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Summary of Final Split-Dollar Regulations

On September 11, 2003, the Department of the Treasury and the Internal Revenue Service released the much-anticipated final split-dollar regulations, comprising 30 pages of background and explanation and 71 pages of regulations (the "final regulations"). These regulations govern the taxation of split-dollar arrangements and were promised by proposed regulations published on July 9, 2002 (REG-164754-01). They largely follow the proposed regulations and supplemental proposed regulations released on May 8, 2003 (REG-164754-01), although there are a few differences and additions. (See Central Intelligence Special Editions dated July 10, 2002, and May 8, 2003, for our discussions of the proposed regulations and supplemental proposed regulations, respectively.) This summary will discuss the final regulations with particular attention to the differences from the provisions of the proposed regulations.

Effective Date: The final regulations apply to any split-dollar arrangement entered into after September 17, 2003, and to any arrangement entered into before September 18, 2003, that is materially modified after September 17, 2003. IRS Notice 2002-8 provided a valuable grandfathering provision to split-dollar arrangements terminated or converted to loan regime arrangements before January 1, 2004. The final regulations provide that arrangements modified to comply with this grandfathering provision will not be considered materially modified for these purposes.

Definition of Split-Dollar Arrangement: Like the proposed regulations, the final regulations generally define a split-dollar arrangement as any arrangement:

- between an owner of a life insurance contract and a non-owner;
- either party to the arrangement pays all or part of the premiums;
- one of the parties paying the premiums is entitled to recover (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 life insurance.

Explicitly excepted from this definition is any arrangement to which the only parties are the owner and the insurance company acting only as issuer of the policy.

The final regulations also retain the special rule definition of split-dollar arrangements that captures compensatory and shareholder arrangements not otherwise described by the general rule. The preamble to the final regulations specifically excludes key man insurance owned by an employer where the employee has no rights in the policy.

Two Mutually Exclusive Tax Regimes: The final regulations retain the provisions of the proposed regulations that require the imposition of two mutually exclusive tax regimes with respect to split-dollar arrangements, viz., the economic benefit regime and the loan regime. As with the proposed regulations, the final regulations provide that the identity of the owner (actual or deemed) of the life insurance policy generally determines which tax regime must be used. The economic benefit regime is required in a compensatory arrangement where the employer is the owner of the policy and in a private arrangement where the donor is the owner of the policy.

The final regulations retain the The final regulations provisions of the proposed regulations that define the owner of the life insurance contract. In short, the owner is generally the owner of record, but a special rule further provides that, notwithstanding the general rule, the employer (or donor) will be treated as the owner if the only economic benefit provided under the arrangement is current life insurance protection.

Arrangements entered into before September 18, 2003 may employ the concept known as "switch dollar". This concept involves electing economic benefit treatment and than switching to a loan at some future date, typically when the life insurance policy first acquires equity or when the economic benefit cost equals or exceeds what the interest cost would have been if loan regime treatment had been elected. For arrangements entered into after September 17, 2003, this discretionary election is not permitted. For such arrangements, switch dollar is only available if the arrangement is modified from one requiring economic benefit regime treatment (such as non-equity split-dollar) to one requiring loan regime treatment (such as equity split-dollar).

Determination of the Owner of the Policy: The final regulations retain the provisions of the proposed regulations with respect to the definition of the owner of the policy, viz., the owner of record is presumptively the owner for tax purposes, except where the owner's right to the policy is limited to current life insurance protection. As in the proposed regulations, 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.

The final regulations add common-sense provisions dealing with modifications of an arrangement where the regulations require that the employer/donor be treated as owner (although another party was owner of record), but the arrangement is modified such that the regulations no longer require such a treatment. After such a modification, the employer/donor will be considered the owner of the policy only if it is, in fact, the owner of record.

Attribution Rules: The final regulations also add attribution rules for compensatory arrangements. In a compensatory split-dollar arrangement, the employer is treated as the owner of the life insurance policy if the policy is in fact owned by (1) a trust described in IRC §402(b)(nonexempt employee's trust), (2) a grantor trust under IRC §§671-677, (3) a welfare benefit trust under IRC §419(e)(1), or (4) a member of the employer's controlled group. These attribution rules do not apply where the employer is not the owner of record, notwithstanding that the employer may be deemed to be the owner under Treas. Reg. §1.61-22(c)(2)(ii).

Taxation under the Economic Benefit Regime (Endorsement Split Dollar) :
The final regulations retain the rules of taxation under the economic benefit regime, viz., the value of the economic benefit to the non-owner, reduced by any consideration paid by the non-owner, is treated as being transferred by the owner to the non-owner. Of course, the nature of the relationship between the owner and non-owner will determine the character of the transfer. For example, if the non-owner is the employee of the owner, the transfer will be treated as taxable compensation to the employee. If the non-owner is the trustee of the owner's trust, the transfer will be treated as a gift.

Calculation of Economic Benefit: The value of the economic benefit is calculated the same as it has been under Revenue Ruling 64-328 (together with the several subsequent pronouncements that developed it), with a minor modification. Under the proposed regulations, the value of the economic benefit was calculated from the *average* death benefit for the relevant tax year. The final regulations, however, provide that the value of the economic benefit is calculated from the death benefit on the *last day of the tax year* (or the policy anniversary date if the parties so elect).

There is no indication in the final regulations of a current change in the mechanics of calculating the value of the economic benefit. In fact, the preamble states that "the tax treatment of a non-equity split-dollar arrangement generally

follows the tax treatment of a non-equity split-dollar arrangement under Rev. Rul. 64-328 (1964-2 C.B. 11) and its progeny", which includes IRS Notice 2002-8 (reiterating the use of Table 2001, with "appropriate adjustments" for multi-life cases). It appears that the insurer's annual renewable term rate may still be used if it is lower than the economic benefit value produced by Table 2001, subject to the limitations imposed by IRS Notice 2002-8.

Applicability: The final regulations also retain the tax treatment set forth in the 2003 supplemental proposed regulations for equity split-dollar arrangements taxed under the economic benefit regime. As we stated in our May 8, 2003 summary of the supplemental proposed regulations, the applicability of these provisions is very limited, because by their terms they apply only to so-called "equity endorsement" arrangements. Thus, the value of the economic benefit is the aggregate value of (1) the value of the life insurance protection provided to the non-owner, (2) the amount of policy cash value to which the non-owner has "access" (not already taken into account), and (3) the value of any "other economic benefits" provided to the non-owner during the relevant tax year. As before, the values considered transferred to the non-owner are determined based on values on the last day of the relevant tax year. The non-owner is considered to have "access" to policy cash values if the non-owner has a current or future right to the cash value under the arrangement *and* such value is currently accessible by the non-owner, directly or indirectly, and inaccessible to the owner or the general creditors of the owner.

While these provisions appear to be a start down the slippery slope of taxing current appreciation of life insurance values, the reader should remember that these provisions only apply to the very rare arrangement where the non-owner has rights and access to the cash value in excess of the owner's interest.

Investment in the Contract/Basis: The final regulations, like the proposed regulations, provide that the non-owner has no investment in the life insurance policy until such time as the policy is transferred to the non-owner. The final regulations also retained the rule that amounts paid by the non-owner to the owner as consideration for economic benefit is includible in the gross income of the owner for income tax purposes. The preamble to the final regulations makes it clear that there can be only one owner of a life insurance policy subject to a split-dollar agreement, and only the owner of the policy may have basis in the policy. There appears to be no distinction between arrangements under which the non-owner pays the economic benefit to the insurance company or the owner and those under which the owner pays the entire premium and receives no contribution from the non-owner. These provisions, together with the language in the preamble concerning "renting out" the death benefit, may create an opportunity for the owner to take a capital loss upon termination of arrangements where the underlying life insurance policy value is less than aggregate premiums paid.

Taxation of Amounts Received under the Life Insurance Contract: There is no change in the final regulations from the proposed regulations regarding the rule that any amount received under the life insurance contract policy (other than an amount received by reason of death) and provided, directly or indirectly, to the non-owner is treated as being paid from the insurance company to the owner and then paid by the owner to the non-owner. As did the proposed regulations, the final regulations apply this rule to "specified policy loans". Policy loans to which the rule applies are loans where (1) the proceeds of the loan are distributed directly from the insurance company to the non-owner; (2) a reasonable person would not expect that the loan will be repaid by the non-owner; or (3) the non-owner's obligation to repay the loan to the owner is satisfied or is capable of being satisfied upon repayment by either party to the insurance company.

Likewise, the final regulations retains the rule that death benefit proceeds paid to a beneficiary are excluded from the beneficiary's gross income from income tax purposes under IRC §101(a) only to the extent that the payment is allocable to current life insurance protection provided to the non-owner under the agreement and either (i) the cost of such protection was paid by the non-owner or (ii) the non-owner accounted for the value as an economic benefit (income to the employee, gift to the donee, etc.). The character of the death benefit deemed transferred is determined by the relationship between the owner and the non-owner.

Transfer of a Life Insurance Contract to the Non-Owner: Like the proposed regulations, the final regulations provide that 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). 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.

Non-Material Modifications: Treas. Reg. §1.61-22(j)(2)(ii) provides a non-exclusive list of changes that will not be considered material changes that would otherwise subject the arrangement to the substantive provisions of the final regulations notwithstanding that the arrangement was first entered into before September 18, 2003. For the most part, the list contains only such changes that are quite clearly not material.such as: a change in the premium payment mode, a change in the interest rate payable on the loan, a change to the beneficiary of the life insurance contract (unless the beneficiary is a party to the split dollar arrangement), and administrative changes such as change of address on the policy. Conspicuously absent however, is any discussion of a tax-free exchange of life insurance policies under IRC §1035. The list is, by its own terms, non-exclusive, however. In addition, Treas. Reg. §1.61(j)(2)(i) states that "if an *arrangement* entered into on or before September 17, 2003, is materially modified after September 17, 2003, the arrangement is treated as a new arrangement entered into on the date of the modification." [Emphasis added.]

Taxation Under the Loan Regime (Collateral Assignment): The final regulations generally follow the rules set forth in the proposed regulations for loan regime split dollar. (Commercial loans, such as premium financing loans from a commercial lender, are specifically exempted from the provisions of IRC §7872 under Treas. Reg. §1.7872-5(b).) Under Treas. Reg. §1.7872-15(a)(2)(i)[unchanged from the proposed regulations], a payment made pursuant to a split-dollar arrangement is treated as a loan, and the owner and non-owner, respectively, as borrower and lender if (i) the
payment is made either directly or indirectly by the non-owner to the owner (including a premium payment made by the non-owner directly or indirectly to the insurance company with respect to the policy held by the owner); (ii) the payment is a loan under general principles of Federal tax law or, if not, a reasonable person would expect the payment to be repaid in full to the non-owner (with or without interest); ***and*** the repayment is to be made from, or is secured by, the policy death benefit proceeds, cash surrender value, or both.

As provided in the proposed regulations, the final regulations provide that if a split-dollar loan does not provide for sufficient interest, the loan is a "below-market loan" for purposes of IRC §7872 and Treas. Reg. §1.7872-15. The provisions of IRC §7872 have now become very familiar to those following the recent development of split-dollar regulations. In short, for income tax purposes, the below-market loan is recharacterized as a loan bearing interest at the applicable federal rate ("AFR"). The lender is deemed to have made a transfer to the borrower in the amount of the shortfall between the AFR and the stated interest rates. The borrower is then deemed to have paid this amount back to the lender by way of interest due. The timing, amount, and character of the deemed transfers, and the AFR are determined by the nature of the relationship between the lender and borrower and the terms of the loan.

Split-Dollar Loans with Stated Interest that is Subsequently Waived, Cancelled, or Forgiven: If a split-dollar loan provides for interest, but such interest is subsequently waived, cancelled, or forgiven, adjustments are required to be made to reflect the difference between the interest payable at the stated rate and the interest actually paid by the borrower. The final regulations provide a new rule that, in such a case, an amount is treated as re-transferred from the lender to the borrower, which amount is increased by a deferral charge.

Gift Tax Treatment of Split-Dollar Arrangements: The final regulations apply for gift tax purposes, including private split-dollar arrangements. Thus, if a non-owner party to a private split-dollar arrangement makes a transfer to the owner party that is a split-dollar loan, no gift occurs. If the transfer is not a split-dollar loan, however, the transfer is a gift of an amount equal to the amount transferred.

If, however, the transferor is treated under Treas. Reg. §1.61-22(c) as the owner of the contract, the transferor is deemed to have made a gift to the transferee of an amount equal to the economic benefits provided (less any amounts paid by the transferee, of course). You will recall from the discussion above of the final regulations provisions (unchanged from the proposed regulations) that a donor will be treated as the owner of the life insurance policy although the donee is the owner of record if, under the split-dollar agreement, the only economic benefit provided to the donee by the donor under the arrangement is the value of current life insurance protection.
EXAMPLE: An irrevocable life insurance trust is the owner of a life insurance policy subject to a split-dollar agreement, Donor is obligated under the agreement to pay the premiums on the life insurance policy, and the trust is entitled to the death benefit from the policy, less aggregate premiums paid by Donor. All rights and access to the lifetime values in the

policy are held by the Donor, who also holds the right to repayment from death benefit of aggregate premiums paid. Under Treas. Reg. §1.61-22(c)(1)(ii)(A)(2), Donor will be treated as the owner of the life insurance contract, and will be deemed to transfer the economic benefit of the current life insurance protection to the trustee of the trust. This transfer will be considered a gift from Donor to the beneficiaries of the trust less any amount paid by the trustee to Donor for the economic benefit. Any amount paid by the trustee to Donor for the economic benefit would be includible in Donor's gross income for income tax purposes.

Applicable Rules for Split Dollar: With the publication of the final regulations, a split-dollar arrangement now will be governed by one of three sets of rules, determined by whether the arrangement was entered into (1) before January 28, 2002, (2) after January 28, 2002, but before September 18, 2003, or (3) after September 18, 2003:

1. Arrangements entered into before January 28, 2002, may continue to be structured and accounted for as they always have been, and enjoy some grandfathered benefits provided by IRS Notice 2002-8 until January 1, 2004.
2. Arrangements entered into after January 27, 2002, but before September 18, 2003, may also continue to be structured and accounted for as always, with some differences, but these arrangements do not enjoy the grandfathering provisions; and
3. Arrangements entered into or materially modified after September 17, 2003, are subject to the final regulations. (As noted above,however, the final regulations permit an economic benefit arrangement entered into before January 28, 2002, to convert to a loan arrangement before January 1, 2004, without being treated as a material modification.) However, the final regulations state that for purposes of determining the effective date, a new split dollar arrangement will be entered into after the latest of the following dates: 1) the date the life insurance policy is issued; 2) the effective date of the life insurance policy; 3) the date of the first premium of the life insurance policy; 4) the date of the split dollar agreement; or 5) the date when the arrangement satisfies the definition of split dollar under these regulations.

Change in the Owner: The final regulations add provisions that govern a situation where an arrangement treated as a loan subject to IRC §7872 is modified such that the non-owner becomes the owner of the policy. Under these new provisions, the economic benefit regime will apply to the arrangement after the modification even with respect to the payments made before the modification.

Sarbanes-Oxley Act of 2002: The preamble to the final regulations addresses comments regarding the application of the Sarbanes-Oxley Act of 2002. Sarbanes-Oxley, among many other provisions, criminalizes loans by publicly traded companies to directors and executive officers of such companies. It remains unclear whether (and, if so, how) Sarbanes-Oxley applies to split-dollar arrangements between publicly traded companies and their directors or executive officers. The preamble states that the interpretation and administration of Sarbanes-Oxley is within the jurisdiction of the Securities and Exchange Commission (SEC), not the Department of the Treasury. Any guidance on whether Sarbanes-Oxley will apply to split dollar will have to come from the SEC.

Impact on Other Planning Techniques: The final regulations do not appear to have a significant impact on the following planning techniques:

- Key-person life insurance;
- Premium financing with a third party lender;
- Premium financing with the insured or the insured's trust, as long as the loan interest rate is a fair market rate;
- Section 162 bonus arrangements; and
- Restrictive Endorsement Bonus Arrangements (REBAs).

Loans from employers to employees would, however, be affected by these regulations.

Conclusion: The final regulations do not contain too many surprises. The informed reader will note that the final regulations mainly track the proposed regulations, with some modifications and additions prompted by comments from taxpayers and advisors. As usual, 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 provisions of the final egulations. Now is a perfect time to contact your clients to discuss the effect that the final regulations will have on their split-dollar arrangements, and on prospective arrangements. 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 final regulaions. Manulife will release an updated version of this summary in the coming days.