WHAT'S NEW, WHAT'S DIFFERENT, AND WHAT'S THE SAME IN SPLIT-DOLLAR? [1]

By

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I. WHAT'S NEW, WHAT'S DIFFERENT, AND WHAT'S THE SAME IN SPLIT-DOLLAR?

A. Uses of Life Insurance:

1. as an investment
2. as asset protection
3. to meet family needs and replace lost income
4. to provide liquidity for estate taxes and other expenses at death
5. to fund buy-outs at death
6. funding charitable goals

B. Who Should Own the Policy?

1. The Insured
2. The Insured's Spouse
3. The Insured's children
4. A Revocable Trust
5. An LLC or Partnership
6. An Irrevocable Trust
7. Charity

II. FUNDING THE INSURANCE TRUST WITH A GIFT

A. Gifts of Insurance in General

1. Gifts of Policies

    a. 3-year rule of Section 2035
    b. Valuation Issues (see below)

2. Gifts of Cash

    a. To pay premiums
    b. To purchase policy

[1] This outline is a compilation of outlines written and revised at various times by Lawrence Brody and/or Mary Ann Mancini, used with both authors' permission.

3. Indirect Gifts

a. Employer paid group term life insurance policies
b. Paying the premium directly to the insurance company when policy held by third party

B. Tax Aspects of Gifting

1. Gifting using Gift Tax Exemption

a. 85-90% of policies lapse before death
b. Is it the best use of the Exemption?

2. Gifting using the Annual Exclusion of Section 2503(b)(1)

a. Annual Exclusion only applies for gifts of present interests. Gifts to trusts are gifts of future interests.

b. Crummey v. Comm'r, 397 F.2d 81 (9th Cir. 1968). If an individual has a presently exercisable right of withdrawal over the gift, the gift is eligible for the annual exclusion.

c. The IRS looks for three things in the withdrawal power:

(1) Actual notice to the recipient.

(2) Reasonable time to exercise the power.

(3) Realistic ability to withdrawal (is there property over which the recipient can exercise his or her power?) See Rev. Rul. 81-7, 1981-1 C.B. 474. PLR 8030085. PLR 8006048.

d. Courts have not been so strict.

(1) In the original Crummey decision, the Tax Court stated that "it is likely that some, if not all, of the beneficiaries did not even know that they had any right to demand funds from the trust . . . . they probably did not know when contributions were made to the trust or in what amounts." The Crummey court concluded that the test is not whether a beneficiary is likely to make an effective demand, but whether he or she had a legal right to make a demand which could not be resisted.

(2) The next case to review these rights was Cristofani v. Comm'r, 97 T.C. 74 (1991), in which the Tax Court rejected as a test the likelihood that the beneficiary will actually receive present enjoyment of the property in favor of the "ability of the beneficiaries, in a legal sense, to exercise their right to withdraw such corpus., and the trustee's rights to legally resist the beneficiary's demand for payment." *See also* Estate of Holland v. Comm'r, 73 T.C.M. 3236 at 3237-9 (1997).

(3) In Turner v. Comm'r, T.C. Memo. 2011-29, "some or even all of the beneficiaries may not have known they had a right to demand withdrawals from the trust." Citing the Crummey and Cristofani cases, the Tax Court concluded that premium gifts to an ILIT qualified for annual exclusion since the beneficiaries had the absolute right to demand withdrawals despite the fact that some or all of beneficiaries did not know of their withdraw right.

(4) But Be Careful. Although the legal rationale of both the Crummey and Cristofani decisions could lead to a conclusion that oral or written notification is not necessary to obtain the benefit of a gift tax annual exclusion because of the existence of a Crummey withdrawal power, and Turner so holds, the cautious practitioner should still insist upon such notification in case other courts do side with the IRS or, at least, to avoid the cost of litigating this issue with the government.

e. Deemed or Indirect Gift

Be sure that the Crummey power is triggered by direct and indirect or deemed transfers. Examples of indirect gifts to a trust include a direct payment of premium to the insurance company rather than through the trust and an Employer who pays group term insurance including contributions by insured employee through payroll deduction. In the Turner case, the decedent paid life insurance premiums directly to the life insurance company. The IRS claimed that the Crummey withdraw right was illusory.

(1) The Turner trust stated that the withdraw power applied to "each direct or indirect transfer to the trust."

(2) The Tax Court cited the trust provision referencing both direct and indirect gifts in approving the Crummey power as a present interest.

f. There is always an issue of the existence of a direct or implicit understanding with the beneficiaries not to withdraw.

(1) Especially when they have so-called "naked" withdrawal rights – rights of withdrawal given to those having no other interest in the trust (and accordingly no economic reason not to exercise their withdrawal rights).

(2) Ltr. Rul. 9045002 dealt with withdrawal powers held by current income beneficiaries, contingent remainder beneficiaries and non-beneficiaries; it concluded only the powers held by the direct beneficiaries qualified, since there wasn't any "logical" reason for any of the others not to withdraw (other than an understanding with the grantor).

(3) On the other hand, Ltr. Rul. 9030005 allowed the exclusion for withdrawal powers held by contingent remaindermen.

(4) In Cristofani, a unanimous Tax Court allowed exclusions for the decedent's children who were current income beneficiaries and for her grandchildren who were contingent remainder beneficiaries.

(5) See however Ltr. Rul. 9141008, issued immediately prior to the opinion in Cristofani, repeating the Service's contrary position and see AOD 1992-09, indicating the Service's view that only current income beneficiaries and vested remaindermen can be "counted" as Crummey powerholders; the AOD acquiesces in the result of Cristofani only – it also indicates that the next "worst" (i.e., more aggressive) case will be challenged.

(6) The Service raised the same challenge in Kohlsaat v. Comm'r, T.C. Memo. 1997-212, a Tax Court Memorandum decision, which the Service lost, reaffirming Cristofani.

(7) See also AOD 1996-10, expanding on the Service's rationale for acquiescing in the result of Cristofani, and indicating its willingness to litigate the issue where there was a pre-arranged understanding that the right wouldn't be exercised or that the exercise would have adverse consequences to the powerholder.

g. Always plan for the gift and estate tax effects on the holders of the power.

(1) Amounts that are not withdrawn by the holders in any year are lapses of the power, which are treated as releases of general powers of appointment for both gift and estate tax purposes, but only to the extent the lapse of the power exceeds the greater of $5,000 or 5% of the value of the trust fund (Section 2514(e)).

(2) Note that it is only lapses of powers which are protected by that floor; presumably waivers or renunciation of the rights would be treated as releases, and not as lapses, and would not receive the protection of Section 2514(e).

(3) The gift and estate tax problem for the holders of the powers arise upon the lapse of the right to withdraw the amount that exceeds the "5 or 5 power". They will be deemed to have made a gift of a future interest to the trust **and** as if they were transferors of such property for purposes of the retained interest rules, possibly resulting in inclusion in the estate under Sections 2036 and/or Section 2038. There are also income tax consequences that can arise from the taxable gift under the grantor trust rules of Section 678.

(4) There are some gift tax, but in most cases no estate tax, solutions for powerholders.

(a) an on-going special (testamentary) power of appointment; or

(b) a "hanging" power that allows the full amount transferred to the trust for the powerholder to be withdrawn, but not lapsed in any year in excess of the "5 or 5 amount" and those excess amounts "hang" in abeyance until they can lapse within the protected amount.

III. THE GENERATION-SKIPPING TRANSFER ("GST") TAX CONSEQUENCES OF INSURANCE PREMIUM PAYMENTS TO TRUSTS

A. Insurance Trusts with Multiple Beneficiaries

1. The traditional insurance trust using multiple <u>Crummey</u> power holders to qualify the contributions of premium amounts for annual gift tax exclusions will not qualify those contributions for annual GST tax exclusions. See Section 2642(c)(2). For a contribution to a trust to qualify for an annual exclusion from the GST tax:

    a. Distributions from the trust must be solely for one individual (i.e., a skip person) during that individual's lifetime. See Section 2642(c)(2)(A).

    b. The trust must be included in that individual's estate if the trust does not terminate before that individual dies. See Section 2642(c)(2)(B).

2. Thus, trusts with multiple current beneficiaries or trusts that are not included in the individual beneficiary's estate do not qualify for the annual exclusion from GST tax.

3. Instead, to obtain GST exempt status for the trust, GST exemption must be affirmatively or automatically allocated to the trust.

B. Beware of Relying on Automatic Allocation Rules

1. A trust is not a GST trust to which automatic allocations of GST exemption would apply if any portion of the trust assets would be included in a non-skip person's estate (other than the initial transferor) if such person died immediately after the transfer. See Section 2632(c)(3)(B)(iv).

2. For withdrawal rights in a trust that are limited to the annual exclusion amount under Section 2503(b), however, the trust is a GST trust if a generation-skipping transfer is likely to occur. See Section 2632(c)(3). As many insurance trusts are meant to benefit the settlor's children and grandchildren, the automatic allocations of GST exemption from the trust qualifying as a GST trust would be helpful.

    a. If these withdrawal rights equal to the annual exclusion amount are permitted to lapse, the beneficiaries who had these withdrawal rights would be deemed to have made a gift of the value of the assets over which they had the power to withdraw in excess of the greater of $5,000 and 5% of the trust. See Section 2514(e). Each beneficiary who made a gift through the lapse of a withdrawal power would become the new transferor for GST tax purposes of the excess, potentially leading to a beneficiary's GST exemption being automatically allocated to the trust unknowingly.

b. Commonly, however, withdrawal rights exceeding the greater of $5,000 and 5% of the trust will hang until the withdrawal right can lapse in another year—many times upon the settlor's death, when the insurance proceeds pour into the trust.

c. When trusts have hanging powers, the trust may cease being a GST trust when there is a new contribution to the trust over which the beneficiary may withdraw the annual exclusion amount. This is because the hanging amount from previous years, plus the new withdrawal right of the annual exclusion amount will exceed the annual exclusion amount. Thus, a trust may receive automatic allocations of GST exemption in one year because of its status as a GST trust and the next year lose that status, eliminating the automatic allocations.

d. If automatic allocations of GST exemption apply to the trust and distributions are made to non-skip persons (e.g., the settlor's children), then GST exemption will be wasted on those distributions.

3. Using a special power of appointment, instead of a hanging power, over the amount exceeding the greater of $5,000 and 5% of the trust would avoid any issue with the beneficiary's withdrawal amount affecting the GST status of the trust.

4. Filing affirmative elections into or out of GST trust status or affirmative allocations of GST exemption also avoid the issues with automatic allocations of GST exemption to insurance trusts.

IV. THE ESTATE TAX CONSEQUENCES OF INSURANCE

A. Estate Tax Inclusion of Insurance in the Insured's Estate Can Arise Under the Following Circumstances:

1. If the policy is held in an irrevocable trust, gifts of the policy or cash can result retained interests under Sections 2036 and/or Section 2038.

a. Unless the insured reserves rights over the trust, this is usually not a problem for the insured.

b. If the insured's spouse is a trustee or beneficiary, if there is a direct or indirect gift by the spouse to the trust, there is a retained interest problem for the spouse.

c. This is not an issue unique to life insurance.

2. Under Section 2041(2), if the insured holds "incidents of ownership" over the policy, it will cause inclusion of the policy death benefit in the estate of the insured, regardless of the actual ownership of the policy.

   a. Definition of "incidents of ownership" in a life insurance policy is found in Reg. Sec. 20.2042-1 and essentially it is the economic benefits of the policy, such as the ability to name beneficiaries, borrow against the policy, pledge the policy or surrender the policy.

   b. Rev. Rul. 84-179, 1984-2 C.B. 195, carved out an exception where the insured inherited ownership and couldn't exercise the incidents of ownership for his own benefit.

   c. A majority (51%) owner of an entity, a manager of an LLC and a general partner of a partnership will all be deemed to own any incidents of ownership owned by the entity that owns (or has rights to) an insurance policy.

3. If the insured transfers the policy to the insurance trust within three years of death, there will be inclusion in the estate of the insured under Section 2035.

   a. Anytime the idea of transferring presently owned life insurance policies to an insurance trust is raised, due to the three-year rule, the following alternatives should be discussed:

      (1) whether it would be possible for the trust to obtain new life insurance on the insured;

      (2) if that is not possible, should the insurance policy include a rider that pays out a larger amount of life insurance if death occurs within three years of the transfer, to offset the estate tax; or

      (3) if the insured is married, should a QTIP trust be set up in the insurance trust so that if the insured dies during the three-year term the marital deduction could be elected to defer the estate tax payable until the death of the spouse?

4. If the death benefit is payable or paid, directly or indirectly to the estate of the insured, the death benefit will be includable in the estate of the insured under Section 2042(1).

   a. Death benefit proceeds received directly or indirectly by the insured's estate will be includable in the insured's taxable estate.

   b. Death benefits payable to an irrevocable trust will generally not be a problem, so long as the trust doesn't require the use of the insurance proceeds to pay estate taxes or other obligations of the insured's estate. For this reason, the provisions of an insurance trust do not direct the use of the death benefit to pay estate taxes. Instead, it authorizes a purchase of assets from the estate or a loan of the proceeds to the estate to provide liquidity to the estate to pay taxes and expenses, without causing Section 2042(1) to apply to the proceeds. See Rev. Rul. 77-157, 1977-1 C.B. 279, PLR 2001407039.

c. Usually the trust agreement also provides that there will be no distribution of the principal of the trust estate for three years after the death of the insured, to ensure the funds remain in the trust and available for transactions with the estate during the time the IRS has to audit the estate tax return.

d. The result of this is that the insurance trust does not disappear at the insured's death, a common misunderstanding of clients. It will continue after the insured's death since it will hold the purchased assets and notes it received from the estate. Accordingly, the provisions of the insurance trust must be as carefully addressed as the provisions for the disposition of the estate.

e. What if the beneficiaries of the estate and the beneficiaries of the insurance trust are not the same? This can cause family conflict and fiduciary issues for the Trustee and Personal Representative.

V. OTHER INSURANCE ISSUES

A. Transfer for Value Rules

1. Transfers of policies for consideration by the owner of the policy are subject to the "Transfer for Value" rules of Section 101, unless certain exceptions apply.

2. Transfer for value rules of Section 101(a)(2)

a. Under the transfer for value rules of Section 101(a)(2), life insurance proceeds in excess of the owner's investment in the contract will be taxed as ordinary income if there has been a transfer of the policy or any interest in the policy for valuable consideration.

(1) It does not apply to the initial purchase of the policy or a pledge of the policy (or using the policy as security for a transaction).

(2) Transfers for value do include any sale or transfer of rights in the policy for consideration, including transferring policies that are subject to loans.

(3) Transfers are broadly defined and include naming someone as a beneficiary of a policy for valuable consideration and reciprocal designations of beneficiaries. In Monroe v. Patterson, 197 F. Supp. 146 (N.D. Ala. 1961), the mutual promises of co-owners in a buy-sell arrangement to transfer life insurance policies amounted to transfers for value.

b. There are five exceptions under Section 101(a)(2). If a policy is transferred for valuable consideration, but the transfer fits within one of these exceptions, the death benefit will not be subject to income tax.

(1) Carryover basis. If the basis in the hands of the recipient is determined, in whole or in part, by reference to the original owner's basis, the transfer for value rules will not apply. This exception can protect part-sale, part-gift situations where the transferor's basis is greater than the consideration paid by the transferee (including gifts of policies with outstanding loans (a transfer for value), so long as the basis is greater than the loan amount). Tax-free transactions, such as contributing policies to an entity, transfers to spouses under Section 1041, and transfers in a tax-free corporate reorganization will also be protected.

(2) Transfers of a policy to the insured are exempt from these rules, even if the policy is sold to the insured. Transfers to a grantor trust in which the grantor is the insured, and transfers between two grantor trusts in which the grantor for both trusts is the insured, will fall under this exception. PLR 201235006.

(3) Transfer to a partner of insured. There is no de minimis rule on how much of a partnership interest the partner has to own. There is no corresponding exception for co-owners of a corporation or beneficiaries of a trust.

(4) Transfer to a partnership in which the insured is a partner.

(a) The Service looks for a business purpose to find a valid partnership.

(b) The Service has ruled in the past that the transfer of a policy from a trust to a limited partnership in which the insureds were limited partners would not constitute a transfer for value, and the limited partnership was a valid partnership. PLR 200111038.

(c) The Service will not rule on this issue at this time.

(d) This exception should include limited liability companies ("LLC"s). PLR 9625013. A recent private letter ruling addressed a partnership in Kansas which was to be converted to LLC and held that although there was a transfer for value, the LLC was treated as a partnership for tax purposes and the exception to the rule was applied.

(e) In Rev. Proc. 99-3, the Service stated that it would not issue advance rulings on the status of the partnerships substantially all of the assets of which consist of life insurance on the lives of the partners, and whether the transfer of the life insurance policies to such partnerships would constitute a transfer for value.

(5) Transfer to a corporation in which the insured is a shareholder or officer.

c. If a previously tainted policy (considered transferred for value) is subsequently transferred under one of the exemptions, it can lose its taint. See Treas. Reg. Section 1.101-1(b)(2) and (3).

3. If a policy is transferred for value, the amount includable in taxable income is the death benefit minus (i) actual value of consideration, and (ii) premiums and other amounts subsequently paid by transferee.

B. Valuation of Life Insurance Policies

1. The gift tax valuation of a policy is set out in Regulation Section 25.2512-6(a), which was written when there was no market for life insurance policies and the only types of insurance policies that were available were whole life policies and term policies. These Regulations were based on early Supreme Court cases dating from the 1940s.

a. In Guggenheim v. Rasquin, 312 U.S. 254, 255 (1941), the Court held that the fair market value of the policy was not its cash surrender value, but rather the purchase price, because "[c]ost is cogent evidence of value" when the purchaser assigned the policy to three of her children at "substantially the same time" as the purchase.

b. In United States v. Ryerson, 312 U.S. 260 (1941), five years had elapsed between the purchase of the policy and its assignment. The Court held that the replacement cost of the policy at that time of the assignment, rather than the policy's original purchase price, was the correct valuation of the policy for gift tax purposes.

2. The Regulations state that the fair market value of a policy for gift tax purposes is the cost of a "comparable" policy.

a. For a new policy, its gift tax value would be the premium paid.

b. For a single premium policy, its gift tax value is its replacement cost. But See Revenue Ruling 78-137, 1978-1 C.B. 280, concluding that since there was no comparable contract providing the same economic benefits (the entire bundle of rights provided in the original policy), the ITR (which is discussed below) approximation of the Section 2512 Regulations, had to be used.

c. For a policy on which further premiums are due and which has been in force for some time (an undefined term), since replacement cost would be hard to determine, the regulations provide that its gift tax value can be approximated by the policy's interpolated terminal reserve ("ITR") plus any prepaid premiums. See, e.g., Rev. Ruls. 81-198, 1981-2 C.B. 188 (holding that a policy that had been in force for seven years had been "in force for some time") and 79-429, 1979-2 C.B. 321 (reaching a similar conclusion for a policy which had been in force for only three years).

3. Interpolated Terminal Reserve

a. The type of policy and the insured's health are not relevant considerations in the ITR determination.

b. The ITR concept only realistically applies to traditional whole life policies (which were the only kind of permanent policy available when the Regulations were adopted), where policy values are guaranteed to increase at stated intervals during the life of the policy.

c. However, ITR is being used as the method of valuation for policies where there is no guaranteed increases in cash surrender value, such as universal, no lapse guarantee, and variable life policies.

d. Reserves that Set the ITR:

(1) There are many different reserves, i.e., the carrier's income tax reserve, the reserve required under state law, and the "deficiency" reserve, to name a few.

(2) Which "reserve" does the carrier use in determining the ITR?

(3) These reserves, which are carried on the carrier's books, can increase the value of term policies.

(4) There is also a concept known as a "shadow account" used in a no-lapse guarantee universal life policy which can increase the policy's ITR (even when cash values are low or even non-existent).

e. Form 712

(1) How values of policies are reported on a Form 712 is not consistent among carriers.

(2) Some carriers will only report the ITR, some report policy cash values as well, and some report alternative values based on its different reserves.

f. The Regulations also provide that if, "due to the unusual nature of the contract" (an undefined phrase) the regulation formula doesn't reasonably approximate its full value (also an undefined phrase), it may not be used (with no indication of what may be used instead)."

(1) See Pritchard v. CIR, 4 T.C. 204 (1944), where the Court held that "normal" policy gift tax values don't apply if the insured

is "near death" (an undefined term) and if this is the case, the fair market value of the policy is close to the face value of the policy.

(2) Are new types of policies, such as variable and universal policies (or even level term policies) so unusual, in light of the policies in existence when the Regulations were written, that the Regulations cannot be used to value any policy other than whole life policies and term policies?

g. Consider two alternative methods of valuation: the life settlement market and an independent appraisal.

(1) A gift of a policy worth more than $5,000 to charity requires an independent appraisal, under Section 170(f)(ii)(c).

(2) Establishing the life settlement market for a policy is difficult because each policy (and each insured) is so different and many insured would be horrified at the idea of an investor owning a policy on the insured's life. Does the insured have to go through the life settlement process, by getting examined and the policy placed for offers in order to establish the market for the policy?

h. Should practitioners request all possible values for a policy before deciding what value to use for reporting the transaction?

VI. LOANS TO TRUST HOLDING POLICY TO PAY PREMIUMS

A. Description of "Premium Financing" of Life Insurance

1. Generally, the insured, as grantor, will create an irrevocable insurance trust to become the owner of a new policy on his or her life (or on the lives of the grantor and his or her spouse on a survivorship basis). The insurance trust will pay all or a portion of the premium payments due on the policy with funds that it borrows (the lender could be a family trust, the grantor or the grantor's spouse, or LLC or a completely unrelated lender, such as a bank). The trust will pay interest on the loan usually with funds received directly or indirectly from the grantor, either as part of the initial trust funding or as annual gifts; the principal of the loan will be repaid at the end of the term of the loan or at the insured's death. If the loan is from a third party, the grantor might guarantee the third party's loans to the trust and/or pledge assets as security for its loans.

2. The transaction could be a series of loans as each premium comes due, or one large loan designed to cover all future premiums (with growth assumptions built into the amount) or to cover a single premium policy. The second alternative allows the grantor to capture current low interest rates.

3. A more complicated alternative involves the insurance trust acquiring both the policy and an annuity, both on the insured's life (from different carriers) and borrowing the single premium for the annuity. The annuity payments would pay the premiums on the insurance policy.

B. The Final Split Dollar Regulations As They Apply to Loans

1. The final split-dollar Regulations define a split-dollar arrangement as one between an "owner" and a "non-owner" of a life insurance contract, pursuant to which either party pays all (or a part) of the premiums and at least one party is entitled to recover all or a portion of those premiums and that recovery is to be made from or is secured by the proceeds of a policy.

    a. Loans used to pay premiums that are secured by the policy (premium financing arrangements) are included in this broad definition, although, in most cases, so long as interest is paid (or accrued) at the AFR, the general tax rules governing loans, and not the special split-dollar loan rules of the final Regulations, will apply.

    b. However, as described below, there are special rules for loans with interest paid at the AFR where the lender is "to pay" the interest to the borrower, for interest which is forgiven, and there are special filing requirements for non-recourse loans, as well as payment ordering rules, all of which could apply to premium financing transactions (especially those where the grantor, his or her spouse, or a controlled entity is the lender).

2. If a payment made under a split-dollar loan is non-recourse, Reg. Sec. 1.7872-15(j) treats the loan as a loan that provides for contingent payments (increasing the complexity of calculating the tax consequences and testing for the adequacy of interest), unless the parties to the arrangement provide a written representation with respect to the loan that indicates that a "reasonable person" would expect all payments under the loan to be made.

    a. The word "non-recourse" is not defined in the Regulations; it isn't clear if it is broad enough to mean a recourse loan to a trust with no assets other than a policy.

    b. The Regulations require that, subject to future IRS rules, representation be attached to both parties' tax returns for each year such a loan is made.

3. The Regulations ignore the stated interest on a loan document (which would cause the loan to be considered a below-market split dollar loan), if "all or a portion of the interest is to be paid directly or indirectly by the lender or a person related to the lender."

    a. The result would be imputed interest as well as possibly reclassification of the loan as a hybrid loan under the split dollar Regulations that, if considered a term loan, will have gift tax consequences equal to the present discounted value of all imputed interest for the term deemed to be transferred to the borrower at the outset of the loan.

    b. A "facts and circumstances" test will be used to determine if the interest is "to be paid" by the lender; there is no definition in the Regulations of the phrase "to be paid."

c. The example in the Regulations provide that amounts to be paid by an employer under a fully vested non-qualified deferred compensation arrangement that will pay the employee an amount of the interest due under the split-dollar loan will be disregarded. However, a fully vested non-qualified deferred compensation arrangement that provides for payment equal to the employee's salary, which the facts and circumstances show is not related to the employee's interest obligations, will not be disregarded.

4. The split dollar Regulations also provide that stated interest that is waived or forgiven by the lender will be treated as transferred from the lender to the borrower and is subject to a deferral charge equal to the underpayment of tax interest penalty.

a. If the loan is a nonrecourse loan where the parties have made the representation described above, then if interest is waived or forgiven, the amount forgiven or waived will still be considered transferred from lender to the borrower, but no deferral charge will be imposed. This is another reason for the parties to execute the representation.

5. Finally, the split dollar Regulations also provide that when repaying a series of loans, the repayment must be in the order the loans were made. So there is no ability to pay off loans with higher interest rates first.

C. Income Tax Consequences of Premium Financing Arrangements

1. The income tax consequences of these transactions are dependent upon whether the trust (or a portion of the trust) is classified for income tax purposes as a "grantor trust" or a "non-grantor trust." If the grantor is the lender and the borrower/trust is a grantor trust, then the arrangement is ignored for income tax purposes.

a. A grantor trust power that is unique to trusts holding insurance: the Section 677(a)(3) power.

(1) Under Section 677(a)(3), the grantor of a trust is treated as the owner of any trust (or a portion of any trust) as to which the grantor or a non-adverse party may apply trust income to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.

(2) The Sections raises certain questions:

(a) Does the term "income" in this Section referring to fiduciary accounting income or taxable income? Fiduciary accounting income does not usually include capital gains, a principal item.

(b) Is it sufficient that the trust may pay the expenses out of taxable income to cause the trust to be a grantor trust, or must it in fact pay such premiums out of such income (and not principal that is not taxable income)?

(c) What if the premiums are less than the income of the trust? Is the trust only partially a grantor trust?

(3) While trust provisions preventing trust income from being used to pay insurance premiums would seem to make Section 677(a)(3) inapplicable to such an insurance trust, there is very little authority on this issue, and much of the authority which does exist is based on the predecessor to Section 677(a)(3).

(a) The Service will not issue private letter rulings regarding the status of irrevocable insurance trusts where the trustee has the power to use trust income or principal to pay premiums on policies insuring the grantor's life.

(b) Ltr. Rul. 8839008 raises the issue of whether an insurance trust can ever be treated as a non-grantor trust. There, grantors, husband and wife, created two irrevocable trusts that did not, at that time, own, nor pay premiums on, any life insurance policies on the life of either grantor. The trust instruments provided that "Trust income shall not be applied toward the payment of insurance premiums for policies on the life of any contributor to Trust." Further, any undistributed income was to be accumulated and added to corpus. Several years later, each trust purchased a survivorship policy on the lives of the grantors, paying the single premium out of the trust principal. The amount of the premium exceeded each trust's total taxable income for that year.

(i) In ruling on whether these trusts were grantor trusts under Section 677(a)(3), the Service began by drawing a distinction between trust accounting income and income as determined for tax purposes.

(ii) The Service concluded that the trust instrument prevented only the use of trust accounting income from being used to pay premiums, but that the source of premium payments for trust accounting purposes is immaterial for purposes of Section 677(a)(3). Therefore, because the amount paid for the insurance premium exceeded the taxable income of each trust during the year the policies were purchased, the grantors were treated as owners of the entire taxable income of the trusts for that year.

(iii) If Congress in enacting Section 677(a)(3) had intended for the source of premium payments to be immaterial, it could have written Section 677(a) to apply to both trust income and corpus, rather than just income, as it did in Section 677(b) where it states that to the extent that the grantor's legal obligation of support is "paid out of corpus or out of other than income for the taxable year," such amounts will be taxed to the grantor under Section 662 and not under the grantor trust provisions.

(iv) The courts have generally restricted attempts by the Service to expand the predecessors of Section 677(a)(3). While most of the cases interpreting the predecessor to Section 677(a)(3) date from the 1930s and 1940s, they are helpful in interpreting Section 677(a)(3) because of the relatively minor differences between Section 677(a)(3) and its predecessors. In these cases, there were three variables that determined the results in the case law under the predecessors of Section 677(a)(3), namely (1) the ability of the trustee to use trust income to pay premiums; (2) whether the trust held an insurance policy on the life of the grantor; and (3) whether the trustee actually paid premiums on such an insurance policy out of the income of the trust.

(v) The easiest cases to resolve were those where: (1) the trustee was not prohibited from using trust income to pay premiums, the trust owned an insurance policy on the grantor's life, and the trustee paid premiums on that policy out of the trust income, and those where (2) the trustee was prohibited from using trust income to pay premiums, the trust did not own an insurance policy on the grantor's life, and the trustee did not pay premiums on that policy out of the trust income. These two cases fall directly inside or outside, respectively, the scope the predecessor of Section 677(a)(3).

(vi) If a trust were to allow the trustee to pay premiums on and were to hold an insurance policy on the grantor's life, but not pay premiums on it out of the trust income, then under the holding of *Chandler v. Comm'r*[1], the trust would not be a grantor trust under Section 167(a)(3). There, the trust instrument provided that premiums should be paid out of trust income only to the extent not paid by insurance policy dividends and contributions from the grantor.

(vii) A trust that granted the trustee the ability to pay premiums but which neither held an insurance policy on the grantor's life nor used its income to pay premiums will not be considered a grantor trust under Section 167(a)(3). This situation arose in both *Moore v. Comm'r*[2] and *Weil v. Comm'r*[3], in which the Service attempted to extend the application of Section 167(a)(3) to trusts that simply allowed for trustees to pay premiums on insurance policies, regardless of whether the trusts actually held insurance policies or paid any premiums. In *Moore*, the trust instrument provided that the trustee "may invest in and/or pay the premiums on policies." In *Weil*, the trust provided that the net income of the trust property should be used to pay the premiums on policies. In neither case did the trusts hold insurance policies or pay premiums.

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[1] 119 F.2d 623 (3rd Cir. 1941).
[2] 39 B.T.A. 808 (1939), *acq.*, 1939-2 C.B. 25.
[3] 3 T.C. 579 (1944), *acq.*, 1944 C.B. 29.

(viii) In *Rand v. Comm'r*[4], the court considered the situation where the trust owned an insurance policy and the trustees paid premiums on the policy out of trust income, even though the trust did not specifically allow for the payment of premiums out of income. The taxpayer argued that, although nothing under state law prohibited a trustee from investing in life insurance and the trust was silent on this issue, the use of trust income to pay insurance policy premiums was not authorized by the trust instrument and was therefore a breach of trust. The court found this result inconceivable, noting that the taxpayer was both grantor and trustee and that it was unlikely that the taxpayer, as trustee, would administer the trust against the wishes of the taxpayer, as grantor. The court concluded that, even where a trust was silent as to whether income could be used to pay premiums, Section 167(a)(3) dictated grantor trust status for a trust that held an insurance policy on the grantor's life, the income of which was used to pay premiums.

(ix) Finally, there is a question as to how a trust will be treated under Section 677(a)(3) if it owns an insurance policy on the grantor's life, the trustees are specifically prohibited from paying premiums out of trust income, and no such premium payments are made out of the trust income. As discussed above, *Chandler*, *Moore* and *Weil* can all be read to stand for the proposition that a trust is a grantor trust only to the extent that trust income is used to pay premiums on an insurance policy on the life of the grantor. In addition, *Rand* indicates that whether a trust expressly provides the trustee with the power to pay premiums out of trust income is immaterial. The court in *Rand* also seemed to imply that even if the trust specifically prohibited the use of income for the payment of premiums, the breach of trust by the trustee who uses trust income to pay premiums would not prevent grantor trust treatment for the trust under Section 167(a)(3).

(c) Accordingly, the case law applying Section 167(a)(3) is in conflict with the Service's position in Ltr. Rul. 8839008. Although, in the ruling, the Service tried to eliminate the distinction between principal and income under Section 677(a)(3) by creating a "trust accounting income" and "taxable income" dichotomy, the general weight of the prior case law is that the trust must own an insurance policy on the life of the grantor and the premiums on that policy must be paid out of the trust income during the taxable year in order for the trust to be considered a grantor trust. The assertion that it is immaterial whether the payments were actually made out of income or principal, so long as the amount of the payments exceeded the taxable income of the trust, is an excessively broad reading of Section 677(a)(3) in light of the substantial precedents under the predecessor to Section 677(a)(3) holding to the contrary, as well as a literal reading of the statute.

(4) Drafting to avoid grantor trust status under Section 677(a)(3)

[4] 40 B.T.A. 233 (1939), *acq.*, 1939-2 C.B. 30, *aff'd*, 116 F.2d 929 (8th Cir. 1941), *cert denied*, 313 U.S. 594 (1941).

(a) Draft the trust agreement so that either income is automatically distributed to the beneficiaries upon receipt, or so that income is segregated in a separate accrued income account and is prohibited under the terms of the trust from being used to pay premiums on policies on the grantor's life (or his or her spouse). To the extent that Ltr. Rul. 8839008 is correct with regard to its "taxable income" versus "trust accounting income" dichotomy, any prohibition on the use of trust income, or any automatic distribution of trust income, should be drafted in such a way that the income to which the prohibition or distribution applies is the "taxable income" of the trust.

(b) Require that any discretionary use of trust income to pay premiums on a policy on the life of the grantor or his or her spouse be consented to by an "adverse party" – a trust beneficiary whose interest would be effected by such a use of trust income.

(c) See Ltr. Ruling 9227017, which addressed a CRT holding life insurance and avoiding Section 677(a)(3).

b. Another grantor trust power that causes an issue for a trust holding an insurance policy.

(1) If it is important to be sure the entire trust will be treated as a grantor trust for income tax purposes, adding an additional grantor trust power, which would not be estate tax sensitive, should be considered and one such commonly used grantor trust power is the administrative power to reacquire trust assets by substituting assets having an equivalent fair market value, held in a non-fiduciary power (by the grantor or by any other – presumably, non-adverse person). The court in *Jordahl v. CIR*[5] held that such a power held by the grantor-insured was not an incident of ownership in the policy owned by the trust for purposes of Section 2042(2). In *Jordahl*, however, that power was held in a fiduciary capacity; would the court find the same way for a power held in a non-fiduciary capacity?[6]

(2) Rev. Rul. 2008-22 held such a power of substitution would not be a Section 2036 nor a 2038 power, so long as the trust instrument or local law required that the trustee has a fiduciary duty to ensure that the properties are, in fact, of equivalent value, and the substitution power cannot be exercised so as to shift beneficial interests. The ruling did not, however, refer to Section 2042.

[5] 65 TC 92 (1975).
[6] See also Ltr. Ruls. 9413045 and 9227013.

(3) Rev. Rul. 2011-28 extended the holding of Rev. Rul. 2008-22 to Section 2042, which should put that issue to rest, so long as the power is similarly limited.

2. Income tax consequences on the termination of the trust's status as a grantor trust (either at the grantor's death or during his or her lifetime) since the Trust has a loan payable to the Grantor in the Transaction.

a. The trust will cease to be a grantor trust upon the death of the grantor, or upon termination of the power(s) which caused it to be treated as a grantor trust during the grantor's life. As a result, the trust will no longer be disregarded for income tax purposes, and instead will be treated as a separate taxable entity.

(1) Upon the termination of the trust's grantor status during the grantor's lifetime, the termination of that status will be treated as a sale of the policy by the grantor for the outstanding loan. That deemed sale would generate gain under Section 1001 Regulations, to the extent the outstanding liability exceeded the grantor's basis in the policy.

(a) Under the general rule of Treas. Reg. Section 1.1001-2(a)(1), the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of such sale or disposition; in this case, the trust's deemed assumption of the grantor trust's loan by the new non-grantor trust will be treated as a discharge of the grantor's liabilities in consideration for the assets (the policy) that the grantor is deemed to have transferred to the new non-grantor trust.

(b) However, Treas. Reg. Section 1.1001-2(a)(3) provides an exception to this rule when a liability is incurred for purposes of acquiring property and is not taken into account in determining the transferor's basis in such property (for example, where the loan is between the grantor and the trust and thus is ignored for income tax purposes under Rev. Rul. 85-13). Under these circumstances, the assumed liability will not be included in the amount realized by the transferor and therefore will not cause recognition of gain.

(i) Example 5 of Treas. Reg. Section 1.1001-2(c) illustrates what is deemed to occur on termination of grantor trust status during the grantor's life. In the Example, a grantor was considered to be the partner of a partnership in which the grantor trust held an interest. Upon termination of grantor trust status on the renunciation of a grantor trust power, a constructive transfer of the partnership interest to the trust was deemed to occur. The Example concludes that the grantor is required to recognize gain to the extent the allocable share of partnership liabilities assumed by the trust exceeds the grantor's basis in the partnership interest.

(ii) Similarly, in *Madorin v. Commissioner*[7], a grantor transferred to a grantor trust an interest in a partnership that held encumbered assets. The grantor deducted the net losses from the partnership until the trustee renounced a power that had caused the trust to be a grantor trust. The court held that the grantor was released from his share of the underlying liabilities and recognized a gain to the extent that these liabilities exceeded the basis of the partnership interest.

(iii) See the issue with the Grantor's basis discussed below under Rev. Ruling 2009-13.

(c) In applying the general rule of Treas. Reg. Section 1.1001-2(a)(1) to a premium financing transaction, on the termination in status of the trust as a grantor trust, the grantor will be deemed to have transferred the life insurance policy to the trust in exchange for the trust's assumption of the loan incurred in connection with the trust's acquisition of the policy. Under the general rule, the grantor will realize income to the extent the liability (i.e., the amount of the loan on termination of the trust's grantor trust status) assumed by the trust exceeds the grantor's basis in the policy. If the exception of Treas. Reg. Section 1.1001-2(a)(3) applies, because the liability (the loan) was incurred in connection with the acquisition of the policy and is not taken into account in determining the grantor's basis in the policy – which would be true of a loan between a grantor and his or her grantor trust – then no income will be realized by the grantor on termination of the trust's grantor trust status, even if the liability deemed assumed by the trust exceeds the grantor's basis in the policy.

(2) There is even less certainty about the income tax consequences of termination of grantor trust status as a result of the death of the grantor, where the trust has outstanding liabilities (to the grantor or to a third party).

(a) Some commentators believe that the grantor's death has no tax consequences; under that analysis, death is not an event that triggers gain recognition. Another possible result, and the one which the IRS would likely endorse, is that the income tax consequences on the death of the grantor follow those that are deemed to occur when grantor trust status is terminated during the grantor's life, as set forth in the regulations under Section 1001 and other authorities. Under that analysis, the income tax consequences would be the same whether termination of grantor trust status is a result of the grantor's death or a termination of the applicable grantor trust power(s) during the grantor's life.

(b) The other open issue here is when the "transfer" takes place – at the moment of, the moment before, or the moment after the

[7] 84 T.C. 667 (1978).

event ending grantor trust status, in this case, the insured's death. There isn't any direct authority on this issue, but there is an arguably analogous area – the termination of grantor trust status of a foreign trust taxed under Section 679. There, on the one hand, Reg. Sec. 1.679-2(c)(2), provides that the deemed transfer there takes place the moment after grantor trust status ends, but on the other hand, Reg. Sec. 1.684-2(e) provides upon the death of the grantor, he or she is treated as having transferred the property to the trust immediately before death. In the transfer for value situation, it would seem that, if that the rule is that the policy would be deemed to be transferred after death, there would not have been even a deemed transfer of the policy during the insured's life.

(3) One issue that may arise upon the termination of the trust's grantor trust status and the resultant deemed transfer of the policy in exchange for the release of the grantor's liability, is that a transfer for value of the policy under Section 101(a)(2) has occurred upon such transfer when the grantor trust becomes a non-grantor trust. If a policy is transferred for value, the amount includable in taxable income is the death benefit minus (i) actual value of any consideration received (in this case, relief from the liability), and (ii) premiums and other amounts subsequently paid by transferee (which, in this case would not occur).

(a) Under the transfer for value rules of Section 101(a)(2), life insurance proceeds in excess of the owner's investment in the contract will be taxed as ordinary income if there has been a transfer of the policy or any interest in the policy for valuable consideration.

(b) Transfers for value include the sale of the policy, the transfer of rights to the policy proceeds for consideration and transfers of policies subject to loans. Transfers are broadly defined under this Section, but it isn't clear that they are so broadly defined as to include a deemed transfer for income tax purposes that does not involve a physical transfer of an interest in a policy – this deemed "transfer" does not change who will benefit from the policy proceeds, which is the concern which underlies the transfer for value concept.[8]

(c) There are five exceptions under Section 101(a)(2). If a policy is transferred for valuable consideration, but the transfer fits within one of these exceptions, the death benefit will not be subject to income tax. Only one of the five exceptions would be applicable in the context of a deemed transfer that would occur when a grantor trust becomes a non-grantor trust and the non-grantor trust is obligated on a note. If the basis in the hands of the recipient (the non-grantor trust) is determined, in whole or in part, by reference to the original owner's basis (the grantor trust), the transfer for value rules will not apply. This exception can protect part-sale, part-gift situations where the transferor's basis (the grantor's basis in the assets held in the grantor trust) is greater

[8] See PLR 9410034, which held that where a partnership was terminated for tax purposes because 50% of the partners (who would have benefited from the proceeds) changed, there was a transfer for value of its policies; here, however, there is no change in the trust beneficiaries as a result of the grantor's death.

than the consideration paid by the transferee (the amount of the liability). Tax-free transactions, such as contributing policies to an entity, transfers to spouses under Section 1041, and transfers in a tax-free corporate reorganization will also be protected.

(d) If a previously tainted policy (considered transferred for value) is subsequently transferred under one of the five exceptions to the transfer for value rules exceptions, it can lose its taint.[9]

(4) For these reasons, consideration should be given to creating the trust as a non-grantor trust.

3. Estate tax consequences of premium financing

a. In Ltr. Rul. 9745019, the Service considered the implications of a private split-dollar arrangement between a husband and wife as the premium providers and their irrevocable insurance trust, with respect to a policy insuring the lives of the husband and wife, on a survivorship basis.

(1) The premium providers initially funded the trust with a cash gift, with which the Trustee purchased and paid for the first premium on a survivorship policy covering their lives. The trust was named as initial owner and beneficiary of the policy. Under the proposed collateral assignment split-dollar agreement, the Trustee was designated as the owner of the policy. The trust would pay the smaller portion of the annual policy premiums and the insureds would pay the balance of the annual premium. The split-dollar agreement was terminable at will by either the Trustee or the insureds, so long as the value of the trust assets (based on the loan value of the policy) equaled or exceeded the amount to be repaid to the insureds on termination of the arrangement. In all other cases, the agreement could be terminated only by mutual consent of the Trustee and the insureds. The agreement would also terminate upon the bankruptcy of the insureds, failure of the Trustee to reimburse the insureds, failure of the insureds to pay their share of the premiums, or the death of the survivor of the insureds. If the agreement terminated prior to the death of the survivor of the insureds, the survivor would be entitled to receive an amount equal to the cash value of the policy, net of the cash surrender value at the end of the initial policy year. If the agreement terminated as a result of the death of the survivor of the insureds, the estate of the survivor would be entitled to receive an amount equal to the cash value of the policy immediately prior to the survivor's death, again, less the cash surrender value at the end of the initial policy year. In order to secure the insureds' interest in the policy, the Trustee assigned to the taxpayers limited rights under a "restricted" collateral assignment. The only rights assigned to the insureds were the right to receive a portion of the death proceeds payable on the survivor's death and the right to receive the cash value of the policy if the policy were surrendered by the

[9] Treas. Reg. Section 1.101-1(b)(2) and (3).

Trustee. All other rights under the policy were reserved to the Trustee under the collateral assignment.

(2) One of the issues on which the Service was asked to rule was whether the insurance proceeds payable to the trust under the split-dollar agreement would be includible in the gross estate of the surviving insured. The Service held that the insureds retained no incidents of ownership in the survivorship policy on their lives, as a conclusion, and without any analysis. Although the ruling discusses the broad nature of the phrase "incidents of ownership" under the Section 2042 regulations, the ruling goes on to apparently hold that the restricted nature of the collateral assignment to the insureds was enough to prevent their interest in the policy from rising to the level of an incident of ownership in the policy. Thus, even though the insureds had a security interest in the policy (although with few of the rights which would normally be granted a secured creditor), they were not deemed to hold any incidents of ownership in the policy which would cause its inclusion in either of their estates under Section 2042. Similarly, the insured's guarantee of a loan used to pay premiums on a policy on the insured's life (or pledge of assets as security for such a loan) should not cause inclusion of the policy proceeds in the insured's estate under Section 2042, so long as the guarantee does not directly grant incidents of ownership in the policy to the guarantor, in the form of subrogation or other similar rights. Since a guarantee typically includes rights of subrogation, however, any guarantee agreement must specifically limit these subrogation rights, as they apply to the policy, so that the insured's rights in the policy as subrogee are limited to the right to receive a portion of the policy cash value, if the policy is surrendered, or to receive a portion of the policy death benefit upon the insured's death.

b. The fact that the source of the policy premiums could be argued to be coming indirectly from the decedent should likewise not cause inclusion of the policy proceeds in the decedent's estate under Section 2042.

(1) In Ltr. Rul. 9809032, the Service considered a situation in which the decedent had directly loaned funds to an irrevocable insurance trust he created, which were used by the trustees to pay the premiums on a policy insuring the decedent's life which was owned by the trust. The executors of the decedent's estate requested a ruling that the decedent did not hold any incidents of ownership in the policy for purposes of Section 2042(2) as a result of having loaned the funds used to pay the premiums on the policy. The Service noted that under the terms of the trust, the decedent held no incidents of ownership in the policy, nor did he transfer any incidents of ownership in the policy during the three year period prior to his death. Therefore, none of the policy proceeds was included in his estate under Section 2042(2).

(2) The Service further noted that the fact that the decedent, through loans, had provided the funds for payment of the policy premiums was irrelevant, since "payment of premiums is irrelevant in determining

> whether a decedent retained any incidents of ownership in the policy proceeds."

D. Will the Loan be Treated as Bona Fide Debt for Federal Tax Purposes?

1. Under the Final Split-Dollar Regulations, as discussed above, a payment made pursuant to a split-dollar life insurance arrangement is treated as a loan for Federal tax purposes, and the owner and non-owner are treated, respectively, as the borrower and the lender, if, among other requirements, the payment is a loan under general principles of Federal tax law, or, if it is not a loan under general principles of Federal tax law (for example, because of the nonrecourse nature of the obligation or otherwise), a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest).

2. Such a loan, since the parties in a premium financing arrangement expect repayment of the amounts loaned, if respected under the split dollar loan regulations will also be respected for gift tax purposes, since the Preamble to the regulations state that regulations apply for gift tax purposes, including private split-dollar life insurance arrangements. Therefore, under these circumstances, the loan likely constitutes a split-dollar life insurance arrangement and is likely treated as a "loan" for Federal income and gift tax purposes.

3. Even if the repayment obligation were to be characterized as something other than debt under the more general principles of Federal tax law (e.g., characterized as proceeds from the sale of the Policy, or a fee payment for the use of the Insured's life) an argument could be made, based on the plain language of the Regulation, that the payment is nevertheless treated as a loan for all Federal tax purposes. The Preamble to the Regulation, in response to commentators questioning whether the provision was necessary, states:

> The IRS and Treasury recognize that, in the earlier years during which a split-dollar life insurance arrangement is in effect, policy surrender and load charges may significantly reduce the policy's cash surrender value, resulting in under-collateralization of a non-owner's right to be repaid its premium payments. Therefore, so long as a reasonable person would expect the payment to be repaid in full, the payment is a split-dollar loan under § 1.7872-15, rather than a transfer under § 1.61-22(b)(5) on the date the payment is made.

VII. ECONOMIC BENEFIT SPLIT DOLLAR ARRANGEMENTS UNDER THE FINAL REGULATIONS

A. Under the Final Regulations, split-dollar arrangements are broadly defined.

1. Any arrangement where one party advances premiums, some or all of which will be repaid from or are secured by either the cash value or the death benefit of the policy.

2. Section 61 (not, as under prior notices, Section 83) will govern endorsement method arrangements, entered into or materially modified after the regulations are adopted.

3. Material Modification under the Regulations

   a. With one exception, these rules apply to arrangements entered into after adoption of the final regulations – that is, they are, with that one exception, prospective.

   b. The one exception is for pre-final regulation arrangements, which are "materially modified" after the final regulations were adopted – September 18, 2003 (with an exception for arrangements converted under a safe harbor under Notice 2002-8 thereafter).

   c. There is no helpful definition of the term material modification in the Regulations. The Regs provide a non-exclusive list of non-material changes – the so-called "angel list."

   d. Without further guidance, which isn't anticipated, clients should assume that any change to the economics of the arrangement or even to the policy is "material."

   e. This is now an area in which the IRS won't rule.

B. Economic Benefit Split-Dollar under the Regulations

1. Endorsement Method

   a. Owner is party advancing funds

   b. Treated as economic benefit arrangement.

2. Collateral Assignment Method

   a. Owner is Insured or third party (not advancing funds)

   b. Treated as loan arrangement

3. Deemed Owner Exception

   a. Both rules are reversed if "deemed owner" rules apply

C. There have always been two tax issues in Economic Benefit split-dollar arrangements.

1. The measure of the economic benefit.

2. The treatment of policy equity (cash values in excess of what is owed the premium provider).

D. Measure of the economic benefit in split-dollar arrangements.

1. The economic benefit is premium insensitive, both as to the level of the premium and whether a premium was paid in a given year.

    a. It is based on the death benefit provided to the policy beneficiary under the arrangement.

    b. Traditionally, the economic benefit was measured by the lower of the carrier's qualifying term rates or the IRS table rates, under Rev. Rul. 66-110.

2. What Rate to Use?

    a. Prior law, especially Rev. Rul. 66-110, requiring the rate be a generally available, published, one-year term rate.

    b. Post-1/28/02 arrangements under Notice 2002-8.

    New limitations are imposed beginning in 2004, designed to assure the rates used to report the economic benefit from the arrangement reflect term policies actually sold.

    c. The proposed and final regulations.

    (1) Generally silent on what rates to use.

    (2) But what they probably suggest for the future about updated Tables – what are called "uniform term factors" (which may be exclusive).

    (3) Unless and until we get exclusive Tables, post-January 28, 2002 qualifying alternative term rates continue to be available, even for post-final regulation arrangements.

    d. There is a risk that the carrier will terminate its support of its alternative term rates, as some have.

    (1) With little, or (even worse) no notice.

    (2) Leaving the insured with no choice, other than to revert to the higher Table 2001 rates.

    f. Survivorship policies

    (1) Historically, the US 38 rates, derived from the PS 58 rates, but only while both insureds are alive.

(2) They will be substantially lower than even the best alternative term rate and are even lower than the US 38 rates. Making survivorship split-dollar especially attractive, after the issuance of Table 2001, while both insureds are alive.

(3) Importantly, once one insured dies, the rates revert to the normal single life rates, described above. Suggesting a possible switch to a loan at that point.

3. These rates are used for both income and transfer tax (gift and GST) purposes where the policy is owned by a third party.

4. The economic benefit will be taxed to the non-owner (unless contributed by the non-owner).

a. If contributed, it will be taxed to the policy owner and will not provide basis to the contributor.

E. Taxation of Policy Equity

1. Any current or future interest in the equity will be taxed to the non-owner (as income or a gift, depending on the relationship of the parties) on a <u>current</u> basis.

a. To the extent the non-owner has "access" (as defined) to the cash value.

b. The equity will be taxed on a current basis, under a constructive receipt theory, if the non-owner has access to the equity (now or in the future), or (surprisingly) the owner or the owner's creditors don't have access to the equity.

(1) The owner wouldn't have access to the equity if its rights were restricted by the agreement (for instance, in a controlling shareholder situation).

(2) The owner's creditors wouldn't have access to the equity if state creditor protection laws prohibited it.

(3) The Explanation to the regulations also provides that the non-owner has access to the equity if he or she can assign his or her rights in the cash value of the policy.

(4) For this purpose, surrender changes are ignored, no losses for declines in cash value are allowed, and cash values are measured at the end of each calendar year (or, on an elective basis, the anniversary date).

c. Special valuation rules are provided for transfers of the policy (or an interest in the policy) to the non-owner.

d. Any amount received under the contract by the non-owner is treated as first having been paid to the owner and then transferred to the non-owner (for income or gift tax purposes).

e. The death benefit will only be excludable by the non-owner's beneficiary to the extent the non-owner paid for or was taxed on the economic benefit.

2. Several cases have analyzed the estate taxation and valuation of intergenerational split dollar arrangements structured under the economic benefit regime, specifically in the context of inclusion of the cash value of the policy in the decedent's estate.

a. In Estate of Cahill v. Comm'r, T.C. Memo. 2018-84, the Tax Court applied the "in conjunction with" analysis under Sections 2036(a)(2) and 2038 and broadly applied Section 2703(a) in valuing a decedent's rights under an intergenerational economic benefit split dollar plan for estate tax purposes.

(1) The transfer of the premium payments to the ILIT constituted a property transfer for purposes of Sections 2036 and 2038 and the split dollar agreement termination rights held by decedent with consent of the ILIT satisfied the "in conjunction with any person" in Sections 2036(a)(2) and "in conjunction with any other person" in Section 2038(a)(1) requirements to designate who would enjoy the property, (i.e. the cash value resulting from the premiums paid).

(2) The bona fide sale exception did not apply because there was no legitimate business purpose for the split dollar arrangement and there was no adequate and full consideration.

(3) The special valuation rules under Section 2703(b) do not apply and therefore the ILIT's ability to veto termination of the split dollar agreements is a restriction that should be disregarded under Section 2703(a)(1) or (2) for purposes of valuing decedent's rights in the split dollar agreements.

b. The Tax Court in Estate of Morrissette v. Comm'r, T.C. Memo. 2021-60, similarly analyzed the application of Sections 2036, 2038, and 2703 to an economic benefit split dollar arrangement, but this time, determined that a legitimate business purpose for the transaction existed.

(1) The bona fide sale exception under Sections 2036 and 2038 applied because that the regulations support a broad definition of "sale" and the decedent received both financial and intangible benefits from the split dollar arrangement, including retained family ownership, succession of management and control of the business interest, and financial security as a result of the buy-sell agreements.

(2) Section 2703(b)'s exception for bona fide business arrangements applied because (i) there was a legitimate business purpose for the split dollar agreements (it was not just a testamentary device to bequeath property to family members) (ii) the termination restrictions were comparable to provisions that would be found in other arms-length buy-sell agreements for similar family businesses, and (iii) the transactions constituted bona fide sales.

c. In the most recent split dollar case, Estate of Levine v. Comm'r, 158 T.C. 2 (Feb. 28, 2022), the Tax Court concluded that Sections 2036(a)(2) and 2038 did not require inclusion of the policies' cash-surrender values because the decedent did not have any right, whether by herself or in conjunction with anyone else, to terminate the policies. Accordingly, since Section 2703 applies only to property owned by a decedent at the time of her death, not to property disposed of before, or property that was never owned by the decedent at all (*e.g.*, the insurance policies).

F. There is one major exception to the general rule that policy ownership is the sole determinant of the tax regime required to be used: the "deemed owner" rules

1. That exception is for non-equity donor-donee or employer-employee (or service provider – service recipient) arrangements, in which the premium provider is entitled to the greater of premiums or policy cash values, which must be treated under the economic benefit regime, regardless of which party owns the policy.

2. The donor or employer is deemed to be the policy owner, resulting in economic benefit treatment.

a. Meaning that these arrangements allow economic benefit treatment for taxing the benefit, even for collateral assignment method arrangements.

b. A similar rule applies to employer-employee or donor-donee arrangements when the employee or donee isn't the owner or treated as the owner.

c. No other non-equity collateral assignment arrangements – such as corporate/shareholder or trust-to-trust arrangements – quality for this treatment.

d. If the arrangement is modified so that it is no longer non-equity, the deemed owner rule no longer applies and the policy is treated as transferred to the real owner.