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SPLIT DOLLAR PROPOSED REGS 20 FREQUENTLY ASKED QUESTIONS

INTRODUCTION

During the past 18 months, there have been continuing proposed changes to the tax treatment of split dollar arrangements in the form of IRS Notice 2002-8, IRS Notice 2002-59, Proposed Regulations issued in July, 2002 and in May, 2003 (REG-16754-01, supplementing the 2002 Proposed Regulations). Additionally, the Sarbanes-Oxley Act of 2002 (an SEC law) contains a provision that raises the issue as to the legality of collateral assignment split dollar arrangements (treated as loans under the proposed regulations) set up and maintained by publicly-traded corporations.

The purpose of this issue is to cover some frequently asked questions and the "best" available answers during this transitional period. There is much that is not certain at this point – and there has always been disagreement – strong in many cases – about how tax law will be interpreted in this area. So I want to caution you that what you are about to read contains explicit language that minors (or people who don't want to see things that do not follow their own interpretation) – may not want to read. The opinions expressed are mine and not necessarily those of our sponsors.

Before we proceed to the Q&A s, there are three important points that I would like to emphasize:

First, all split dollar plans should be monitored constantly until the Final Regulations are issued and its implications fully understood.

Second, every equity split dollar plan should be reviewed very thoroughly – and very soon. Some arrangements with substantial employee equity should be converted to loans prior to 2004 or terminated. In other cases, they should be retained beyond 2003 but terminated or converted to a loan before significant employee equity develops. Careful and deliberate consideration must be made on a case by case basis, and the appropriate planning action should be taken in a timely manner.

Third, ignorance, complacence, or disregard of the potential problems will lead to dissatisfied and potentially litigious clients. DO NOT WAIT until December to study the issues and develop a game plan and, if appropriate, an exit strategy!

Q1: What is the effective date of the two sets of proposed regulations? Will these regulations apply to existing plans?

A1: **General Rule**: Neither set of proposed regulations apply to **existing** split dollar arrangements nor to any arrangement implemented before the regulations are finalized. Both sets of regulations are to take effect upon the publication of the Final Split Dollar Regulations in the Federal Register.

It appears at this point that the rules of IRS Notice 2002-8 discussed below apply to all existing plans – and will continue to apply to those plans – even after the final split dollar regulations are issued.

Exception: If there is a “material modification” to a pre-final regulation arrangement after issuance of the Final Regulations, that arrangement will be governed by the proposed and final regulations

Q2: What is meant by “material modification”?

A2: The answer is not entirely clear. Certainly, common sense suggests a significant increase in the amount of coverage or substantial expansion of the rights or benefits of the benefited party in the split dollar arrangement would be considered a material modification. But a more definitive explanation must await issuance of Final Regulations.

Q3: How are the costs for current term insurance protection under split-dollar measured?

A3: According to Notice 2002-8, the term cost calculations below would apply to both income and gift tax purposes:

General Rule: Notice 2002-8 allows the continued use of the appropriate table (Table 2001) rates, or, if lower, the insurer's generally available, published, individual, initial issue one-year term rates. [CAVEAT: IRS Notice 2002-59 makes it clear that the use of any technique by any party to under or overstate the value of policy values or benefits in order to distort the income, employment, or gift tax consequences of the arrangement and which does not conform to, and is not permitted by, any published guidance will not be respected!]

Pre-January 28, 2002 Arrangements: The use of the insurer's alternative term rates will continue to be allowed for such arrangements – meaning the use of such rates is permissible assuming they meet the requirements of prior rulings. They will not be subject to the more restrictive rules applied to agreements established on or after January 28, 2002.

January 28, 2002 and Later Arrangements: For periods after December 31, 2003, the alternative term rates for such arrangements established prior to final regulations are required to meet ALL of the following tests:

1. the "generally available, published one year term rate" test (i.e., the "old" test),

2. the "availability of the rates known to term coverage applicants" test, and

3. the "regularly being sold through the carrier's normal distribution channels" test.

Post–Final Regs Arrangements: Both sets of proposed regulations suggest that – instead of alternative term rates – term rates may be measured by "designated or permitted premium factors." Supposedly, these premium factors will be published in Internal Revenue Bulletins.

Q4: Do P.S. 58 rates still apply?

A4: **Currently**: P.S. 58 rates may no longer be used. Either Table 2001 rates or the insurer's alternative term rates, if lower, must be used.

After Final Regs: It is likely that the IRS will publish its own rates (premium factors) in Internal Revenue Bulletins – which may or may not be interpolations or averages based on insurers' actual (truly, and honestly used in real life) term rates. These will probably replace the current Table 2001 rates.

Q5: How will the rates for survivorship (second-to-die) arrangements be determined?

A5: It appears that it is currently possible – using the interpolative process described in the "Greenberg-to-Greenberg" letter – to derive the survivorship rates from Table 2001. It is probable, but not certain, that the IRS will allow the same interpolative formula in the Final Regulations. If it does, non-equity survivorship split dollar would continue to be a very appealing arrangement.

Q6: How is reverse split dollar taxed as of now and after the final regulations are issued?

A6: Neither set of proposed regulations deals specifically with reverse split dollar, but Notice 2002-59 undoubtedly does. Its spirit and substance – if not its words – make it clear that to the extent reverse split-dollar is based on the use of unrealistic and artificially inflated rates to value the cost of term insurance protection, those artificial rates cannot be used – no matter where they are taken from!

Q7: How is the "equity" in equity split dollar taxed?

A7: Equity split-dollar life insurance is defined as an arrangement under which one party typically receives an interest in the cash value (or equity) of the life insurance policy disproportionate to that party's share of premiums in addition to the benefit of current life insurance protection. Conversely, non-equity split-dollar life insurance is defined by the Service as an arrangement under which one party typically provides the other party with current life insurance protection but no interest in the policy cash value.

Pre-Final Regulation Arrangements: Under plans set up between now and the date final regulations are published, split dollar arrangements – therefore, the "equity" (the portion of the cash value inured by the benefited party) – are taxed under either one of two mutually exclusive regimes: (1) Economic Benefit, or (2) Loan.

(1) The **economic benefit** regime requires that the taxpayer (generally the benefited party, e.g., employee, under the arrangement) report (A) the current life insurance term cost as measured above, and (B) the policy equity as received at policy roll-out. So if the pre-final regulations policy is not rolled-out during the insured's lifetime, the benefited party should not have any currently reportable income from the equity build-up. If the split-dollar arrangement can be maintained until the insured's death, the equity will never be subject to income tax.

(2) The **loan** regime considers the agreement between the parties as an interest free (below market) loan under which one party "charges" the second with interest, at the Applicable Federal Rate (AFR), and with the corresponding imputed interest payment and interest income to the parties (e.g., employee and employer) involved under the principles of Code Section 7872. The taxpayer (e.g., employee) therefore is treated as the absolute owner of the contract and as if paying premiums with his/her own after-tax dollars. The employee must report as income the imputed interest (the amount the employer would have charged had it been an arm's length loan at the appropriate AFR rate). There would be no separately reportable term insurance cost or annual increase in equity to the employee.

Unless and until materially modified, plans set up between now and issuance of Final Regulations will be taxed under these rules – not only until the final regulations are issued but even after that date. [See below for taxation of post Final Regulations "equity" split dollar arrangements.]

Q8: What special tax treatment is available to pre-January 28, 2002 equity split dollar arrangements?

A8: If, prior to January 1, 2004, the parties (e.g., employer and employee) either (1) roll out the contract, or (2) convert the entire arrangement to an "ab initio" interest-free loan that includes all prior employer outlays, the IRS has agreed to never subject the then existing employee equity to income tax!

Additionally, to qualify for these "Get out of Dodge before Noon" safe harbors, the underlying documents (e.g., split dollar agreement, and/or other side agreements) must stipulate that the employer (or other sponsoring party) is entitled to repayment of its premium contributions. Therefore, it is imperative that all relevant documents are thoroughly reviewed.

Q9: What happens to a pre-January 28, 2002 arrangements and to arrangements established on January 28, 2002 or later but before the date final regulations arrangements are published if they do not qualify for either of the safe harbors?

A9: My guess is that surprisingly few clients will have significant equity in their split dollar plans for several years to come – in which case it is not necessary to convert to a loan before 2004.

Taxpayers who purposely or unintentionally fail to take advantage of one of the above safe harbors are subject to income tax on the lifetime receipt of policy equity – even in pre-January 28, 2002 arrangements.

Of course, if no equity is ever taken and the insured dies prior to the receipt of any equity, there will be no income taxation for pre-January 28, 2002 policies. The equity in a split dollar policy purchased under a prior-to-final regulations arrangement – including those currently being purchased – will never be taxed if the arrangement is kept in effect until the insured dies.

Another possible course of action is that equity is taken in the form of a post-2003 roll-out, and the taxpayer challenges the IRS. The IRS is bound to ignore the proposed regulations and Notice under the "no inference" language, and must claim the equity is taxable based on cases and rulings prior to Notice 2002-8 and the 2002 and 2003 Proposed Regulations.

This, of course, is the direction that would be taken by those with a high risk taking propensity and affinity to litigate. Some of them strongly believe that the IRS has been wrong all along about the taxation of the equity build-up inside the split dollar life insurance policy – either currently or at any time. They may also feel strongly that the IRS will not prevail if it decides to pursue taxpayers who take this position and either roll out the contracts or take policy equity after December 31, 2003. Personally, I still think this is a potentially dangerous and expensive course of action to take, particularly if gift and generation-skipping transfer taxes are involved.

Q10: What if a client continues a pre-Final Regulation split dollar policy but takes policy loans or withdrawals after 2003? Will that trigger taxable income?

A10: There are those who maintain that if the split dollar arrangement is kept in effect and current term insurance costs are reported, then policy loans and/or withdrawals can be taken with tax impunity.

I am not among them. It is true that the IRS has agreed that for Pre-Final Regulation arrangements, the IRS will not impose current taxation as long as the contracts are kept in force and the economic benefits in the form of term costs are reported. But I don't think that's the full picture.

First, as an economic and practical matter, relatively few trusts or other taxpayers will have the financial ability and will to continue paying constantly rising significant economic benefit costs as the insured lives into his/her late 70s, 80s and even 90s. Certainly, it would be difficult economically for a trust with few other assets or a trustee unwilling to use those "outside" assets or the income to finance the ever increasing economic benefit (term insurance) costs to maintain the arrangement and keep the policy in force as the insured ages.

More to the point, in my opinion, the spirit of the proposed law requires that – in order for equity to be deferred from current taxation – no equity be taken, in any form, during the insured's lifetime! My prediction is that the IRS will treat any receipt of such otherwise tax-deferred income (any "accessing of the policy values") as currently taxable. In my opinion (and certainly there are those who disagree with this viewpoint), direct or indirect receipt of the equity (in excess of what little basis – if any -- the trust or other owner may have, and in excess of the amount of policy cash value payable to the sponsoring party) will be taxable. The Service will treat the receipt of the equity as a violation of the spirit of its "Keep the Policy in Force and We Will Not Tax You" promise, which I interpret as really meaning: Don't Take the Equity and We Will Not Tax It!

As to basis, my prediction is that the IRS will not give basis credit to a taxpayer's payment of economic benefit costs against policy equity and will argue that what was paid – the cost of term insurance –

was used up in obtaining that term insurance protection – and cannot be double-credited against policy cash values.

Q11: Does it make sense to terminate an equity arrangement before it has significant equity?

A11: No. Although ALL equity split dollar plans should be reviewed well before the end of 2003, not all plans should be terminated. In fact, many plans with no equity currently or in the next few years should probably not be terminated or converted to loans. Generally, planners should at least "wait and see" what the final regulations provide before advising the client to terminate a plan with little or no equity or convert it to a loan regime. There are no apparent advantages to ending or converting such a plan, and the ultimate decision must be based on each client's specific circumstances, and planning objectives.

Certainly, very careful consideration should be given before discontinuing or changing pre-January 28, 2002 plans that are strictly established to provide death proceeds, and can take advantage of an insurer's one-year term rates with less restrictions than later plans. In most cases such arrangements will not be adversely impacted by Final Regulations and should be continued.

Q12: What is the impact of a switch (roll-out) to an employee after 2003 of a pre-final regulations arrangement contract from an equity split dollar to a loan?

A12: Clearly, there should be no taxation if there is no employee equity at that time. As a practical matter, the policy would have no cash value – assuming the employer takes its share of the cash value when the roll out occurs – and the policy would technically lapse. The real question is, can the employee (or third party owner) be able to pay additional premiums to keep the policy in force without violating the 7-pay limit under MEC or the guideline premium rules? But if there is equity, I believe the IRS will claim the equity (in excess of the taxpayer's basis, if any) is taxable at that time. The conversion of a collateral assignment equity split dollar to a loan would be considered a taxable event. Of course, the taxpayer is free to defend his/her/its position in court – but in my opinion the taxpayer will lose.

Q13: How do the 2003 Proposed Regulations require the taxpayer under a post-Final Regulations equity endorsement split dollar to report income?

A13: The reportable value of the economic benefits provided to the non-owner for a taxable year equals the sum of three elements:

(1) the cost of any current life insurance protection provided to the non-owner,

(2) the amount of policy cash value to which the non-owner has current access (to the extent that such amount was not actually taken into account for a prior taxable year), and

(3) the value of any other economic benefits (other than current life insurance protection and policy cash value, but including all other policy rights, benefits and features) provided to the non-owner (to the extent not actually taken into account for a prior taxable year).

Q14: How is the employee's equity in an equity endorsement split dollar arrangement taxed after final regulations are issued?

A14: The latest (2003) proposed regulations provide that equity from arrangements established after final regulations are published is taxed on a current basis.

The taxation is based on one or more of the following judicial theories or doctrines: Constructive Receipt, Economic Benefit, and Cash Equivalence – assuming:

A. The Employee has "access" to the policy cash value, or

B. The Employer does not have access to the policy cash value, or

C. The Employer's general creditors do not have access to the policy cash value.

Note that the existence of the access triggers B, and C overrides the normal risk of forfeiture and substantial limitations or restrictions rules.

Briefly, the employee's "access" to equity is broadly defined to include: any direct or indirect right to obtain, use or realize potential economic value from the policy cash value. "Current access" occurs if the employee can anticipate, assign, pledge or encumber policy cash value, or directly or indirectly withdraw, or partially or totally surrender the policy.

The employer does not have access to the policy cash value if it does not have the full rights to the policy cash value normally held by a policy owner. Likewise, the employer's general creditors do not have access to the cash value if the creditors cannot reach the full policy cash value in the event of the employer's insolvency.

Also note that under the 2003 proposed regulations, policy cash value is determined "without regard to surrender charges or other similar charges or reductions" – that is, any devices or artifices that may be designed to suppress or understate the cash value. (Expect to see the IRS extend this phrase and philosophy to "pension rescue," Section 412(i) plans, and other contexts to warn against or thwart valuation ploys and artificial suppression of policy values.)

Q15: How are variable life policies impacted by the 2003 Proposed Regulations?

A15: These policies, which of course vary in value on a continual basis, are subject to the general rule above. In other words, for uniformity, certainty, and administrative ease (and to prevent valuation manipulations) cash values must typically be determined as of the last day of the non-owner's taxable (typically calendar) year. If the policy values drop, no loss is allowed. Gain would probably not have to be recognized until it exceeded the prior year's value.

Q16: What is the major thrust of the latest proposed equity endorsement split dollar regulation?

A16: The major thrust of these proposed regulations, which apply not only to income but also gift and employment tax purposes as well, is that a non-owner of a post-Final Regulations arrangement who has current access (as broadly defined above) to policy cash values becomes richer each year and must therefore annually report current income. The taxation is not due to the application of Code Section 83, but because of the operation of the doctrines of (1) constructive receipt, (2) economic benefit, and (3) cash equivalence.

Q17: What is the key to understanding the direction the IRS is going?

A17: The IRS is adamant that all parties should account for shifts in wealth – despite the "black box" of life insurance in a split dollar "wrapper," and regardless of the setting (e.g. employer – employee, parent – child or parent – trust) – and the appropriate party is taxable for such shifts. The IRS wants to use future regulations to clarify and solidify its position on the law governing split dollar arrangements – both in form and in operation. Simultaneously, the Service wants to frustrate (if not completely shut down) the various schemes and attempts used by overly aggressive marketers to "game the system" to achieve results counter to the spirit and substance of the law.

Q18: What is the future of future (after final regulations) split-dollar?

A18: **Non-Equity Split Dollar**: Assuming the IRS requires that term insurance costs to be based on government issued rates and they are realistic, non-equity split dollar will continue to be a practical technique for one party to assist another party in obtaining life insurance protection.

As for a non-equity split-dollar entered into prior to January 28, 2002, in most cases the coverage should be maintained. Likewise, most coverage from arrangements entered into on or after that date but before the issuance of Final Regulations should be maintained – but this decision should be postponed until the issuance of final regulations.

Equity Split Dollar: My guess is that equity split dollar as we once knew it will be rarely used after the final regulations are issued. But in its place will be the funding of life insurance through split dollar arrangements under the loan regime whereby one party loans money to another at the AFR (Applicable Federal Rate). This means interest will vary by type and term of the loan, and typically fluctuating on a monthly basis.

For example, an employer may make loans to an employee. These loans, sufficient to pay premiums, will then be used by the employee or other individual and/or trust to purchase life insurance. The employee or other owner will own all rights to the policy including cash values and can of course, pledge the policy or use it as collateral (including to the employer for its loan advances). [CAVEAT: Generally, under Section 7872 "below market" loan treatment, the employee will have imputed income for the forgone loan interest, and the employer will have imputed interest income. But if the employer charges, and the employee actually pays, interest at a rate equal to or greater than the appropriate AFR, there would be no imputed income.]

Assume the employer is willing to both make loans equal to the premiums as well as bonus amounts equal to the sum of the loan interest and the "grossed up" taxes on each of the bonus amount. In this example, the employee incurs no out-of-pocket cost and has received the use of employer dollars, under a very appealing benefit arrangement. The employer's cost is the sum of the time value of its loaned money plus the after-tax cost of its bonuses. Since the employee owns the policy, cash values will grow tax deferred.

[CAVEAT: The loan regime under the proposed regulations will probably not be available to executives of public corporations because of the Sarbanes-Oxley Act of 2002.]

Q19: What do the two sets of proposed regulations tell us about the final regulations?

A19: Certainly, the tough tenor of the proposals indicates the IRS is not likely to back off from the general direction it started to go in the '96 TAM and has continued since then. For split-dollar arrangements established on or after the date the final regulations are published, an employee (or other individual) enriched through a split-dollar arrangement (defined very broadly) must pay tax currently as enrichment occurs and any shift of wealth from one party to another will have immediate tax (income, gift, generation-skipping transfer or a combination of) consequences.

I predict that the IRS will eliminate the taxpayer's ability to use insurance carriers' alternative term rates. Also, expect the IRS will go overboard to prevent what it considers artifices and devices affecting valuation or other maneuvering to sidestep the purpose and spirit of basic tax law.

Q19: What's the expected date of final regulations?

A19: The Treasury and IRS have requested comments on the latest proposed regulations, and a public hearing has been scheduled for July 29, 2003. The final regulations will probably be issued sometime around mid October.

PLEASE NOTE: **This material contains references to concepts that have legal and tax implications. It is not intended as legal or tax advice. Clients should consult their own attorney and/or tax advisor for advice regarding their particular situation.**

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