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FINAL SPLIT DOLLAR REGULATIONS

INTRODUCTION

Split-Dollar Final Regulations were released jointly by the Treasury and IRS on September 11, 2003. Officially, these are called Split-Dollar Life Insurance Arrangements, TD 9092.

WHAT: These regulations – with few exceptions – reiterate and underscore the three key messages of the 2002 and 2003 proposed regulations:

"We will not be hamstrung by a literal reading of facts or law that does not comport with the substance or spirit of the law!

All parties must account for all benefits!

If someone is enriched, someone is taxable!
When wealth is transferred, tax will follow!"

The final regulations are designed to provide rules and guidance to persons (or parties) entering into split-dollar life insurance arrangements, and cover the income, employment, and gift tax aspects of such arrangements.

Under these new rules, the insureds in employment-related split dollar arrangements of the future may be required to pay higher taxes. In some cases, they will be required to pay their employers interest on the premiums, as premium payments will be considered split dollar loans. When an employer charges interest at below-market rates, the insured will have to pay tax on the difference between the market rate and the actual interest paid. For private or family arrangements, the donor (or premium sponsor) may incur higher gift taxes.

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WHEN: The final regulations apply to any split-dollar life insurance arrangement entered into after September 17, 2003. This means IRS Notice 2002-8 will be a primary source of guidance for split-dollar arrangements entered into on or before September 17, 2003.

WHAT NOT? There are still questions left unanswered by the final regulations. First, they do not address the possible application of section 402 of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), Public Law 107-204, to all or certain split-dollar life insurance arrangements entered into by companies subject to Sarbanes-Oxley. The position of the IRS and Treasury is that "interpretation and administration of Sarbanes-Oxley fall within the jurisdiction of the Securities and Exchange Commission."

Second, the final regulations provide no clear indication as to how the value of the term insurance protection is to be calculated (especially for survivorship type of coverage). We expected to (and predict we still may yet) see new, more realistic P.S. 58 type tables and more definitive guidelines concerning the use of the issuing company's one-year term rates.

2002 PROPOSED REGULATIONS

On July 9, 2002, the Treasury and Service issued proposed regulations (67FR 45414) that contained comprehensive rules for the income, gift, employment, and self-employment taxation of equity and non-equity split-dollar life insurance arrangements.

Split Dollar Defined: The regulations, both proposed and final, define split-dollar as an arrangement between two or more parties to allocate the policy benefits and, in some cases, the costs of a life insurance contract.

Equity Split Dollar Defined: An equity split-dollar life insurance arrangement is defined under the 2002 proposed regulations as one in which one party to the arrangement typically receives an interest in the policy cash value (or equity) of the life insurance contract disproportionate to that party's share of policy premiums. In other words, one party pays less than and gets more than his/her/its share and the other party pays more and gets less. The party that pays less than his/her/its premium share also typically receives, in addition to cash values, the benefit of current life insurance protection under the arrangement.

Non-Equity Split Dollar Defined: A non-equity split-dollar life insurance arrangement is one where one party typically provides the other party with current life insurance protection but no interest in the policy cash value.

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Two Mutually Exclusive Regimes: The 2002 proposed regulations provide two mutually exclusive regimes for the taxation of split-dollar life insurance arrangements. The first is a loan regime. The second is an economic benefit regime.

Loan Regime: Under the loan regime, the non-owner of the life insurance contract is treated as lending the amount of its premium payments to the owner of the contract. If the transaction takes the form of a collateral assignment (the legal owner assigns the policy as collateral security for the premium advances of the other party), the loan regime generally governs the taxation of the arrangement.

Economic Benefit Regime: Under the economic benefit regime, the owner of the life insurance contract is treated as providing economic benefits to the non-owner of the contract. If the arrangement takes the form of an endorsement (e.g. the corporation ("owner") advances the money but allows the insured-covered employee ("non-owner") to name the recipient of the death benefit by an endorsement to the contract), generally, the economic benefit regime governs the taxation. The 2002 proposed regulations "reserved" on the rules for valuing economic benefits provided to the non-owner under an equity split-dollar life insurance arrangement governed by the economic benefit regime, pending receipt of comments from interested parties. Simply put, all bets were off until the IRS and Treasury were ready to state how the economic benefits the "non-owner" received would be valued.

2003 PROPOSED REGULATIONS

On May 9, 2003, the IRS and Treasury issued a second and different proposed regulation (FR68 24898). The 2003 proposed regulations covered the taxation under equity split-dollar life insurance arrangements governed by the economic benefit regime.

Valuation of Economic Benefits: In a nutshell, the 2003 proposed regulations provide that, in the case of an equity split-dollar life insurance arrangement, the value of the economic benefits provided to the non-owner under the arrangement for a taxable year equals the sum of:

(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 provided to the non-owner (to the extent not actually taken into account for a prior taxable year).

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FINAL REGULATIONS

Essentially, the final regulations adopt and amplify – with few exceptions - the 2002 and 2003 proposed regulations described above. Following are the exceptions – in the form of "amendments."

SPLIT DOLLAR INSURANCE ARRANGEMENT DEFINED

A split-dollar life insurance arrangement is generally "any arrangement between an owner of a life insurance contract and a non-owner of the 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 (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the contract."

Exception for Policy Owners and Insurers: If the only parties to the arrangement are the policy owner and the life insurance company acting only in its capacity as issuer of the contract, that arrangement would fall outside the definition of a split-dollar arrangement.

Exception for Performance of Services and Shareholders: Certain arrangements entered into either (a) in connection with the performance of services, or (b) between a corporation and another person in that person's capacity as a shareholder in the corporation will be considered split-dollar life insurance arrangements even if they might otherwise not meet the general definition of a split-dollar life insurance arrangement.

Exception for Key Employee Coverage: True key employee coverage, under which a company purchases a life insurance contract to insure the life of a "key" employee or shareholder, will not be considered a split-dollar arrangement under either the general rule or any of the special rules - if the employer retains all the rights and benefits of the contract (including the rights to all death benefits and cash value).

NO GAMES RULE

To make absolutely positively sure that no one tries to play games by inappropriately structuring contracts to avoid the application of these regulations (for instance by using separate life insurance contracts that are, in substance, one life insurance contract), the regulations remind us that the IRS has "existing authority" to challenge such transactions. (See also discussion on "Two or More Owners" on next page.)

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TWO MUTUALLY EXCLUSIVE REGIMES

The two mutually exclusive regimes established in the proposed regulations, i.e., an economic benefit regime and a loan regime, are retained under the final regulations for determining the tax treatment of split-dollar life insurance arrangements.

Ownership Rules: Generally, the policy ownership (e.g., is the owner the corporation or the insured-covered employee?) will be the primary determinant as to which of the two regimes applies. The Treasury and IRS take the position that taxpayers can, in essence, elect which regime (economic benefit or loan) will apply to their split-dollar life insurance arrangements by selecting one party or the other as the contract owner.

Special Ownership Rule: When the employer, service recipient, or donor is the owner of the insurance contract, the economic benefit regime applies. In addition, the economic benefit regime is applied to a "non-equity" split-dollar life insurance arrangement where the arrangement is entered into in connection with the performance of services; or the arrangement is entered into between a donor and a donee (for example, a life insurance trust).

Special "Transfer of Contract" Rule: A special rule applies when payments under the arrangement had been treated, prior to transfer, as split-dollar loans under Reg. Section 1.7872-15, and the contract is transferred from an owner to a non-owner. Under this rule, the economic benefit regime applies to the split-dollar life insurance arrangement from the date of the transfer. Payments made (both before and after the transfer) are not treated as split-dollar loans on or after the date of the transfer. The transferor of the life insurance contract must fully take into account all economic benefits provided under the split-dollar life insurance arrangement.

OWNERS AND NON-OWNERS

One Owner: Under the final regulations, the owner generally is the person named as the policy owner. The IRS reasoning is that it is reasonable to determine tax ownership based on who is the named owner of the policy because (a) the division of the burdens and benefits of the life insurance contract vary widely in split-dollar life insurance arrangements, (b) title of ownership generally is a factor in determining tax ownership, and (c) this rule provides a clear, objective standard so that both taxpayers and the IRS can readily determine which regime applies.

Two or More Owners: If two or more persons are designated as the policy owners, the first-named person (or party) generally is treated as the owner of the entire contract.

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Exception: If two or more persons/parties are named as policy owners and each has, at all times, all the incidents of ownership with respect to an "undivided interest" in the contract, those persons/parties are treated as owners of separate contracts for purposes of these regulations. An undivided interest is defined as an identical fractional or percentage interest or share in each right, benefit, and obligation with respect to the contract.

Example: Assume an employer and an employee own a life insurance contract and share equally in all rights, benefits and obligations under the contract. As noted above, they will be treated as each owning a separate contract. Although, ordinarily neither contract would be treated as part of a split-dollar life insurance arrangement, if the employer and the employee agree to enter into a split-dollar life insurance arrangement with respect to what otherwise would have been treated as the employer's (or the employee's) separate contract, the purported undivided interests will be disregarded, and the entire arrangement will be treated as a split-dollar life insurance arrangement.

Facts and Circumstances Testing: The IRS will consider all of the facts and circumstances of an arrangement to determine whether the parties have appropriately characterized the arrangement as one involving undivided interests and, therefore, not subject to these regulations.

Attribution Rules: The final regulations provide attribution rules for compensatory split-dollar life insurance arrangements. They work as follows:

The employer or service recipient will be treated as the owner of the life insurance contract if the contract is owned by

(1) a member of the employer's "controlled group,"
(2) a Section 402(b) "secular" trust,
(3) grantor trust (including a rabbi trust treated as owned by the employer), or
(4) a Section 419(e)(1) welfare benefit fund.

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TAXATION UNDER THE ECONOMIC BENEFIT REGIME

In general, the final regulations provide (essentially the same as the 2002 and 2003 proposed regulations) that, for these arrangements:

(1) the owner of the life insurance contract is treated as providing economic benefits to the non-owner of the contract, and
(2) those economic benefits must be accounted for fully and consistently by both the owner and the non-owner, and
(3) the value of the economic benefits, reduced by any consideration paid by the non-owner to the owner, is treated as provided from the owner to the non-owner.

Relationship Governs: The tax consequences of the provision of economic benefits will depend on the relationship between the owner and the non-owner. This means when one party provides an economic benefit for another, it may be treated as:

(1) Payment of compensation;
(2) A distribution (typically a dividend) under Code Section 301;
(3) A capital contribution;
(4) A gift; or
(5) A transfer having a different tax character.

The parties must account for any benefit provided based on its character.

Example: Assume an employer provides an employee with economic benefits under a split-dollar life insurance arrangement. The employee must report the benefits received as compensation on the employee's Federal income tax return for the year in which the benefits are provided. The employer would report the transaction by recording them on the appropriate employment tax and information returns.

Example: Suppose a donor provides economic benefits to an irrevocable life insurance trust through a split-dollar life insurance arrangement. The donor would take those economic benefits into account by reporting them on the Federal gift tax return the donor is required to file. The trust would not be required to take any action because those economic benefits would be excludable from gross income under Code Section 102.

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NON-EQUITY SPLIT DOLLAR ARRANGEMENTS

Generally, the final regulations adopt the familiar tax treatment of a non-equity split-dollar arrangement under Rev. Rul. 64-328 (1964-2 C.B. 11) and its progeny (i.e., the economic benefit regime).

Special Rule: Non-equity arrangements entered into in a compensatory context or a gift context will be subject to the economic benefit regime.

Subsequent Modification: Under the final regulations, the replacement of a non-equity arrangement with a successor equity arrangement will be treated as a modification of the non-equity arrangement for purposes of the following rules.

(a) If the parties to a non-equity split dollar arrangement subsequently modify the arrangement so that it is no longer a non-equity arrangement, and if, immediately after the modification, the employer, service recipient, or donor is the owner of the life insurance contract (determined without regard to the special rule for non-equity arrangements), the employer, service recipient or donor continues to be treated as the owner of the life insurance contract. As a result, the normal rules of the economic benefit regime for equity split-dollar life insurance arrangements apply.

(b) If, immediately after the modification, the employer, service recipient, or donor is not the owner, the employer, service recipient, or donor is treated as having made a transfer of the contract to the employee, service provider, or donee as of the date of the modification.

Timing of Current Protection Valuation: Subject to an anti-abuse rule, current life insurance protection is determined on the last day of the non-owner's taxable year unless the parties agree to use the policy anniversary date. Taxpayers may change the valuation date with the consent of the IRS. (Note the anti-abuse rule is designed to prevent the parties from manipulating the policy cash value for purposes of determining the value of the economic benefit that the non-owner must take into account. The rule also extends to the value of the current life insurance protection.)

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EQUITY SPLIT DOLLAR ARRANGEMENTS

It is important to understand how the Treasury and IRS came to their conclusions with respect to the taxation of equity build-up. Their position is that a shift in equity is not income tax-free to the non-owner. The rationale stated in the final regulations is that:

"The tax-deferred inside build-up provided by section 72(e) properly applies only to the taxpayer that owns the life insurance contract.

If the owner of the contract provides any of the rights or benefits under the contract to another taxpayer, that provision of rights and benefits is subject to tax under the rules that otherwise follow from the relationship between the parties.

For example, this result applies whenever an employer that owns a life insurance contract compensates an employee by giving the employee rights to the policy cash value. In that case, the employer (as the owner of the contract) enjoys tax-deferred inside build-up under section 72(e), but the employee has gross income under section 61(a)(1) equal to the value of the economic benefit attributable to the employee's rights to the policy cash value. Thus, the regulations are consistent with section 72(e)."

The IRS and Treasury emphatically rejected a Section 83 approach because Section 83 applies only in connection with a transfer of property. They noted that a non-owner may have currently includible income by reason of another rule or tax principle – such as the doctrines of constructive receipt, cash equivalence, or economic benefit. It was considered "inappropriate to limit current taxation to circumstances that constitute transfers of property under section 83, and it would be inappropriate in this context to apply section 83 to circumstances that give rise to income under other Code provisions or judicial doctrines."

Measurement of Economic Benefits: Here's how the value of the economic benefits provided by the owner to the non-owner for a taxable year is measured under the final regulations. It's the sum of:

(1) the cost of any current life insurance protection provided to the non-owner, plus
(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 provided to the non-owner (to the extent not actually taken into account for a prior taxable year).

Full and Consistent Accounting Required: The owner and the non-owner also must account fully and consistently for any right in, or benefit of, a life insurance contract provided to the non-owner under an equity split-dollar life insurance arrangement. This makes it clear that, no matter what a benefit is called or what form it takes, its value must be taken into account and properly reported by the parties.

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Anti-abuse Rule: Under the final regulations, the policy cash value (as in the case of the amount of current life insurance protection discussed previously) is determined as of the last day of the non-owner's taxable year, unless the parties agree to use the policy anniversary date. The anti-abuse rule is retained to prevent the parties from manipulating the policy cash value for purposes of determining the value of the economic benefit that the non-owner must take into account.

Concept of Access: The final regulations provide that the non-owner has current access to the policy cash value if the non-owner has a current or future right that is (directly or indirectly).

(a) accessible by the non-owner,
(b) inaccessible to the owner, or
(c) inaccessible to the owner's general creditors.

Impact on True Non-Equity Arrangements: The non-owner – under the rules stated above – is considered to have current access to policy cash value only if, under the arrangement, the non-owner has a current or future right to policy cash value. Whereas in a true non-equity arrangement, the non-owner will have no such right and therefore not be taxable with respect to the cash value.

Impact of Restrictions on Owner's Creditors' Rights: If the non-owner has any of the access rights described above, any restriction on the owner's creditors to reach policy cash value, whether established by contract or by local law, results in an economic benefit to the non-owner. According to the Treasury and IRS, this follows the economic reality of an equity split-dollar life insurance arrangement, i.e., if the owner commits funds to a life insurance contract and promises it will not withdraw those funds, the amounts so committed are no longer a general asset of the owner, since the owner has parted with the ownership and use of the funds for the benefit of the non-owner.

Broad Construction of the Term "Access": The access concept is broadly construed. It includes any direct or indirect right under the arrangement allowing the non-owner to obtain, use, or realize potential economic value from the policy cash value.

> **Example:** A non-owner is deemed to have access to policy cash values if he/she/it can directly or indirectly (1) make a withdrawal from the policy, (2) borrow from the policy, or (3) affect a total or partial surrender of the policy.

> **Example:** A non-owner is deemed to have access to policy cash values if the non-owner can (1) anticipate, (2) assign (either at law or in equity), (3) alienate, (4) pledge, or (5) encumber the policy cash value or (6) if the policy cash value is available to the non-owner's creditors by attachment, garnishment, levy, execution, or other legal or equitable process.

When the Owner is Deemed to have No Access: The final regulations consider policy cash value to be inaccessible to the owner if the owner does not have the full rights to policy cash value normally held by an owner of a life insurance contract.

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When Creditors are Deemed to have No Access: Policy cash value is deemed to be inaccessible to the owner's general creditors if, under the terms of the split-dollar life insurance arrangement or by operation of law or any contractual undertaking, the creditors cannot, for any reason, effectively reach the policy cash value in the event of the owner's insolvency.

Special Acceleration Rule: In certain cases, a separate tax rule may require a non-owner to include an amount in gross income under an equity split-dollar life insurance arrangement at a time earlier than would be required under these regulations. This may constitute a tax trap for the unwary.

> **Example:** Code Section 457(f) generally requires an employee of a tax-exempt organization (other than a church organization) or of a state or local government to include deferred compensation in gross income when the employee's rights to the deferred compensation are not subject to a substantial risk of forfeiture.
>
> Under the final regulations, an equity split-dollar life insurance arrangement governed by the economic benefit regime constitutes a deferred compensation arrangement. Accordingly, an employee of a tax-exempt organization or of a state or local government may have to include an amount in gross income attributable to an equity split-dollar life insurance arrangement even if the employee does not have current access to the policy cash value under these regulations.

TAX CONSEQUENCES OF AMOUNTS PAID BY NON-OWNER

Non-Owner has No Investment in Contract: A non-owner has no investment in the contract under Code Section 72(e) prior to a transfer of the contract. The Treasury/IRS rationale is that only one person is generally treated as the owner of the life insurance contract and, since only the owner of a life insurance contract can have an investment in that contract, a non-owner cannot have basis in the contract for any of the costs of current life insurance protection. Nor can the non-owner include such costs in the non-owner's basis or investment in the contract if and when the non-owner becomes the owner of the contract. The rationale for this is that, because those payments were made for annual (i.e., current) life insurance protection – and that protection was exhausted prior to the non-owner's acquisition of the contract – there's nothing to add to basis.

Inclusion in Owner's Income Required: Any amount paid by the non-owner to the owner for any economic benefit must be reported in the owner's gross income. The fact that the split-dollar life insurance arrangement may require the non-owner to reimburse the owner for the cost of the death

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benefit protection provided to the non-owner does not mean that such payment is not income to the owner. The rationale is that the owner is "renting" out part of the benefit of the life insurance contract to the non-owner for consideration and that consideration constitutes income to the owner.

TAXATION OF AMOUNTS RECEIVED UNDER THE LIFE INSURANCE CONTRACT

Amounts Received and Provided to Non-Owner: Any amount received under the life insurance contract (other than an amount received by reason of death) and provided, directly or indirectly, to the non-owner is treated as though paid by the insurance company to the owner and then by the owner to the non-owner. This rule also applies to certain policy loans (referred to in the regulations as "specified policy loans"). The Treasury and IRS imposed this to ensure that parties to a split-dollar life insurance arrangement do not avoid current taxation of the non-owner with respect to amounts provided to the non-owner directly through the contract.

Death Benefit Proceeds: Only the amount of the death benefit proceeds attributable to the current life insurance protection for which the non-owner paid or which the non-owner took into account is excludable from the income of the non-owner's estate or designated beneficiary.

Stated more technically, Code Section 101(a) excludes death benefit proceeds from the gross income of the beneficiary (other than the owner of the life insurance policy) – but only to the extent that amount is allocable to current life insurance protection provided to the non-owner under the split-dollar arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account as an economic benefit provided by the owner. To the extent the non-owner has neither paid for nor taken into account the current life insurance protection, the proceeds paid to the estate or designated beneficiary of the non-owner is treated as a separate transfer of cash that is not shielded from tax by the Code Section 101(a) exclusion.

What is the impact of the receipt of death proceeds by the non-owner's beneficiary if the non-owner has not paid for or not reported current life insurance protection? The final regulations creates a tax fiction that the money was paid to the owner (and is therefore excludable from the owner's income under the Code Section 101(a) exclusion), and is then paid by the owner to the non-owner's beneficiary (whether or not paid to the beneficiary directly by the insurance company) in a second transfer.

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How is that second transfer treated for tax purposes? The character of death benefit proceeds transferred or deemed transferred by the owner to the non-owner is determined by the relationship between the owner and the non-owner.

> **Example:** Suppose such death benefit proceeds were received by the beneficiary of a shareholder who is a non-owner. They would be treated as first paid or payable to the shareholder's corporation and then paid by the corporation to the beneficiary. The result will be treated as a taxable distribution (typically a dividend) to the shareholder – and non-deductible by the corporation.

> **Example:** Assume death benefit proceeds under a split-dollar life insurance contract are payable to a beneficiary of a service provider who is a non-owner. Here, the death benefit proceeds would be considered a payment of compensation payment to the service provider for past services (and therefore deductible to the service provider to the extent deemed "reasonable") rather than a corporate distribution.

TWO MUTUALLY EXCLUSIVE REGIMES

Timing: A transfer of a life insurance contract (or an undivided interest therein) underlying a split-dollar life insurance arrangement occurs on the date that the non-owner becomes the owner of the entire contract (or the undivided interest therein). Unless and until ownership of the contract is formally changed, the original owner will continue to be treated as the owner for all Federal income, employment, and gift tax purposes.

Value: The fair market value of an undivided interest must be the proportionate share of the fair market value of the entire contract without regard to any discounts or other arrangements between the parties.

Ownership for Tax Purposes: After a transfer of an entire life insurance contract, the transferee generally becomes the owner for Federal income, employment, and gift tax purposes. The implication is that, if the transferor pays premiums after the transfer, the payment of those premiums may be includible in the transferee's gross income – unless the payments are split-dollar loans under Reg. Section 1.7872-15. Alternatively, the arrangement will be subject to the loan regime if the payments constitute split-dollar loans under §1.7872-15.

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TAXATION UNDER THE LOAN REGIME

Generally, a payment made pursuant to a split-dollar life insurance arrangement is considered a split-dollar loan and the owner and non-owner are treated, respectively, as borrower and lender, if

(1) the payment is made either directly or indirectly by the non-owner to the owner;
(2) the payment is a loan under general principles of Federal tax law or, if not a loan under general principles of Federal tax law, a reasonable person would expect the payment to be repaid in full to the non-owner (whether with or without interest); and
(3) the repayment is to be made from, or is secured by, either the policy's death benefit proceeds or its cash surrender value, or both.

A payment will not be treated as a loan if, because of an agreement between the owner and non-owner, the arrangement does not provide for repayment by the owner to the non-owner. For example, if a non-owner makes a payment purported to be a split-dollar loan to an owner, and the non-owner and owner enter into a separate agreement providing that the non-owner will make a transfer to the owner in an amount sufficient to repay the purported split-dollar loan, this will not cause the payment to be treated as a loan.

Certain Stated Interest Disregarded: There is a new rule that disregards certain stated interest, if such interest is to be paid directly or indirectly by the lender (or person related to the lender).

Each Payment Separate Loan: Each payment under a split-dollar life insurance arrangement is treated as a separate loan for Federal tax purposes. Treating separate extensions of credit as separate loans is considered by the Treasury and IRS to be consistent with the 1985 proposed Section 7872 regulations and the legislative history of section 7872, and to most accurately account for the benefits provided by the lender to the borrower when the loans are below-market.

Non-Recourse Loans – Contingent Payments: If a payment on a split-dollar loan is non-recourse to the borrower and the loan does not otherwise provide for contingent payments, the loan is treated as a split-dollar loan that provides for contingent payments – unless the parties to the split-dollar life insurance arrangement provide a written representation with respect to the loan. Non-recourse split-dollar loans do not have to provide for interest payable at a stated rate.

Below Market Loans: If a split-dollar loan does not provide for sufficient interest, the loan is a below-market split-dollar loan. This means it is subject to Code Section 7872, and Reg. Section 1.7872-15. If a split-dollar loan is a below-market loan, then, generally, the loan is re-characterized as a loan with interest at the applicable Federal rate (AFR), coupled with an imputed transfer by the lender to the borrower.

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The timing, amount, and characterization of the imputed transfers between the lender and borrower of the loan depend upon the relationship between the lender and the borrower.

Example: If the lender is the borrower's employer, the imputed transfer is generally characterized as a compensation payment.

Example: The characterization and taxation of the imputed transfer will also depend on whether the loan is a demand loan or a term loan.

Sufficient Interest Loans: If the split-dollar loan provides for sufficient interest, then the loan is subject to the general rules for debt instruments (including the rules for OID).

No Interest Deduction: Generally, interest on a split-dollar loan is not deductible by the borrower.

Special Rules for Variable and Contingent Interest Rates: Special rules apply for split-dollar loans that provide for certain variable rates of interest, contingent interest payments, and lender or borrower options. Reg, Section 1.7872-15 also provides rules for below-market split-dollar loans with indirect participants.

Special Rules for Certain Term Loans: Special rules apply if the split-dollar term loans are:

(1) payable upon the death of an individual,
(2) conditioned on the future performance of substantial services by an individual, or
(3) gift split-dollar term loans.

These are all considered to be split-dollar term loans for purposes of determining whether the loan provides for sufficient interest.

Term Loans with Insufficient Interest: If a split dollar term loan does not provide for sufficient interest when the loan is made, forgone interest is determined on the loan annually similar to a split-dollar demand loan.

Determining the Rate: The rate used to determine the amount of forgone interest each year is the AFR based on the term of the loan, determined on the date the split-dollar loan is made. The rate is not redetermined annually.

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Impact of Waiving Interest: If a split-dollar loan provides for stated interest but that interest is subsequently waived, cancelled, or forgiven, appropriate adjustments are required to be made by the parties to reflect the difference between the interest payable at the stated rate and the interest actually paid by the borrower at that time.

If stated interest is subsequently waived, cancelled or forgiven, an amount is treated as retransferred from the lender to the borrower. This amount generally is increased by a deferral charge under the final regulations.

Substance Counts: Payment by the lender to the borrower that, in substance, is a waiver, cancellation or forgiveness is treated as a waiver, cancellation, or forgiveness.

If a split-dollar loan is non-recourse and the parties to the split-dollar arrangement had made the representation under §1.7872-15(d)(2), although adjustments are required to be made by the parties if the interest paid on the split-dollar loan is less than the interest payments required under the split-dollar loan if all payments were made, a deferral charge is not imposed.

Payment Ordering Rules: Payments made by a borrower to a lender pursuant to a split-dollar life insurance arrangement are applied in the following order:

(1) to accrued but unpaid interest (including any OID) on all outstanding split-dollar loans in the order the interest accrued;
(2) to principal on the outstanding split-dollar loans in the order in which the loans were made;
(3) to payments of amounts previously paid by the lender pursuant to the split-dollar life insurance arrangement that were not reasonably expected to be repaid; and
(4) to any other payment with respect to a split-dollar life insurance arrangement.

The payments to which the payment ordering rule applies are limited to only those that are made to or for the benefit of the lender.

EMPLOYMENT TAXES AND SELF-EMPLOYMENT TAX

An imputed transfer under the split-dollar loan rules that is treated as an imputed transfer of compensation will have consequences for the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) if the adjustment represents wages to the borrower.

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GIFT TAX TREATMENT OF SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENTS

As noted above, these final regulations apply for gift tax purposes – even to private split-dollar life insurance arrangements.

> **Example:** Suppose an irrevocable life insurance trust is the owner of the life insurance contract underlying the split-dollar arrangement. If a reasonable person would expect that the donor, or the donor's estate, will recover an amount equal to the donor's premium payments, those premium payments are treated as loans made by the donor to the trust. The result is that each premium payment by the donor is treated as a split-dollar loan to the trust in the amount of the premium payment.

Valuation Where Loan Repayable at Death: If the loan is repayable upon the donor's death, the term of the loan is the donor's life expectancy determined under the appropriate table under Reg. Section 1.72-9 as of the date of the payment. The value of the gift is the amount of the premium payment less the present value (determined under section 7872 and Reg. Section 1.7872-15) of the donor's right to receive repayment.

If, however, the donor makes premium payments that are not split-dollar loans, then the premium payments are governed by general gift tax principles. In that case, each premium payment is considered a gift to the trust by the donor equal to the amount of that payment.

Where Donor is Owner: If the donor is treated as the owner of the life insurance contract underlying the split dollar arrangement, the donor is treated as making a gift to the trust. The value of the gift is the value of the economic benefits provided to the trust, less the amount of any premium paid by the trustee.

> **Example:** Suppose that under the terms of the split-dollar life insurance arrangement, on termination of the arrangement or the donor's death, the donor or donor's estate is entitled to receive an amount equal to the greater of (a) the aggregate premiums paid by the donor, or (b) the cash surrender value of the contract.
>
> The donor would be deemed to be making gifts to the trust equal to only the cost of the current life insurance protection provided to the trust less any premium amount paid by the trustee. Note that a payment by the donor will not constitute a gift if the trust pays the portion of the premium equal to the cost of the current life insurance protection and the donor pays the balance of the premium.

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Example: Assume the donor or the donor's estate is entitled to receive an amount equal to the lesser of (a) the aggregate premiums paid by the donor, or (b) the cash surrender value of the contract. Here, the amount of the economic benefits provided to the trust by the donor equals

(1) the cost of any current life insurance protection provided to the trust, plus
(2) the amount of policy cash value to which the trust has current access (to the extent that such amount was not actually taken into account for a prior taxable year), plus
(3) the value of any other economic benefits provided to the trust (to the extent not actually taken into account for a prior taxable year).

The value of the donor's gift of economic benefits equals the value of those economic benefits provided to the trust for the year minus the amount of premiums paid by the trustee.

Donor Treated as Owner if Donee only gets Term Coverage: The donor is treated as the owner of a life insurance contract where the donee is named as the policy owner if, under the split-dollar life insurance arrangement, the only economic benefit provided to the donee by the donor under the arrangement is the value of current life insurance protection. Any amount paid by a donee, directly or indirectly, to the donor for such current life insurance protection would generally be included in the donor's gross income.

Gift Tax Implications where Donor is Owner: Where the donor is the owner of the life insurance contract that is part of the split-dollar life insurance arrangement, amounts received by the irrevocable insurance trust (either directly or indirectly) under the contract (for example, as a policy owner dividend or proceeds of a specified policy loan) are treated as gifts by the donor to the irrevocable insurance trust.

The donor must also treat as a gift to the trust the amount set forth in §1.61-22(g) upon the transfer of the life insurance contract (or undivided interest therein) from the donor to the trust.

Gift Tax Implications of Policy Transfer: The gift tax consequences of the transfer of an interest in a life insurance contract to a third party will continue to be determined under established gift tax principles. It doesn't matter who the final split dollar regulations treat as the owner.

Estate Tax Implications: Similarly, for estate tax purposes, no matter who is considered policy owner under the final split dollar regulations, the inclusion of the policy proceeds in a decedent's gross estate will continue to be determined under Code Section 2042.

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Example: Assume the policy proceeds will be included in the decedent's gross estate because (a) they are receivable by the decedent's executor, or (b) the policy proceeds are receivable by a beneficiary other than the decedent's estate and the decedent possessed any incidents of ownership with respect to the policy. The characterization of owner under the final regulations is irrelevant; Code Section 2042 would require inclusion.

Note that the regulations do not address the question of the extent to which a decedent's interest in a co-owned policy is included in that decedent's gross estate under section 2042. The Treasury and IRS stated that issue is beyond the scope of these regulations but may be addressed in future guidance.

EFFECTIVE DATE AND OBSOLESCENCE OF PRIOR GUIDANCE

Sept. 17 Magic Date: These final regulations apply to any split-dollar life insurance arrangement entered into after September 17, 2003.

Material Modification: These final regulations also apply to any split-dollar life insurance arrangement entered into on or before September 17, 2003 if the arrangement is materially modified after September 17, 2003.

Note that a split-dollar life insurance arrangement that is otherwise described in Section IV, Paragraph 4 of Notice 2002-8 (2002-1 C.B. 398) will not be treated as materially modified for these purposes if the change in the split-dollar life insurance arrangement is made solely to comply with Section IV, Paragraph 4 of Notice 2002-8.

Changes not Resulting in Material Modification: These final regulations provide a non-exclusive list of changes that will not result in a material modification for purposes of the effective date.

Example: No material modification is deemed to occur because of a change solely in the mode of premium payment or a change solely in the interest rate payable on a policy loan under the life insurance contract.

Example: A change solely in the mode of premium payment (for example, a change from monthly to quarterly premiums);

Example: A change solely in the beneficiary of the life insurance contract, unless the beneficiary is a party to the arrangement;

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Example: A change solely in the interest rate payable under the life insurance contract on a policy loan;

Example: A change solely necessary to preserve the status of the life insurance contract under section 7702;

Example: A change solely to the ministerial provisions of the life insurance contract (for example, a change in the address to send payment);

Example: A change made solely under the terms of any agreement (other than the life insurance contract) that is a part of the split-dollar life insurance arrangement if the change is non-discretionary by the parties and is made pursuant to a binding commitment (whether set forth in the agreement or otherwise) in effect on or before September 17, 2003;

Example: A change solely in the owner of the life insurance contract as a result of a transaction to which section 381(a) applies and in which substantially all of the former owner's assets are transferred to the new owner of the policy;

Example: A change to the policy solely if such change is required by a court or a state insurance commissioner as a result of the insolvency of the insurance company that issued the policy; or

Example: A change solely in the insurance company that administers the policy as a result of an assumption reinsurance transaction between the issuing insurance company and the new insurance company to which the owner and the non-owner were not a party.

Note that the replacement of the life insurance policy in the split dollar agreement with a new policy (e.g., a Sec. 1035 exchange) is not in the list. The implication is that such a change may trigger the much more restrictive and harsh post-September 17th final regulation rules.

A material modification after September 17 has the following implications:

- forces the client into one of the two tax regimes of the regulations,
- forces taxation based on policy ownership, and
- may eliminate the use of insurance company term rates after 2003, unless they meet new and more stringent standards.

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Reliance on Proposed Regs: The 2002 and 2003 proposed regulations provided rules under which taxpayers were permitted to rely on arrangements entered into on or before September 17, 2003.

This reliance also was intended to be available in circumstances under which taxpayers relied on the proposed regulations to determine that the arrangement would not be subject to the proposed regulations (for example, if the arrangement does not fall with the definition of a split-dollar life insurance arrangement).

Planned Obsolescence: Concurrent with the publication of these final regulations, the IRS and Treasury issued Rev. Rul. 2003-105 to obsolete certain revenue rulings with respect to split-dollar life insurance arrangements entered into or materially modified after September 17, 2003.

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The Prudential Insurance Company of America
751 Broad Street
Newark, NJ 07102-3777

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