussion of their provisions, we will follow up with a more extensive analysis of the consequences we feel the proposed regulations have on existing and future split-dollar arrangements.

The preamble to the proposed regulations provides that the proposed regulations apply to split-dollar arrangements in employer/employee, corporation/shareholder, and donor/donee scenarios. In other words, the regulations clearly apply to private split dollar arrangements in addition to those arising from employment arrangements. In addition, IRS Notice 2002-8 appeared to have limited the use of P.S. 58 rates to measure the economic benefit of the employee in arrangements that affirmatively required its use. The preamble to the proposed regulations repeats this limitation, stating this time that P.S. 58 may not be used in private, non-compensatory arrangements. Simply put, the proposed regulations prevent the continued use of P.S. 58 rates in reverse split dollar arrangements.

As provided by IRS Notice 2002-8, the proposed regulations treat all split-dollar arrangements under one of two mutually exclusive regimes, *viz*., the economic benefit regime or the loan regime. The economic benefit regime applies to arrangements where the owner of the contract provides economic benefits to the non-owner of the contract. Likewise, the economic benefit regime will apply to (i) employer/employee arrangements where the employee is not the owner of the contract; and (ii) donor/donee arrangements where the donee is not the owner of the contract. In short, the economic benefit regime generally applies to what we have traditionally referred to as endorsement split-dollar[1]. The loan regime applies to all other arrangements.

DETERMINATION OF THE "OWNER OF THE CONTRACT"

The proposed regulations provide, for the first time, that the party considered the "owner" of the contract for tax purposes may not be the owner of record of the contract. Proposed additions to IRS Reg. §1.61-22 provide the general rule that the owner of record is the owner for tax purposes and that where two or more owners are listed, each with all incidents of ownership of an undivided interest in the contract, each such owner is the owner for tax purposes. If two or more owners are listed and each does not have all incidents of ownership of an undivided interest in the contract, then the first owner listed is the owner for tax purposes. This rule will impact many so-called shared ownership arrangements whereby two nominal owners of a policy own disproportionate rights under the contract. In essence, the proposed regulations seem to have the impact of treating shared ownership arrangements the same as split dollar arrangements.

Proposed regulation §1.61-22(c)(1)(ii) provides the special rule that (i) the employer is treated as the owner of the contract, regardless of the owner of record, if, at all times, the only economic benefits provided to the employee is current life insurance protection (*e.g.*, non-equity collateral assignment split-dollar arrangements), and (ii) the donor is treated as the owner of the contract, again regardless of the owner of record, if, at all times the only economic benefits provided to the donee is current life insurance protection (*e.g.*, non-equity collateral assignment private split-dollar arrangements). Of course, what the special rule describes is so-called "traditional" split-dollar, under which arrangements the premium provider is entitled to the return of the greater of premiums paid or cash surrender value, leaving to the owner of record only the pure life insurance protection. Because equity collateral assignment split-dollar arrangements give to the employee (or the donee) more than just current life insurance protection (as do arrangements "in between" pure equity collateral assignment and traditional split-dollar), these arrangements are not captured by the language of this special rule. Thus, in traditional split-dollar arrangements, for tax purposes, the employer (or the donor) will be considered the owner of the contract, even though the employee (or the donee) is the owner of record of the policy.

DEFINITION OF SPLIT-DOLLAR ARRANGEMENT

For economic benefit regime purposes, IRS Reg. §1.61-22(b)(1) defines "split-dollar arrangement" for tax purposes. The general rule set forth thereunder defines split-dollar as any arrangement between an owner of a life insurance contract and a non-owner under which (i) either party pays, directly or indirectly, all or part of the premium (including premium payments financed by loans secured by the contract), (ii) one of the premium-paying parties is entitled to recover, conditionally or unconditionally, all or part of the premiums paid, and this recovery is to be made from, or secured by, proceeds from the contract, and (iii) the arrangement is not part of an IRC §79 group-term plan.

This proposed regulation expands the general rule with a special rule that includes in the definition of split-dollar arrangement (i) any (non-group-term) employer/employee arrangement where the employer pays at least part of the premium of a contract the beneficiary of which is either designated by the employee (or someone the employee would designate), and likewise (ii) any corporation/shareholder arrangement where the corporation pays at least part of the premium of a contract the beneficiary of which is either designated by the shareholder (or someone the shareholder would designate).

Of course, the definition of split-dollar arrangement now appears to include premium-financed arrangements and split-ownership arrangements, potentially changing the expected tax treatment of such arrangements fundamentally. It appears that conventional compensatory bonus arrangements (such as REBA, §162 bonus arrangements, etc.) and nonqualified deferred compensation arrangements informally funded with life insurance are not captured by the new definition of split-dollar (of course, unless such arrangements expressly include a split-dollar component).

For loan regime purposes, IRS Reg. §1.7872-15 imports the definitions of "split-dollar arrangement" set forth above from IRS Reg. §1.61-22.

ECONOMIC BENEFIT REGIME

As we have already pointed out, under the proposed regulations only those arrangements traditionally described as endorsement split-dollar (where the owner of the contract provides economic benefits to the non-owner) and non-equity collateral assignment split-dollar are taxed under the economic benefit regime. For example, in an employer/employee scenario, if the employer is the owner of the contract, and the employee has the right to name the beneficiary of the death benefit, the employer would be treated as providing economic benefits of the contract to the employee. Likewise, in a private, donor/donee scenario, if the grantor/donor is the owner of the contract, and the ILIT/donee has the right to name the beneficiary, the grantor/donor would also be treated as providing economic benefits to the ILIT/donee. The proposed regulations provide that the nature of the economic benefits so transferred depend on the relationship between the owner and the non-owner (*e.g.*, employer/employee, corporation/shareholder, donor/donee). This aspect of the proposed regulations is significant in that it appears to signal the IRS' intent to treat the benefits provided to a shareholder under an economic benefit regime arrangement as a dividend – at least in certain situations.

Non-Equity Endorsement Split-Dollar. IRS Reg. §1.61-22(d)(2) addresses non-equity ("traditional") endorsement split-dollar arrangements. For example, in an employer/employee scenario, the employer owns the contract, and the only economic benefit provided to the employee is the right to name the beneficiary of the death benefit of the contract, minus the cash surrender value at the time of death. This section provides that the amount of the current life insurance protection provided to the non-owner is the excess of the death benefit over the amount payable to the owner under the arrangement. The preamble to the proposed regulations provides an example:

> *[A]ssume that employer R is the owner of a $1,000,000 life insurance contract that is part of a split-dollar life insurance arrangement between R and employee E. Under the arrangement, R pays all of the $10,000 annual premiums and is entitled to receive the greater of its premiums or the cash surrender value of the contract when the arrangement terminates or E dies. Assume that through year 10 of the arrangement R has paid $100,000 of premiums and that in year 10 the cost of term insurance for E is $1.00 for $1,000 of insurance and the cash surrender value of the contract is $200,000. Under §1.61-22, in year 10, E must include in compensation income $800 ($1,000,000 - $200,000, or $800,000 payable to R, multiplied by .001 (E's premium rate factor)). If, however, E paid $300 of the premium, E would include $500 in compensation income.*

The "premium rate factor" referred to in the example, that reflects the value of the current life insurance protection provided, will replace the Table 2001 valuations introduced by IRS Notice 2001-10 and reaffirmed by IRS Notice 2002-8. The proposed regulations look to IRS Reg. 601.601(d)(2)(ii) for the Service's authority to promulgate these rate factors; at present it has not done so. The failure of the proposed regulations to introduce a new rate table or adopt Table 2001 is surprising. The "fairness" of Table 2001 continues to be challenged by many in the industry who feel that the costs of term insurance reflected therein is too high. Others, specifically those who wish to utilize the Table 2001 rates in "reverse" split dollar arrangements, have contended that the Table 2001 rates are too low. In any event, introduction of the appropriate rate table will have to wait for another day. But, what appears relatively clear is that the final regulations will no longer allow the measurement of the economic benefit based upon the insurance company's cost of term insurance. It should be noted that the Notice allows the use of Table 2001 rates, or the insurer's annual renewal term rates if lower, until the effective date of *"future guidance"*. Because the effective date of the proposed regulations is the date that they are published in the Federal Register as final regulations, it would appear that these provisions of the Notice remain unchanged. If so, split-dollar arrangements entered into today may still rely on these provisions.

Equity Endorsement Split-Dollar. Subsection (d)(3) likewise addresses the tax treatment of equity split-dollar arrangements under the economic benefit regime. Remember, if we are under the economic benefit regime, then we are necessarily looking only at endorsement split dollar (where the owner provides economic benefits to the non-owner); thus, (d)(3) provides tax treatment of equity, endorsement split dollar, *e.g.*, where the employer owns the policy and endorses to the employee the right to name the beneficiary of the policy *plus* some interest in the cash surrender value in the policy.

The subsection states plainly that any right in, or benefit of, a life insurance contract (including, but not limited to, an interest in the cash surrender value) provided to a non-owner under a split-dollar arrangement is an economic benefit for split-dollar taxation purposes. However, this subsection (like that addressing non-equity split dollar) does not contain provisions for valuing the economic benefit. Subsection (d)(3)(ii) is reserved for future provisions concerning the valuation of economic benefit of equity endorsement split-dollar and the language of the preamble describing this subsection invites comments on the appropriate methodology. While the preamble seems to make clear its intention that any such right or benefit will be taxable, the preamble reserves to a later date the decision whether the taxation will be accelerated, annual, or otherwise.

Taxation of Amounts Received From the Policy. With respect to split-dollar arrangements under the economic benefit regime, the proposed regulations provide for the taxation of value taken from the contract and made available to the non-owner (including, but not limited to, policy dividends, withdrawals from policy values, and policy loan[2]). Once again, remember that under the economic benefit regime, we are talking only about endorsement split-dollar. Thus, these provisions apply, for example, in an employer/employee scenario, to values taken from a policy owned by the employer that are paid, directly or otherwise, to the employee (or the employee's spouse, child, or ILIT). Likewise, the provisions apply, in a donor/donee scenario (i.e., private split dollar arrangements), to values taken from a policy owned by a grantor/donee that are paid to the beneficiary ILIT/donee. IRS Reg. §1.61-22(e) provides that such values are treated as received by the owner of the contract and then transferred to the non-owner of the contract, and are to be accounted for accordingly, whether as compensation, a dividend, or a gift.

The amount that must be accounted for as received by the owner is quite straightforward: it is the amount of the value received from the policy. However, the amount that the owner and non-owner must take into account as being transferred from the owner to the non-owner is less straightforward. If the arrangement is a non-equity arrangement, it simply is generally the amount received. In an equity endorsement split-dollar arrangement, however, it is (take a deep breath here) the amount received minus (i) the economic benefit already accounted for by the non-owner, reduced by any economic benefit that would have been taken *if the arrangement were a non-equity arrangement*, plus (ii) any consideration paid for such economic benefits, again, reduced by any consideration that would have been paid *if the arrangement were a non-equity arrangement*. As Shakespeare put it, all is as clear as the summer sun. The proposed regulations offer the following example, involving an employer/employee scenario and a withdrawal from policy values received by the employee.

> *In year 1, R purchases a life insurance contract on the life of E. R is named as the policy owner of the contract. R and E enter into an arrangement under which R will pay all the premiums on the life i insurance contract until the termination of the arrangement or E's death. Upon termination of the arrangement or E's death, R is entitled to receive the lesser of the aggregate premiums or the cash surrender value of the contract. The balance of the death benefit will be paid to a beneficiary designated by E. In year 10, E withdraws $100,000 from the cash value of the contract.*
>
> *In year 10, R is treated as receiving a $100,000 distribution from the insurance company. This amount is treated as an amount received by R under the contract and taxed pursuant to §72. This amount reduces R's investment in the contract under §72(e). R is treated as paying the $100,000 to E as cash compensation, and E must include that amount in gross income less any amounts determined under paragraph (e)(3)(ii) of IRS Reg. §1.61-22.*

On the other hand, under the economic benefit regime, death benefits received by a beneficiary that is not the owner are excluded from the beneficiary's (and non-owner's, if different) gross income for income tax purposes to the extent the non-owner either paid for the economic benefit of the life insurance protection or took it into account (*e.g.*, recognized the economic benefit as income).

Transfer of the Policy (or an Undivided Interest in the Policy). The transfer of a policy under the economic benefit regime occurs under the proposed regulations on the date that the non-owner becomes the owner of all rights in the contract. Upon such a transfer, the transferor and transferee must account for and treat as transferred an amount equal to the value of the policy minus the sum of (i) any amount paid by the transferee at the time of the transfer, and (ii) the economic benefit already accounted for by the non-owner, reduced by any economic benefit that would have been taken *if the arrangement were a non-equity arrangement*, plus any consideration paid for such economic benefits, again, reduced by any consideration that would have been paid *if the arrangement were a non-equity arrangement*. Sound familiar?

LOAN REGIME

IRS Reg. §1.7872-15 provides that a split-dollar arrangement will be treated under the loan regime if (i) payment is made, directly or indirectly, by the non-owner to the owner (or directly to the insurance company), (ii) expectation of repayment, with or without interest, to the non-owner is reasonable[3], and (iii) such repayment is to be made from (or secured by) policy values or death benefit. The proposed regulation further provides that if a loan regime split-dollar arrangement is not a below-market loan as defined by IRC §7872 and the regulations below it, it is governed by the general rules for debt instruments and original issue discount. That is to say, a loan that, by its own terms, is not a below market loan as defined by §7872, is *generally* not subject to the provisions of IRC §7872 or the regulations thereunder.[4]

If, however, the split-dollar loan is a below market loan, the loan is recharacterized as a loan bearing interest at the applicable federal rate ("AFR") with imputed transfers consistent with the general provisions of IRC §7872. That is, generally speaking, the amount by which the AFR exceeds the stated interest is deemed to have been transferred from the lender to the borrower and then paid back to the lender as interest income. The timing, amount, and nature of the imputed transfers will depend upon the relationship between the lender and the borrower (at this point familiarly, employer/employee, corporation/shareholder, donor/donee, etc.) and whether the loan is a demand loan or a term loan.[5]

IRS Reg. §1.7872-15(b) defines "split-dollar demand loans" and "split-dollar term loans" consistent with the definitions of demand and term loans under IRC §7872: a "split-dollar demand loan" is a split-dollar loan that is payable in full at any time on the demand of the lender; a "split-dollar term loan" is a split-dollar loan that is not a split-dollar demand loan. Because demand loans may, by definition, be called at any time, the actual term of the loan is not known. Thus, the AFR applied to determine if the split-dollar demand loan is a below market loan is the **blended annual rate** for each year. A split-dollar demand loan is tested each year that it is outstanding to determine whether it is a below-market loan for that year. Also by definition, the term of a split-dollar term loan is fixed. The AFR applied to determine if the split-dollar term loan is a below market loan is the rate appropriate for the fixed term of the loan. The split-dollar term loan is tested only in the year that it is made to determine whether it is a below-market loan.

In the case of private split-dollar term loan, it is generally the case that the loan term will end on the date of the donor's death. The proposed regulations treat such a loan as a demand loan, but rather than valuing foregone interest by the blended annual rate, the parties are entitled to use the AFR (based on annual compounding) appropriate for the loan term (generally life expectancy of the donor determined under §1.72-9) for the month in which the loan is made. For these reasons, private split-dollar loans will generally be attractive only as term loans. Likewise, in an corporate/shareholder scenario, involving a controlling shareholder, the risk of estate inclusion under a demand loan will also generally compel the use of term loans.

Split-Dollar Demand Loans. A split-dollar demand loan is a below-market loan if the stated rate of the loan is lower than the blended annual rate for the year in which the loan is tested. If a split-dollar demand loan is a below-market loan, the foregone interest is deemed to be transferred annually from the lender to the borrower and then retransferred to the lender as interest. The amount of foregone interest is the amount of interest that would have accrued at the AFR on the loan principal for that year, minus the interest actually accrued at the rate stated in the loan for that year. The proposed regulations offer the following example:

(i) On January 1, 2009, Employer X and Individual A enter into a split-dollar life insurance arrangement under which A is named as the policy owner. A is the child of B, an employee of X. On January 1, 2009, X makes a $30,000 premium payment, repayable upon demand without interest. Repayment of the premium payment is fully recourse to A. The payment is a below-market split-dollar demand loan. Assume that the blended annual rate for 2009 is 5 percent, compounded annually.

(ii) Based on the relationships among the parties, the effect of the below-market split-dollar loan from X to A is to transfer value from X to B and then to transfer value from B to A. The below-market split-dollar loan from X to A is restructured as two deemed below-market split-dollar demand loans: a compensation-related below-market split-dollar loan between X and B and a gift below-market split-dollar loan between B and A. Each of the deemed loans has the same terms and conditions as the original loan.

(iii) Under the proposed regulations, the amount of foregone interest deemed paid to B by A in 2009 is $1,500 ([$30,000 x 0.05] – 0).

As already discussed, the nature of such deemed transfers depends on the relationship of the parties. For example, in the employer/employee scenario, where the employer is the lender and the employee is the borrower, the imputed transfer of foregone interest from lender to borrower would be income to the employee/borrower, and the subsequent transfer from the borrower to the lender would be interest income to the employer/lender. On the other hand, in the donor/donee scenario, where the donor is the lender, and the donor's ILIT is the borrower, the imputed transfer of foregone interest from lender to borrower would be a gift from the donor/lender to the donee/borrower, and the retransfer from borrower to lender would be interest income to the donor/lender. Of course, if the donor's ILIT qualifies as a grantor trust, then for income tax purposes the donor and the ILIT are considered the same taxpayer. Consequently, the transfer of interest income from the borrower to the lender would not be taxable.

Split-Dollar Term Loans. A split-dollar term loan is a below-market loan if, on the day the loan is made, the present value of all payment due on the loan, discounted at the AFR for the term of the loan (the "imputed loan amount"), is less than the amount lent. If a split-dollar term loan is a below-market loan, the excess of the imputed loan amount over the amount lent is deemed to be transferred from the lender to the borrower and retransferred to the lender in the year that the loan is made. Split-dollar loans are subject to the provisions of IRC §§1271-1275, governing original issue discount ("OID"); therefore, the issue price of a split-dollar term loan is the amount determined under IRC §1273, minus the amount of the imputed transfer. That is to say, a split-dollar term loan is treated as having original issue discount ("OID") equal to the amount of this imputed transfer, plus any other OID on the loan (deriving from the loan as written[6]. While the timing of the deemed transfers under a split-dollar term loan are accelerated as compared to those under the split-dollar demand loan described above, the *nature* of the deemed transfers (compensation, gift, interest income, etc.) are the same as described above.

An example will illustrate the amount and timing of transfers imputed under such a term loan under IRC §7872:

On June 10, 1984, L lends $45,000 to B, a corporation in which L is a shareholder, for five years in exchange for a $50,000 note bearing interest at a below-market rate. Assume that the present value of all payments that B must make to L is $42,000.

On June 10, 1984, L is treated as transferring $3,000 (the excess of $45,000 (amount loaned) over $42,000 (present value of all payments)). This imputed transfer is treated as a contribution to B's capital by L. An amount equal to the imputed transfer is treated as original issue discount. This original issue discount is in addition to the $5,000 ($50,000, the stated redemption price, less $45,000, the issue price) of original issue discount otherwise determined under IRC §1273. As a result, the loan is treated as having a total of $8,000 of original issue discount.

The acceleration of the benefit under below market split-dollar term loans make them rather unattractive under normal circumstances, of course. For this reason, where a term loan is indicated for a split-dollar arrangement (*e.g.*, corporate/shareholder scenarios involving a controlling shareholder, private split-dollar, etc.), care should be taken to ensure that the split-dollar arrangement at no time can fall within the definition of a below-market split-dollar loan as defined by IRC §7872, and will not fall under the provisions of IRC §7872.

Adjustments for Waived, Cancelled, or Forgiven Interest. If accrued but unpaid interest on a split-dollar loan is waived, cancelled, or forgiven by the lender, the interest will be deemed to have been paid on that date by the borrower to the lender and then subsequently transferred back to the borrower. How much is deemed so transferred depends on whether the loan is a term or demand loan and whether the loan is a below-market loan. The amounts, timing, and nature of the imputed transfers is consistent with the provisions of IRC §7872 already discussed.

SOME UNANSWERED QUESTIONS

After the Notice raised the issue of limited grandfathering of split-dollar arrangements existing on January 28, 2002, many advisors puzzled about the effect of changes to the policy underlying the arrangement, and minor changes to the arrangement itself. For example, would a tax-free exchange under IRC §1035 of a life insurance policy subject to a split-dollar arrangement predating January 28, 2002, destroy the grandfathering of the arrangement even if no substantive changes were made to the arrangement? Likewise, the application of the provisions of the proposed regulations only to arrangements entered into after the date of final regulations raises the same question: what changes, if made to an arrangement existing on the date of final regulations, will cause the provisions of those final regulations to apply? The proposed regulations do not address the question at all.

Also, the proposed regulations contain no provisions relevant to arrangements that are created as non-equity (or equity) and subsequently change to equity (or non-equity). Similarly, they are silent with respect to arrangements that would begin under the economic benefit regime and subsequently switch to the loan regime. Such a change is very attractive in survivorship split-dollar cases where the low economic benefit rates are employed in the early years of joint survivorship, and a change to a loan arrangement is contemplated when the interest charge would be lower than the escalating economic benefit cost (for instance, after the first death). While it appears that a party may roll out of the earlier economic benefit arrangement and, subsequently, enter into a late-start split-dollar loan with respect to the policy, it is not addressed at all in the proposed regulations[7].

BASIS UNDER ECONOMIC BENEFIT REGIME

For the first time, the Service has authoritatively[8] addressed basis issues with respect to split dollar arrangements. The proposed regulations are silent with respect to basis issues when the below-market loan regime applies (i.e., if the arrangement is set up as equity collateral assignment split dollar). This silence is understandable because the owner of the policy (i.e., the borrower) is simply using borrowed funds to purchase an asset (i.e., the policy). Under basic tax rules, amounts used to purchase an asset create basis (and also specifically for a life insurance contract comprise the owner's investment in the contract) for income tax purposes. However, new basis rules will apply when the economic benefit regime applies to a split dollar arrangement. Thus, we now have specific basis rules for traditional endorsement split dollar and non-equity collateral assignment split dollar arrangements (because, as stated above, non-equity collateral assignment arrangements are deemed to be subject to the economic benefit method).

The proposed regulations provide that the non-owner (e.g., an employee or an ILIT) "does not receive any investment in the contract under section 72(e)(6)" with respect to the life insurance policy. For example, this means that in an employment context, the employee receives basis neither for the amount of economic benefit he takes in to income nor for any amounts he actually pays towards policy premiums.[9] Only the employer (as the actual or deemed owner) would be allocated basis in the contract. Upon a transfer of the policy from the employer to the employee, the employee would receive basis. His basis would be equal to the greater of (a) the cash value of the contract or (b) the sum of (i) the amount, if any, the employee paid the employer for the contract upon transfer and (ii) the total amount of economic benefit the employee previously took into consideration (no credit is given, however, for economic benefit representing the term cost of insurance protection the employee included previously in income or paid to the employer).

REVOCATION OF REVENUE RULINGS UPON DATE OF FINAL REGULATIONS

The proposed regulations provide that the following IRS Revenue Rulings will become obsolete concurrent with the publication of final regulations relating to split-dollar life insurance arrangements in the Federal Register: Rev. Rul. 64-328, Rev. Rul. 66-110, Rev. Rul. 78-240, Rev. Rul. 79-50, and Rev. Rul. 81-198. Taxpayers may continue to rely on these revenue rulings to the extent described in the Notice.

We have provided an overview of the proposed regulations. Much of what has been expressed here is consistent with what the Notice promised. In the coming days we will provide further guidance as to what sales and marketing ideas are affected and how and what new sales opportunities are made available by the proposed regulations. As we mentioned with the Notice, now is a perfect time to contact your clients to discuss the affect that the Notice and the proposed regulations will have on their split dollar agreements. Also, over the next few months, you will want to ask each new prospect whether he or she has an existing split dollar arrangement and offer to review it with him or her in light of the Notice and the proposed regulations. As stated above, these are proposed regulations, they will not be effective until they are reviewed, commented upon and published as final regulations in the Federal Register. The Treasury and Service have asked for written comments and will hold a public hearing to discuss the proposed regulations on October 23, 2002. Thus, it is unlikely that we will have final regulations before the end of 2002, and very likely not until some time in early or mid-year 2003.

Now is the time to act. Make your clients aware of this window of opportunity. Split dollar arrangements that are put in place before the final regulations generally will not be subject to the new regulatory framework the final regulations will bring. For instance, clients can still choose whether to use collateral assignment split dollar or endorsement split dollar. This is especially important for private collateral assignment non-equity split dollar arrangements between a donor and a donee (the typical ILIT situation) or between a controlled corporation and an owner/employee. Once the final regulations are issued, clients who wish to avoid below-market loan treatment for private split dollar or in a controlled corporation context will be forced to use endorsement split dollar. Endorsement split dollar arrangements in such cases may have adverse estate tax effects (*i.e.*, total inclusion of the policy proceeds in the donor or controlling shareholder's estate). Clients can still choose to treat collateral assignment split dollar arrangements (whether equity or non-equity) under traditional economic benefit rules or as a below-market loan. It appears that a client who sets up a collateral assignment split dollar arrangement today may continue to take advantage of insurer's lower alternative term rates. Perhaps most important, such a client may also preserve the ability to switch to loan treatment at any time in the future.

For more information on the proposed split dollar regulations, please contact the Advanced Markets Group at (888) 266-7498, option 3.

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1 In addition, as is discussed in the following section, "Determination of the Owner of the Contract", the employer (or the donor) may be deemed the owner of the contract in non-equity collateral assignment split-dollar arrangements. Consequently, because the employee (or the donee) is not the owner of the contract for purposes of the proposed regulations (though each would be the owner in fact), the economic benefit regime will also apply to such arrangements.

2 Only loans that are "specified policy loans" are included in these provisions. Specified policy loans are loans where (i) the proceeds are distributed directly to the non-owner from the insurance company, (ii) the loan is not reasonably expected to be repaid by the non-owner, or (iii) the non-owner's obligation to repay the loan may be satisfied if *either* party repays the loan to the policy.

3 The preamble preemptively dismisses the suggestion that, because cash surrender values in the early years of a collateral assignment equity split-dollar arrangement are much lower than premiums advanced by the non-owner, full repayment of premiums advanced in those early years is not reasonable.

[4] Certain provisions of IRS Reg. §1.7872-15 can apply to loans which are determined not to be below-market loans. For example, §1.7872-15(h), provides that if the lender waives, cancels, or forgives interest on a loan that is not a below-market loan, transfers between the lender and borrower will be deemed to have taken place.

[5] In an employer/employee scenario, the employer will generally be able to wash the interest income with the deduction it is entitled to for the deemed transfer to the employee. The employee, on the other hand, will not have any such offsetting deduction.

[6] Original issue discount, or OID, is governed by the provisions of IRC §§1271-1275. OID can be illustrated by the following example: A 10-year $1,000 par 5% coupon bond is issued at a price of $950. That is, a buyer can obtain the bond for the price of $950, and the bond pays 5% annually on the par amount of $1,000, or $50 a year. After 10 years, the bond matures and the bondholder receives the face amount of $1,000. Because of the original issue discount ($950 instead of $1,000), the bondholder has actually received the equivalent of 5.67% annually on the bond instead of the stated 5%.

[7] Of course, the proposed regulations requirement that certain arrangements to be treated under the economic benefit regime (*e.g.*, endorsement split-dollar) places a limitation of what kinds of loan arrangements may be converted to.

[8] Prior to issuance of the proposed regulations, the only rulings addressing basis issues were in the form of private letter rulings. See PLRs 7916029 and 8310027.

[9] Indeed, any payments up to the amount of the economic benefit actually paid by the employee must be taken into income by the employer and are added to the employer's basis. Presumably, any amounts contributed in excess of the economic benefit amount would be deemed to be below-market loans from the employee to the employer!