COMMENTS CONCERNING PROPOSED REGULATIONS
ON SPLIT-DOLLAR LIFE INSURANCE

The following comments regarding the proposed regulations on split-dollar life insurance arrangements published by the U.S. Department of Treasury ("Treasury") on July 9, 2002 represent the individual views of the members of the Section of Real Property, Probate and Trust Law and the Section of Taxation who prepared them. These comments do not represent the position of the American Bar Association or any of its Sections.

Individual members of several committees within the Section of Real Property, Probate and Trust Law and the Section of Taxation of the American Bar Association prepared these comments. Participating in the preparation of the comments were: Michael L. Graham, Mark E. Griffin, Michael D. Gunter, J. Alan Jensen, Edward F. Koren, Andrew C. Liazos, Mary Ann Mancini and Tom Quinn.

These comments were reviewed by Joseph Kartiganer, Co-Chair of the Probate and Trust Division’s Committee on Coordination of Government Submissions, Tom Hoecker, Chairman of the Tax Section Employee Benefits Committee, David Raish of the Tax Section Committee on Government Submissions, and the Tax Section Employee Benefits Committee Quality Assurance Group, whose members consist of former Chairs of the Employee Benefits Committee.

Although members of the Sections who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments.

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I. EXECUTIVE SUMMARY

Our recommendations regarding the proposed regulations are as follows:

A. Defining split-dollar life insurance arrangements

1. An “arrangement” should be considered to have been entered into for purposes of the proposed regulations upon the execution of an agreement evidencing the parties' intent with respect to the material provisions regarding the sharing of premium costs, cash surrender value and death benefits and the delivery of a signed application form and a check to the insurance carrier. Failure to receive an insurance policy should not preclude the existence of an "arrangement" unless there is an unreasonable delay in receiving the policy from the issuer by reason of action or inaction by the insured.

2. While we do not in any way intend to validate the use of "reverse" split-dollar arrangements that prompted the issuance of Notice 2002-59 or to address any other tax issues raised by these arrangements, we suggest that consideration be given to covering both traditional and so-called “reverse” split-dollar life insurance arrangements under Section 1.61-22 for purposes of valuing current life insurance protection upon establishing uniform table rates.

3. A "split-dollar life insurance arrangement" should exist only if the relationship between the owner and non-owner is that of an employer-employee, donor-donee, entity-stakeholder or independent contractor-service recipient, except as provided in Part F.2 of these comments.

4. The regulations should clearly provide that an "owner" or "non-owner" of a policy for purposes of Section 1.61-22 may be any "person" as defined under Section 7701(a)(1) of the Code.

B. Economic Benefit Regime

1. The equity under endorsement equity split dollar life insurance arrangements should be taxable only upon a complete or partial termination of the arrangement based on actual cash value at that time.

2. Payments by a non-owner towards policy premiums (as well as amounts included in the non-owner's gross income as an economic benefit during periods that premiums are actually paid towards the policy) should be treated as an "investment in the contract" under Section 72(e)(6).
3. The proposed rule under Section 1.61-22(f)(3) treating premium payments made by a non-owner as gross income to the owner and an "investment in the contract" by the owner should be withdrawn.

4. The "specified loan proceeds" provision within Section 1.61-22(e)(1) and (f)(2) should be narrowed. Loan proceeds payable to a non-owner should be treated as taxable compensation, dividend income or a gift (depending on the nature of the relationship) only if the policy loan proceeds are neither subject to a bona fide repayment obligation nor reasonably expected to be repaid.

5. The regulations should clearly provide that paid-up additions which remain within the policy are not an "amount received under a life insurance contract" under Section 1.61-22(e).

6. Objective and consistent rules should be provided for determining the fair market value of a life insurance policy upon transfer to a non-owner.

C. Valuation of Current Life Insurance Protection

1. Fair, reasonable and uniform life insurance premium factors should be established for single life and survivorship policies to report the value of life insurance coverage. These factors should be established after consultation with the private sector. The use of these factors should not be required for split-dollar arrangements entered into prior to the publication of the final regulations and not materially modified thereafter.

2. Parties to a split-dollar life insurance arrangement should be allowed to report the value of current life insurance protection on each policy anniversary based on the adjusted face amount of current life insurance protection at that time (less the employer's recovery amount) absent any activities by the parties to the split-dollar arrangement that will directly or indirectly result in a change to the face amount.

3. Any good faith effort to report or pay for current life insurance protection should be accepted for purposes of the rule conditioning the tax-free nature of proceeds received on death of the insured.

D. Loan Regime

1. The regulations should clarify how the reasonable expectation of repayment standard differs (if at all) from established general principles for determining what constitutes a loan under Federal tax law. Alternatively, this standard should be deleted.
2. Parties should be allowed to aggregate premium payments made during a specified period, not to exceed a calendar quarter, as a single loan made on the last day of the specified period.

3. The parties should be allowed to use the AFR determined in the month in which a hybrid loan is made for as long as the hybrid loan is outstanding. The AFR should not be re-determined annually.

4. An imputed transfer between a corporation and a shareholder under Section 7872 should not be treated as involving a dividend under the second class of stock rule of Section 1361(b)(1)(D).

E. Transition Issues

1. Only a change that provides permanent and material additional benefits to an employee, donee or shareholder from the other party to a split-dollar life insurance arrangement should be treated as a "material modification" resulting in a new arrangement subject to the final regulations. An exchange of policies subject to Section 1035 should not result in a "material modification" regardless of whether there is any change to the policy death benefits, provided that the premium payment obligation for the employer, donor, corporation or other entity does not materially increase. New policies added to an existing split-dollar life insurance arrangement should be treated as part of a new separate split-dollar life insurance arrangement and not as a material modification of the existing arrangement.

F. Special transfer tax considerations

1. The regulations should clearly provide that the "deemed ownership" provisions in Section 1.61-22(c) apply for purposes of Sections 61 and 7872 only. Regulations under Section 2042 should provide that the insured shall not be considered to hold incidents of ownership in a policy subject to a split-dollar life insurance arrangement solely because of being considered the deemed owner under Sections 61 and 7872 of the Code.

2. The regulations should clearly provide that a "private" split dollar life insurance arrangement may be created between two parties, neither of which is an employer, corporation or other entity, even though there is no gift made to either of the parties.

II. BACKGROUND

On July 9, 2002, Treasury issued extensive proposed regulations concerning split-dollar life insurance arrangements and their treatment for income, payroll and transfer tax purposes. Consistent with Notice 2002-8, equity split dollar life insurance arrangements
would be subject to tax depending upon the ownership of the policy under one of two mutually exclusive regimes. If the owner of the policy is the employer, donor or corporation, as the case may be, the policy owner will be treated as providing economic benefits to the non-owner under the so-called economic benefit regime (Section 1.61-22 of the proposed regulations). If the owner of the policy is the employee, donee or shareholder, as the case may be, the non-owner will be treated as making a series of loans in the form of policy premiums to the owner under the so-called "loan regime." (Section 1.7872-15 of the proposed regulations). The proposed regulations would apply to any equity split-dollar life insurance arrangement entered into after the regulations are finalized and to pre-existing arrangements that are "materially modified" after final regulations are issued. The guidance and transition rules under Notice 2002-8 continue to apply in the interim.

For the sake of simplicity and clarity, our comments in Part III below are organized based on the structure of the proposed regulations as follows:

Section A addresses provisions in the proposed regulations that apply to all split-dollar life insurance arrangements.

Section B addresses changes to the taxation of equity split-dollar life insurance under the economic benefit regime, including taxation of policy equity and proposed changes to longstanding rules based on the deemed ownership provisions.

Section C addresses the valuation of current life insurance protection and the proposal to tax death benefit proceeds under certain circumstances under the economic benefit regime with respect to both equity and non-equity split-dollar life insurance arrangements.

Section D addresses some of the proposed rules for split-dollar life insurance under the loan regime.

Section E addresses special transition rules applicable to all split-dollar life insurance arrangements, including the material modification provisions of the proposed regulations.

Section F addresses special transfer tax considerations raised by the proposed regulations.

III. COMMENTS

A. DEFINING SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENTS

1. Defining an "arrangement" for purposes of the proposed regulations and Notice 2002-8

Issue
Both the proposed regulations and Notice 2002-8 use the term "arrangement" with reference to split-dollar life insurance but do not provide any definition. This omission is quite significant and is likely to cause uncertainty as to which tax rules apply to a split-dollar life insurance arrangement in certain situations. The date on which an "arrangement" is entered into must be determined in order to identify which tax rules apply. Special grandfather status is available under Notice 2002-8 only if the "arrangement" was entered into before January 28, 2002. Further, Notice 2002-8 provides that "arrangements" entered into before the publication of final regulations in the Federal Register will be subject to transition safe harbors.

For example, consider a non-employee shareholder entering into a written agreement with the corporation one day prior to the date of the issuance of the final regulations. Under the terms of the agreement, the shareholder will own any policy that is purchased, as provided in the agreement, subject to an assignment of certain rights in the policy to the corporation. The corporation is to pay the entire premium of any such policy and is entitled to the receipt of the lesser of the premiums paid or the cash surrender value of such policy at the termination of the agreement. If this agreement is subject to the rules of the final regulations, Section 1.7872-15 would apply and premium payments made under the arrangement would be treated as loans. If Notice 2002-8 applies, this arrangement may be taxed under the economic benefit regime.

Comment

The proposed regulations imply that a policy must be issued before an "arrangement" exists. Section 1.61-22(b)(1) defines a split-dollar life insurance arrangement as "any arrangement between an owner and a non-owner of a life insurance contract." Thus, there arguably can be no "arrangement" without a life insurance contract. It follows from this analysis that the Service's position may be that there is no split-dollar life insurance arrangement eligible for special grandfather treatment under Notice 2002-8 unless the insurance carrier issued the subject policy prior to January 28, 2002.

This implication, if intended as a substantive rule, is inconsistent with the ordinary meaning of an "arrangement." Webster's Dictionary (Third Edition) defines an "arrangement" as the act of "put[ting] in order beforehand; to make preparations for or to effect." The preparations for split-dollar life insurance consist of finalizing the understanding between the employer and the employee (in the case of employment based split-dollar), the donor and the donee (in the case of private split-dollar) and the entity and its stakeholder (in the case of entity split-dollar) as to the allocation (or "split") of premiums, cash surrender value, death benefits and other attributes under one or more identified life insurance policies. Whether or not the policy has in fact been issued is irrelevant to whether there is actually an "arrangement." Note that in no instance is the issuer of the life insurance policy a party to the "arrangement," however that term is defined.
The legislative history to the Deficit Reduction Act of 1984 provides a useful standard by which to define an "arrangement." When Section 7702 of the Code (relating to the definition of life insurance) was adopted in 1984, which generally applies to "contracts issued after December 31, 1984," the legislative history provided the following with respect to when a contract would be issued for this purpose: "[T]he issue date of a contract is generally the date on the policy assigned by the insurance company, which is on or after the date the application was signed." This sentence was footnoted with the following: "The use of the date on the policy would not be considered the date of issue if the period between the date of application and the date on which the policy is actually placed in force is substantially longer than under the company's usual business practice." 1

This general approach was again followed four years later in crafting transition rules for policies that would be exempt from the modified endowment contract rules. When Congress in 1988 enacted Section 7702A of the Code, which generally applies to "contracts entered into on or after June 21, 1988," the legislative history provided the following with respect to when a contract would be issued for this purpose: "For purposes of this effective date, a contract is considered entered into no earlier than the date that (1) the contract is endorsed by both the owner of the contract and the insurance company; or (2) an application is executed by both the applicant and the insurance company and a premium payment is made by the applicant to the insurance company. The backdating of an application or an insurance contract shall be disregarded for purposes of this effective date." 2

Recommendation

An “arrangement” should be considered as having been entered into for purposes of the proposed regulations upon the execution of an agreement evidencing the parties' intent with respect to the material provisions regarding the sharing of premium costs, cash surrender value and death benefits and the delivery of a signed application form and a check to the insurance carrier. Failure to receive an insurance policy should not preclude the existence of an "arrangement" unless there is an unreasonable delay in receiving the policy from the issuer by reason of action or inaction by the insured.

2. Coverage of split-dollar life insurance transactions described in Notice 2002-59 under the proposed regulations.

Issue

The definition of a split-dollar life insurance arrangement under the proposed regulations provides that the amount recovered by the party paying the premiums need not be determined by reference to the amount of those premiums. Section 1.61-22 only requires that a party to the arrangement paying premiums be “entitled to recover (either

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2 Id.
conditionally or unconditionally) *all or any* portion of those premiums” (emphasis added). The breadth of this definition raises the question whether all split-dollar arrangements, including so-called “reverse” split-dollar life insurance arrangements, are (and should be) covered by the final regulations.

**Comment**

We recognize that the Service issued Notice 2002-59 within in a very short time frame in order to clarify its position concerning certain "reverse" split dollar transactions that were reported by the national media. We commend the Service for promptly advising taxpayers of its position with respect such transactions. We also do not object to using the standard announced in Notice 2002-59, at least on an interim basis, to determine whether a particular arrangement indirectly provides policy benefits other than current life insurance protection when the fairness of the insurance rates selected by the parties, including Table 2001, is questionable.

Our sense is that the approach taken under Notice 2002-59 may create long-term administrative difficulties for legitimate transactions. Notice 2002-59 calls all transactions that may be viewed as "reverse" split-dollar into question but provides no rules for determining when and whether permanent policy benefits are being transferred to a party under the arrangement. Neither Notice 2002-59 nor the proposed regulations provide any guidance between distinguishing between different types of split-dollar life insurance arrangements.

Once uniform life insurance premium factors have been developed to value current life insurance protection, however, we wonder whether the approach announced in Notice 2002-59 is necessary. There does not appear to be any principled reason to distinguish between traditional split dollar life insurance arrangements and “reverse” split dollar life insurance arrangements so long as there is confidence in the general fairness of the life insurance premium factors. Both types of arrangements can be used to confer benefits other than current life insurance protection if the rates to be used do not reasonably reflect mortality experience and other risk factors. Problems of the type described in Notice 2002-59 resulted because term factors that were used did not reflect current mortality experience.

We recognize that in some instances use of uniform table rates may result in an overpayment for life insurance protection by one party subject to a reverse-type split dollar arrangement, thereby resulting in an indirect transfer of policy benefits to the other party without taxation. However, it is just as likely that an employee will report more than one hundred percent of the value of the actual economic benefit under a traditional endorsement method split-dollar life insurance arrangement using uniform table rates.

**Recommendation**

While we do not in any way intend to validate the use of "reverse" split-dollar arrangements that prompted the issuance of Notice 2002-59 or to address any other tax
issues raised by these arrangements, we suggest that consideration be given to covering both traditional and so-called “reverse” split-dollar life insurance arrangements under Section 1.61-22 for purposes of valuing current life insurance protection upon establishing uniform table rates.


Issue

Section 1.61-22(b)(1) generally defines a split dollar life insurance arrangement with reference to "any arrangement" between an owner and a non-owner of a life insurance contract, in which either party to the arrangement "pays, directly or indirectly," all or any portion of the premiums on the life insurance contract and at least one party to the arrangement paying the premiums is entitled to recover (conditionally or unconditionally) all or any portion of the premium, and such recovery is to be made from or secured by the policy proceeds. The use of the phrases “any arrangement” and “pays, directly or indirectly” are so broad that they may cover transactions that have not been traditionally considered split-dollar life insurance.

Comment

This definition covers loans that may be provided by a financial institution. For example, an executive officer at a public company may arrange for a loan from a bank to continue premium payments on a life insurance policy, particularly as a result of the Sarbanes-Oxley Act. As a condition for making the loan, the bank acquires a security interest in the policy and transfers the loan proceeds to the insurance carrier. This type of loan should not be considered to raise issues under Section 7872 so long as the employer does not arrange or guarantee the loan.

Section 7872 does not by its terms apply to all arrangements that are "below-market loans" (i.e., loans that do not provide for the payment of adequate interest and principal to the lender). Instead, Section 7872(c)(1) provides for only certain types of "below-market loans" to be taxable under Section 7872. Specifically, Section 7872(c)(1) recognizes "gift loans," "compensation-related loans" and "corporation-shareholder loans." These provisions under Section 7872 correlate to the types of relationships in which the Service has recognized split-dollar life insurance arrangements.

Recommendation

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4 Section 7872(f)(3) of the Code defines a "gift loan" as a "below-market loan where the forgoing of interest is in the nature of a gift."

5 Section 7872(c)(1)(B) of the Code defines a "compensation-related loan" as a "below-market loan directly or indirectly between (I) an employer and an employee, or (ii) an independent contractor and a person for whom such independent contractor provides services.

6 Section 7872(c)(1)(C) of the Code defines a "corporation-shareholder loan" as a "below-market loan directly or indirectly between a corporation and any shareholder of such corporation."
A "split-dollar life insurance arrangement" should exist only if the relationship between the owner and non-owner is that of an employer-employee, donor-donee, entity-stakeholder or independent contractor-service recipient, except as provided in Part F.2 of these comments.

4. Arrangements between parties to make life insurance premium payments other than those expressly described in the proposed regulations

Issue

The proposed regulations provide that the "nature of the relationship" between the owner and the non-owner governs the tax treatment of the economic benefit provided to a recipient under a split-dollar life insurance arrangement. Relationships specifically mentioned by the proposed regulations include an employer-employee, donor-donee and corporation-shareholder. No provision in the proposed regulations addresses whether a partnership-partner or limited liability company-member relationship is covered under the definition of a split-dollar life insurance arrangement.

Comment

The Service has previously recognized that a split-dollar life insurance arrangement may be created between a partnership and one of its partners. The treatment would also extend to limited liability companies treated as partnerships for tax purposes. There does not appear to be any reason why this treatment should not be extended prospectively as part of the final regulations.

Recommendation

The regulations should provide that an "owner" or "non-owner" of a policy for purposes of Section 1.61-22 may be any "person" as defined under Section 7701(a)(1) of the Code.

B. ECONOMIC BENEFIT REGIME

1. Treatment of policy cash surrender value under equity split-dollar life insurance arrangements

Issue

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7 See PLR 9639053 (applying split-dollar principles in finding that a trust and trustee will not be deemed to have received partnership distributions when a partnership pays the premiums and is reimbursed by the trust for insurance owned by the trust on the trustee's life).
Notice 2002-8 provides that the cash surrender value in excess of an employer's premium payments (the so-called "equity") in a policy subject to an equity split-dollar life insurance arrangement entered into before the issuance of the final regulations is not subject to tax prior to termination of the arrangement. In contrast, the proposed regulations provide for taxation of policy equity prior to termination of the arrangement. Section 1.61-22(d)(3)(i) states that "any right in, or benefit of, a life insurance contract [subject to an equity split-dollar life insurance arrangement] (including, but not limited to, an interest in the cash surrender value) provided during a taxable year" is an economic benefit subject to immediate tax. Section 1.61-22(d)(3)(ii) reserves how to value economic benefits taxable under Section 1.61-22(d)(3)(i).

**Comment**

The valuation of a non-owner's "equity" (i.e., policy cash surrender value in excess of premiums to be recovered by the owner) prior to the termination of an equity split dollar life insurance arrangement raises a number of difficult issues, since the ultimate value that will be realized will depend upon uncertain future events. The approach suggested in the preamble attempts to address these difficulties by calling for the non-owner to be taxed currently on the difference between the total amount of premiums paid by the owner and the owner's net present value recovery right. Although this approach may seem fair, a careful analysis suggests otherwise, at least in the context of a life insurance contract under which the equity may decline or disappear in the future, such as a variable life contract. With a variable life contract and perhaps other contracts, there is no assurance that the non-owner will ever recognize any tangible permanent economic benefit from the arrangement. For example, in the typical arrangement, if the arrangement terminates at a time when the fair market value of the policy is less than the total premium payments made by the owner, the non-owner will receive nothing even though the non-owner had "equity" in the contract at an earlier point in time. In essence, the non-owner will have been taxed on phantom income under this approach.

Rather than developing rules that allow the non-owner to recover these "losses," we recommend a continuation of the approach adopted in Notice 2002-8, at least in the context of arrangements in which the equity may decline or disappear in the future. With the Notice 2002-8 approach, parties to the split-dollar arrangement will have certainty as to the timing of tax results, the benefits resulting from policy equity will be calculated only once, and situations in which the non-owner may be taxed on benefits that are never realized are avoided. Special partial termination rules could be developed for taxing permanent benefits that might be received before a complete termination of the arrangement. These situations would include an employee's withdrawal of cash surrender value, an employee's receipt of a policy loan without any intent to repay and uses of policy cash surrender value for the employee's personal benefit (such as might result from assigning the equity to a third party for consideration).

**Recommendation**
The regulations should provide that the equity under endorsement equity split dollar life insurance arrangements is taxable only upon a complete or partial termination of the arrangement based on actual cash value at that time.

2. **Premium payments by a non-owner as an investment in the contract under Section 72(e)(6)**

**Issue**

Section 1.61-22(f)(2)(i) provides that amounts paid by a non-owner toward policy premiums will not be recognized as an "investment in the contract" for purposes of Section 72(e)(6) of the Code. Similarly, it appears that the value of the current life insurance protection that is taxable to a non-owner (employee) as an economic benefit will not be treated as an "investment in the contract" under this proposed rule. A previous private letter ruling from the Service suggested that such amounts would be an "investment in the contract." In PLR 8310027, the Service allowed an employee to reduce the amount realized from the rollout of a policy subject to an endorsement method equity split-dollar life insurance arrangement by an amount equal to the employee's total premium payments. These premium payments also offset the economic benefit received by the employee from the policy.

**Comment**

The apparent rationale for the proposed rule is that only an owner can have an investment in the contract when making a premium payment. Nothing in Section 72 requires that the person paying the premium actually be the owner of the policy at the time of payment. In fact, regulations under Section 72 have long recognized that taxable current life insurance protection provided under a life insurance policy held by a tax-qualified retirement plan increases an employee's "investment in the contract." Applying this approach to split-dollar life insurance structured under the endorsement method is consistent with the economic realities of the arrangement. The employer has no economic ownership in the policy related to the premium payments by an employee. In effect, the employer acts only as an agent for the employee in remitting the premium payment to the insurance company.

As noted in the prior comment letter by members of the Tax Section dated July 23, 2001, recognizing an "investment in the contract" with respect to employee premium payments results in a dual benefit. The premium payments by the non-owner (employee) create an investment in the contract and reduce taxation that would otherwise result from receiving current life insurance protection under a split-dollar life insurance arrangement. However, this benefit appears contemplated by the statute, as Section 72 does not provide for the policy's "investment in the contract" to be reduced by the term portion of the insurance premium. Presumably, the Service would not challenge an individual owning a policy outside of a split-dollar life insurance arrangement from applying the entire premium towards the investment in the contract.
Recommendation

We recommend that payments by a non-owner towards policy premiums (as well as amounts included in the non-owner's gross income as an economic benefit during periods that premiums are actually paid towards the policy) be treated as an "investment in the contract" under Section 72(e)(6).

3. **Premium payments by a non-owner as income to, and an "investment in the contract" for, an owner of a policy**

**Issue**

Section 1.61-22(f)(3) provides that "any amount paid by a non-owner, directly or indirectly, to the owner of the life insurance contract for current life insurance protection or for any other economic benefit under the life insurance contract is included in the owner's gross income." In addition, the amount treated as income is then treated as an additional investment in the life insurance contract for purposes of Section 72(e)(6). There is no suggestion in Revenue Ruling 64-328 or any subsequent guidance that payments by a non-owner should be treated as income to the owner.

**Comment**

These proposed changes are the apparent corollary to denying the non-owner "investment in the contract" for its premium payments, as someone must receive basis for the premium payment. Nevertheless, treating the premium payments by a non-owner under a split-dollar life insurance arrangement as gross income to the owner is inconsistent with the economic realities of the arrangement. As noted above, the owner is merely acting as an agent of the non-owner and has no economic interest in the policy with respect to amounts paid by the non-owner towards premium payments. All the owner is entitled to receive back from the policy at any time is its premium payments.

We note that failure to change this rule would impair longstanding gift tax planning used by employees with irrevocable life insurance trusts. If the employer is the deemed owner of the policy and the trust is the non-owner, the employer is treated as transferring the economic benefit of each premium payment to the employee, and the employee is then deemed to have transferred this benefit to the trust. When a trust holds an insurance policy, there is a concern that the “deemed” gift from the employee to the trust will be taxable regardless of the value of the benefit. Consequently, it is common for the trust to pay a portion of the premium equal to the deemed gift amount. Unless a change is made to

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8 The reason for the concern is the eligibility of that deemed gift for the annual exclusion from gift taxes under Section 2503. In order to qualify a gift to a trust for the annual exclusion, the trust beneficiaries must have a right of withdrawal over such gifted amount for a certain period of time. However, a right of withdrawal over a deemed gift, if the trust has no other assets with which to satisfy the withdrawal right, if exercised, may be deemed to be illusory. As a result, such deemed gifts may not qualify for the annual exclusion from gift taxes.
the proposed regulations, any amount paid by the trust to the employer for the current life insurance protection presumably would be income to the employer.

**Recommendation**

The proposed rule under Section 1.61-22(f)(3) treating premium payments made by a non-owner as gross income to the owner and an "investment in the contract" by the owner should be withdrawn.

4. **Treatment of "specified loans" from a policy subject to equity split-dollar life insurance under the endorsement method**

**Issue**

Section 1.61-22(e)(1) proposes special deemed distribution rules that would tax proceeds from so-called "specified policy loans" that are distributed to a non-owner of a life insurance contract. Specifically, the proposed rule treats the proceeds as if "such amount had been paid to the owner of the life insurance contract and then paid by the owner to the non-owner who is a party to the split-dollar life insurance arrangement." The deemed payment to the non-owner (and the owner for gift tax and employment tax purposes) is treated "as a payment of compensation, a distribution under Section 301, a gift, or other transfer depending on the relationship between the owner and the non-owner." Any loan will be a "specified policy loan" to the extent that ")(i) the proceeds of the loan are distributed directly from the insurance company to the non-owner; (ii) a reasonable person would not expect that the loan will be repaid by the non-owner; or (iii) 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."

**Comments**

We agree that the regulations should not allow loans to be used as an indirect mechanism for a non-owner to access policy cash surrender value without triggering tax liability. However, the proposed rule is broader than is necessary to accomplish this objective. A policy owner may access cash surrender value in the form of a loan for any number of reasons. It may desire to pay compensation to an employee or provide a separate loan to the employee. We see no reason why the loan proceeds from the policy should be presumed to be compensation, a gift, or a dividend (depending upon the relationship of the parties) just because the non-owner receives the loan proceeds directly from the insurance carrier. In addition, any subsequent repayment of the loan by the owner does not necessarily mean that there was not a bona fide loan to the non-owner initially. Instead, we believe the proper test is whether there is a loan consistent with the rules under Section 7872 of the Code. A loan should be considered to exist, for example, if the non-owner executes full recourse loan documentation.
Recommendation

The "specified loan proceeds" provision within Section 1.61-22(e)(1) and (f)(2) should be narrowed. Loan proceeds payable to a non-owner should be treated as taxable compensation, dividend income or a gift (depending on the nature of the relationship) only if the policy loan proceeds are neither subject to a bona fide repayment obligation nor reasonably expected to be repaid.

5. Treatment of paid up additions as amounts received under the contract by the non-owner

Issue

Section 1.61-22(e) provides that a "policy owner dividend" received under a life insurance contract is, to the extent provided directly or indirectly to a non-owner, taxable as compensation, a gift or a dividend, depending upon the relationship of the parties. The proposed rule does not distinguish among different types of dividends.

Comment

Life insurance contracts commonly provide for dividends to remain within the policy and be reinvested as "paid up additions." These dividends result in additional current life insurance coverage, enhanced cash surrender value accumulation or both. These dividends are not treated as constructively received by the policyholder for tax purposes. To the extent there is any additional current life insurance protection provided from a paid up addition, the economic benefit provided to the non-owner will be subject to tax.

Recommendation

The regulations should clarify that paid-up additions which remain within the policy are not an "amount received under a life insurance contract" under Section 1.61-22(e).

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9 Section 72(e)(4)(B) of the Code.
6. Determining the fair market value of a life insurance contract transferred to a non-owner on rollout

Issue

Section 1.61-22(g)(2) provides that the value received by a non-owner upon receiving a transfer of a permanent life insurance policy equals "the cash surrender value and the value of all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than the value of current life insurance protection." A corresponding change is proposed to the regulations under Section 83. No guidance is provided regarding the valuation of "all other rights under the contract." If these proposed changes are finalized in their current form, taxpayers may no longer be able to rely on the cash surrender value reported by an insurer in determining the tax liability resulting from a policy transfer.

Comment

We agree that cash surrender value, by itself, does not reflect the fair market value of a life insurance contract in all instances. For example, certain life insurance policies provide for so-called "springing cash value" features.\(^\text{10}\) The purpose of these features is often to depress artificially the policy cash surrender value. This is usually accomplished through the use of reserve accumulations or an account for advance premiums. When the policy is distributed, only the policy's cash surrender value is reported as the amount of the distribution to the non-owner even though the reported amount will increase significantly after the transfer. The springing feature in the contact is a permanent economic benefit that should be valued at the time of the policy transfer.

We are concerned, however, that the proposed subjective standard, without more guidance, will prove unduly difficult to administer with any reasonable degree of certainty. For example, does a variable contract with a feature allowing for separate accounts have more "value" than a traditional whole life product that allows for no investment discretion? Must parties take into account that the identity of the insurer may impact actual value, as some companies have different financial ratings and better dividend paying histories? These types of factors, which are not germane to the actual terms of the policy, frequently are very difficult, if not impossible, to value.

The Treasury and the Service should provide objective rules to value contractual rights common to insurance policies. For example, an insurance policy may have an accumulation (or "reserve") account separate from policy cash surrender value. This account, which reflects accumulated amounts not available to the policyholder on immediate surrender of the policy, is potentially available to generate cash value at a later time. It is unclear under the proposed regulations whether this policy feature is a "right" and, if so, how it would be valued, regardless of whether the policy is viewed to

\(^{10}\) See IRS Announcement 88-51 and Notice 89-25 (describing arrangements viewed to have a "springing cash value feature").
have a "springing cash value" feature. As this feature is common to most policies, taxpayers need objective rules that can be applied in a relatively straightforward manner.

We note that this subject is already fraught with difficulty due to the varying formulas used to determine policy fair market value in other tax situations. In the context of a distribution of a policy from a tax-qualified retirement plan, Section 1.402-1(a)(2) uses the concept of "entire cash value" as opposed to "cash surrender value." In the context of gift transactions, Revenue Ruling 59-195 provides the interpolated terminal reserve value method as the proper measure for determining fair market value. There is no apparent justification for why different valuation standards should apply depending upon which entity transfers a life insurance contract to a third party.

Recommendation

Objective and consistent rules should be provided for determining the fair market value of a life insurance policy upon transfer to a non-owner.

C. CURRENT VALUATION OF LIFE INSURANCE PROTECTION

1. Benefit of using a single table to value current life insurance protection under the economic benefit regime

Issue

The proposed regulations suggest that "life insurance premium factors" will be "designated or permitted" to measure the value of current life insurance protection provided to a non-owner under a split-dollar life insurance arrangement. It is unclear what factors are being developed and whether the rules under Notice 2002-8 will continue to govern the taxation of current life insurance protection after the Treasury and Service publish the life insurance premium factors.

Comment

As suggested in comments by members of the Tax Section to Notice 2001-10 on April 23 and July 23, 2001, the Treasury and Service should publish regulations providing for the exclusive use of life insurance premium factors to report current life insurance protection. This step will dramatically reduce audit controversies and provide certainty when reporting benefits under split-dollar life insurance arrangements. Unlike alternative term rates that raise numerous interpretative issues, applying uniform factors will be much simpler for taxpayers to understand and apply. We are also concerned that tax law

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11 Issues raised in audits and by Notice 2002-8 include (i) defining "one-year" term insurance, (ii) proving whether a rate is "published," (iii) taking into account non-smokers for standard risks, (iv) defining the meaning of "generally makes the availability of such rates known to persons who apply for term insurance coverage from the insurer," and (v) defining the meaning of "regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels."
valuation rules have become an important factor for taxpayers in deciding from whom to purchase life insurance coverage. The value of the coverage provided to the taxpayer should be the same regardless of the insurer's identity.\textsuperscript{12} Our comments at this time focus upon what factors should be considered in connection with developing life insurance premium factors and how often the factors should be updated for changes in mortality experience.

Many of the one-year term insurance rates charged by insurers that purport to meet the standards under Revenue Ruling 66-110 (as modified by Notice 2002-8 for arrangements entered into after January 28, 2002) were often fifty percent or less than the Table 2001 rates, which were derived from the table under Section 79 used to value group term life insurance. While this difference may be explained in part by aggressive pricing, it seems that the population and the underwriting assumptions used to determine value under the Section 79 table reflect risks that are not taken into account when individual policies are underwritten based on the health characteristics of the insured. It is also our understanding that the insurance industry does not consider the rates to be reflective of actual underwriting experience. We suggest a collaborative effort with qualified actuaries from the private sector to ensure that the life insurance premium factors appropriately reflect realistic pricing assumptions, mortality experience and traditionally applied insurance industry underwriting guidelines.

We believe that the uniform life insurance premium factors (one for single life policies and one for survivorship policies) for valuing the relative contributions and tax consequences for the parties to a split dollar life insurance arrangement should be applicable to all forms of split dollar insurance, whether "standard" or "reverse" and without regard to the identity of the parties. Recognizing the perceived abuses that triggered the issuance of Notice 2002-59, it appears to us from reading the Notice that those abuses occurred because there was a choice of permissible rates. With uniform factors in effect, that type of "gaming" cannot exist, and taxpayers will be able to use the table rates in all forms of split dollar insurance arrangements. For example, a company may use a split dollar life insurance arrangement as key person death benefit protection while allowing the employee to maintain the policy after his or her termination of employment. If appropriate factors have been created, the measurement of the contribution by the employer and the cost to the employee should be the same whether the coverage is provided under a traditional or reverse split dollar plan.

Assuming an exclusive life insurance premium factor approach is adopted, the Treasury should commit to updating the published rates on a regular periodic basis to reflect changes in mortality experience and other events that may impact pricing. The basis for using uniform factors for simplicity and ease of administration is no longer compelling when the rates become out of date and uniformly misstate economic benefits. If the table is not updated timely, taxpayers should be entitled to use an insurer's published premium rates available to all standard risks under the principles set forth in Notice 2002-8 for split-dollar life insurance arrangements entered into after January 28, 2002. This

\textsuperscript{12} It is not uncommon for multiple valuation rates to be used for identical coverage under different policies issued to the same insured.
approach would provide a safety valve for taxpayers if the life insurance premium factors are not timely revised.

We also note that there has been some confusion regarding the calculation of rates for survivorship policies (i.e., policies covering two lives). Some taxpayers continue to report taxable benefits arising from survivorship split dollar arrangements with reference to U.S. 38 tables, which are based on revoked P.S. 58 rates. Others have relied upon outside professionals representing that their survivorship tables reflect the rates in Table 2001 after using the conversion process suggested in the "Greenberg to Greenberg" letter. If uniform factors are to be used for single life policies, similar factors should also be published for survivorship policies.

Parties to split-dollar life insurance arrangements entered into before the publication of final regulations in the Federal Register should be entitled to rely on the rates determined in accordance with Notice 2002-8 on a going forward basis. Split-dollar life insurance arrangements are long-term investments and taxpayers should be permitted to rely upon cost estimates developed in policy illustrations. If uniform rates resulted in imputed amounts higher than under existing rates, the policyholder's expectations would be defeated. Of course, taxpayer expectations are not reasonable if the rates relied upon in entering into a split-dollar life insurance arrangement are not consistent with the interim rules set forth in Notice 2002-8 for purposes of valuing current life insurance protection.

Recommendation

Fair, reasonable and uniform life insurance premium factors should be developed for single life and survivorship policies. These factors should be based on reasonable actuarial methods and assumptions and should be developed in consultation with the private sector. The use of these rates should not be required for split-dollar arrangements entered into prior to the publication of the final regulations and not materially modified thereafter.

2. Need for guidance to compute value of current life insurance protection when policy amounts vary during the course of the taxable year

Issue

Existing split-dollar guidance does not address how to determine the amount of current life insurance protection when the amount of death benefit varies during the year. Changes in policies that provide for variable increases in the amount of death benefit have resulted in various practices to account for these benefits. There does not appear to be a single predominant practice. In addition, changes to the policy by the parties may result in changes to the level of current life insurance protection. The preamble to the proposed regulations requested comments on whether there is a need for more specific guidance than already provided in the proposed regulations regarding the computation of the cost of a

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13 Information letter from Norman Greenberg, Chief, Actuarial Branch, Department of Treasury, dated August 10, 1983.
death benefit that varies during the course of a taxable year. Comments were also requested on whether a convention requiring the amount of the death benefit to be recomputed on a quarterly or semi-annual basis would properly balance the accurate computation of the death benefit against compliance and administrative burdens.

Comment

Any rule to measure the value of current life insurance protection must balance the need for reasonable accuracy in quantifying taxable benefits and the desirability of uniform, consistent standards that can be administered without undue burden. Factors to consider for this purpose primarily consist of the variability of death benefit protection within a single year, the accessibility of required data by the parties to the split-dollar life insurance arrangement, the costs associated with measuring and reporting death benefits more than once per year and the ease with which the Service can verify compliance by taxpayers. Taking these factors into account, in most cases any benefits to the tax system from measuring current life insurance protection more than once per year are outweighed by the costs and burdens on employers. Our experience is that policy death benefits usually do not vary by more than five percent if there are no changes to the policy. Measuring death benefits more than once a year is only reasonable if the level of current life insurance protection is significantly impacted by actions of the parties (and not financial performance of the policies), such as by an election to increase the face amount, payment of additional premiums, or accessing cash surrender value through withdrawals or policy loans.

Recommendation

Parties to a split-dollar life insurance arrangement should be allowed to report the value of current life insurance protection on each policy anniversary based on the adjusted face amount of current life insurance protection at that time (less the employer's recovery amount) absent any activities by the parties to the split-dollar arrangement that will directly or indirectly result in a change to the face amount.

3. Taxation of life insurance proceeds on death when current life insurance protection has not been paid or accounted for

Issue

Section 1.61-22(f)(2)(ii) limits the circumstances under which proceeds from a life insurance policy on death are not tax-free. A beneficiary (other than the policy owner) who receives proceeds upon the death of the insured under a policy subject to a split-dollar life insurance arrangement is not automatically entitled to the exclusion under Section 101(a) of the Code under the proposed regulations. To qualify for the exclusion under Section 101, the death benefit proceeds received must be "allocable to current life insurance protection . . . the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account" under the economic benefit regime.
The basis for the proposed rule appears to be that if the non-owner has not paid or accounted for the current life insurance protection, then the owner is deemed to receive and distribute all of the proceeds to the non-owner's beneficiary. We understand that Treasury and the Service have concerns about whether the non-owner has taken into account the entire value of current life insurance protection. Indeed, there have been many disputes over the proper valuation of death benefits under the standards set forth in Revenue Ruling 66-110. However, the remedy for the failure to properly report or pay for current life insurance protection should not be the loss of the tax-free status of policy proceeds payable on death. If this rule were literally applied to all tax years when a non-owner has reported current life insurance protection under Revenue Ruling 66-110, there would be substantial uncertainty as to the continuing tax-free nature of the policy death benefits.

Recommendation

Any good faith effort to report or pay for current life insurance protection should be recognized for purposes of Section 1.61-22(f)(2)(ii).

D. LOAN REGIME

1. Scope of a “split-dollar loan”

Issue

Section 1.7871-15(a)(2)(i) defines a “split-dollar loan" as a premium payment under an equity split-dollar life insurance arrangement by a non-owner on an owner's behalf that is "a loan under general principles of Federal tax law or, if it is not a loan under general principles of Federal tax law, a reasonable person would expect the payment to be repaid in full to the non-owner (with or without interest)." The proposed regulations do not address what types of arrangements involve a reasonable expectation of repayment in order to constitute a loan for purposes of Section 7872 of the Code.

Comment

The reasonable expectation of repayment standard is a new concept introduced by the proposed regulations. The need for this standard is questionable, as Section 1.7872-2 of the proposed regulations already broadly interprets what types of arrangements constitute a loan. For example, an obligation to repay that is non-recourse against the borrower is a "loan" under 1.7872-2 and established Federal tax principles. Split-dollar life insurance arrangements that are non-recourse against the owner of the policy already fall within this definition. It is unclear how this new standard assists taxpayers in determining whether a premium payment under an equity split-dollar life insurance arrangement is subject to Section 7872.
Recommendation

It should be made clear how the reasonable expectation of repayment standard differs (if at all) from established general principles for determining what constitutes a loan under Federal tax law. Alternatively, this standard should be deleted.

2. Identifying Loans Subject to Section 7872

Issue

The proposed regulations provide that the treatment of a split-dollar loan that is a below-market rate loan is governed generally by Section 7872 and the regulations thereunder. Under a literal reading of the proposed regulations, each premium payment made under a split-dollar arrangement is treated as a separate split-dollar loan for purposes of applying the Section 7872 below-market rate loan rules.14

Comment

This treatment can be complicated for taxpayers and burdensome to administer. For instance, if each premium payment is considered to be a separate loan and premiums are paid monthly, an employer involved in a number of split-dollar arrangements with its employees would need to track loans and related compensation with respect to twelve separate loans each year under each arrangement for the life of the arrangement.

Members of the Tax Section suggested in their comment letter dated July 23, 2001 that consideration be given to allowing parties to aggregate premium payments during a selected twelve-month period and treat them as a single loan for purposes of Section 7872. Alternatively, the July 23rd comment letter suggested that all prospective premium payments made within a calendar quarter be aggregated and treated as a single loan made on the last day of such quarter. It was also suggested that premium payments made in prior years that can still be recovered should be treated as made on January 1 of the current year when a split-dollar life insurance arrangement is recharacterized as a loan.

Permitting such treatment of premium payments for this purpose will reduce the number of outstanding loans with respect to any single arrangement. This will provide the Service and taxpayers with a level of predictability in ascertaining the correct interest rate while reducing the administrative burden to employers and third-party service providers.

14 See Prop. Reg. section 1.7872-2(a)(3) (stating "each extension of credit or transfer of money by a lender to a borrower is treated as a separate loan"); Prop. Treas. Reg. section 1.7872-15(a)(2)(i) (stating that “[a] payment” made pursuant to a split-dollar life insurance arrangement is treated as a loan for Federal tax purposes).
Recommendation

Parties should be allowed to aggregate premium payments made during a specified period, not to exceed a calendar quarter, as a single loan made on the last day of the specified period.

3. Clarification of the AFR for Hybrid Loans

Issue

The proposed regulations provide special rules for hybrid loans - term loans that are treated in some respects as demand loans - for purposes of applying the below-market rate loan rules. For this purpose, a hybrid loan is: (1) a split-dollar term loan that is payable on the death of an individual, (2) a split-dollar term loan that is conditioned on the future performance of substantial services by an individual and (3) a gift term loan. If a hybrid loan does not provide for sufficient interest, as determined under the proposed regulations, then Section 7872 applies to the loan, and the loan is treated as a below-market demand loan.

Comment

For purposes of determining the amount of forgone interest for a hybrid loan, the proposed regulations state that “[f]or each year that such a loan is outstanding,” the applicable Federal rate (“AFR”) used in the determination of forgone interest is not the blended annual rate (as it would be for a demand loan generally), but rather is the AFR (based on annual compounding) appropriate for the loan’s term “for the month in which the loan is made.” This statement indicates that the appropriate AFR for the loan is determined in the month in which the loan is made. Presumably, the AFR determined in the month in which the loan is made is used for as long as the loan is outstanding, and is not re-determined annually.

However, this statement in the proposed regulations could be read as requiring that the appropriate AFR is determined in the month in which the loan is made and is re-determined “[f]or each year that such loan is outstanding.” Stated differently, if it is determined in the month in which the loan is made that the long-term AFR for the month is equal to five-percent, then for each year that the loan is outstanding, forgone interest should be determined using five-percent as the AFR, and not the applicable long-term AFR as re-determined in the year.

Recommendation

It should be made clear that the AFR determined in the month in which the loan is made is used for as long as a hybrid loan is outstanding, and is not re-determined annually.

Issue

If a split-dollar loan is a below-market loan under Section 7872, then the loan is recharacterized generally as a loan with interest at the applicable federal interest rate, coupled with an imputed transfer by the lender to the borrower. In the case of a below-market loan from a corporation to a shareholder, the proposed regulations do not address what, if any, effect an imputed dividend payment would have on the corporation's continued qualification under Subchapter S of the Code.

Comment

Special dividend rights with respect to stock held by any shareholder may disqualify the corporation from Subchapter S status under the one class of stock rule under Section 1361(b)(1)(D) of the Code. Any amounts considered a deemed dividend payment under Section 7872 should not terminate a corporation's status under Subchapter S under the one class of stock rule.

Recommendation

It should be made clear that an imputed transfer between a corporation and a shareholder under Section 7872 is not treated as involving a dividend under the second class of stock rule under Section 1361(b)(1)(D).

E. TRANSITIONAL ISSUES

1. Need for guidance setting forth standards and examples for what is and is not a material modification.

Issue

The proposed regulations, as finalized, apply to any split-dollar life insurance arrangement that is "entered into" after the date final regulations are published in the Federal Register. An arrangement that is "entered into" on or before the date final regulations are published in the Federal Register and is "materially modified" after that date is treated as a new arrangement "entered into" on the date of the modification. As a result, split-dollar life insurance arrangements that currently are eligible for special transition treatment under Notice 2002-8 and are "materially modified" after the Federal Register publication date will be subject to the final regulations.15 The term “materially modified”...
modified” is not defined in the proposed regulations. Comments were requested regarding whether certain modifications should be disregarded as immaterial in determining whether a modified arrangement should be treated as a new arrangement.

Comment

A modification to the terms of a split-dollar life insurance arrangement should be considered material if it provides permanent and material additional benefits to the party that is intended to benefit primarily under the arrangement (i.e., an employee in the case of employment based split-dollar arrangement, a donee in the case of private split-dollar arrangement, and a stakeholder in the case of an entity-stakeholder split-dollar arrangement). For example, a split-dollar life insurance arrangement in place before January 28, 2002, extended by an employer to one of its employees should be treated as "materially modified" if the employer is required to make material additional premium payments on the employee's behalf by virtue of the modification (except as noted in Part (ii) below). Changes to reduce an employee's rights (such as a requirement for an employee to make material additional premium payments), to simplify administration of the arrangement, or to further secure or otherwise enhance the employer's rights should not be considered material modifications.

It is important that final regulations provide guidance on what type of changes to a split-dollar life insurance arrangement do (and do not) constitute “material modifications.” The following discussion addresses whether certain changes to a split-dollar life insurance arrangement affect the parties’ rights and benefits in a manner that should cause the arrangement to be “materially modified” for purposes of the effective date rule.

(i) Adding Policies to the Split-Dollar Life Insurance Arrangement

Policies may be added to a split-dollar life insurance agreement over time to meet the needs of the parties. Instead of executing a new agreement for each new policy, it is customary to add the policies as a rider to an existing agreement. Any new policies that may be added after the issuance of final regulations should be considered not a modification to the existing split-dollar life insurance arrangement but the establishment of a new arrangement under an identical split-dollar life insurance agreement with respect to such policies. This approach avoids a trap for the unwary, does not appear to represent an opportunity for abuse and is consistent with the Service's approach in other areas to material modification principles.16

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arrangements entered into before the date of final regulations, there will be no tax on increase in cash surrender value until termination of the arrangement and modified rules to report taxable benefits from current life insurance protection are available.

16 For example, an increase to the number of shares subject to an incentive stock option is not considered to be a modification to the existing option. Instead, the new shares are considered to be part of the grant of a new option to acquire additional stock. See Treas. Reg. Sec. 1.425-1(e)(5)(i).
(ii) Change in the Amount of Premiums Paid by the Parties

The parties to a split-dollar agreement may agree to reallocate responsibility to pay a portion of premiums based upon changes in the valuation rules for current life insurance protection. "Contributory" split-dollar life insurance arrangements require the employee to pay for current life insurance protection based on one or more sets of rates that have been allowed from time to time under Revenue Ruling 66-110 and other rulings, including now outdated P.S. 58 rates. Any changes to valuation rules cannot be made to existing split-dollar life insurance arrangements without making amendments that might jeopardize grandfather status under Notice 2002-8. Parties should be allowed to amend split-dollar life insurance agreements to change the required contribution amount to reflect changes made to the valuation of current life insurance protection under future guidance even if the change results in a smaller contribution obligation for the employee.

(iii) Changes to the Life Insurance Policies

Changes to a life insurance policy do not, by themselves, modify a split-dollar life insurance arrangement. We believe that a modification of a life insurance policy should not be treated as materially modifying a split-dollar life insurance arrangement unless it requires the employer, donor, corporation or other entity, as the case may be, to make material additional premium payments under the arrangements. Each of the following changes to a policy subject to a split-dollar life insurance arrangement should not be considered a material modification.

Policy Changes Not Affecting Issuance Date

Changes to a life insurance policy that do not affect the date the contract is issued, entered into, or purchased for federal income tax purposes should not be treated as a material modification under the proposed regulations. The legislative history to several Code provisions governing the tax treatment of life insurance provide guidance as to the types of changes that would result in a loss of grandfather status for purposes of tax law changes. We see no reason why these rules should not also be extended to changes to a policy subject to a split-dollar life insurance arrangement.

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17 Life insurance contracts are subject to transition rules under the following provisions of the Code: (1) Section 72, which sets forth rules for the tax treatment of amounts received under an annuity, endowment, or life insurance; (2) Section 101(f), which provides the federal income tax treatment of proceeds of a “flexible premium life insurance contract” issued before January 1, 1985; (3) Section 264, which sets forth the federal income tax treatment of certain amounts paid in connection with insurance contracts purchased or issued after certain dates; (4) Section 7702, which defines the term “life insurance contract” for federal income tax purposes for contracts issued (or treated as exchanged) after December 31, 1984; and (5) Section 7702A, which defines the term “modified endowment contract” generally for contracts entered into (including a contract that is “materially changed”) on or after June 21, 1988.

Tax-Free Exchange of Policies under Section 1035

Section 1035 of the Code provides that no gain or loss is recognized on certain exchanges of a life insurance contract for another life insurance contract, endowment contract or annuity contract. This section operates to prevent taxation of contract owners who have merely exchanged one insurance policy for another better suited to their needs and who have not actually recognized any gain or loss because the new contract is substantially a continuation of the investment in the exchanged contract still unliquidated.¹⁹

Contract Changes as Required by
Split-Dollar Life Insurance Arrangement

A change to a life insurance contract might be required under the terms of a split-dollar agreement that results in a change in the amount, but not the nature of the parties’ rights and benefits under an arrangement. For example, an agreement under a split-dollar life insurance arrangement between an employer and an employee might provide for an amount of insurance coverage on the life of the employee that increases in amount with the employee’s compensation and/or position with the employer. In the event of such an increase in compensation or a promotion, the death benefit under the life insurance contract related to the arrangement will need to be increased. This change is dictated by the terms of the split-dollar life insurance arrangement and thus reflects the execution of, rather than the modification of, the arrangement. Hence, we believe such a change should not be treated as a material modification under the effective date rule.

Routine Adjustments to the Life Insurance Policy

Routine adjustments to a life insurance contract subject to a split-dollar life insurance arrangement that do not materially increase the obligations of an employer, donor or corporation or other entity, as the case may be, should not be treated as a material modification. For example, a change in the number or identity of the investment options that might be available under the policy and a change in the beneficiary named under a contract are routine adjustments that do not modify the basic nature of the policy and arrangement.

(iv) Changes Between Equity and Non-Equity Split Dollar Life Insurance Arrangements

A party to a split-dollar life insurance arrangement may transfer rights to "equity" (i.e., policy cash surrender value in excess of policy premiums) to the other party during the term of the arrangement. For example, the preamble to the proposed regulations identifies a situation involving a “non-equity” split-dollar life insurance arrangement under which the employee or donee is subsequently provided with an interest in the cash value of the related life insurance contract. This change should result in a material modification as the employee or donee has acquired substantial rights that did not previously exist. On the other hand, an employee or donee might relinquish any current or future rights to equity and retain a right to only current life insurance protection under an existing split-dollar life insurance arrangement in exchange. We understand that some taxpayers have considered making this change in response to the loan prohibition under Section 402 of the Sarbanes-Oxley Act. This type of transfer of rights should not be a material modification as the employee or donee has not benefited from the transfer.

(v) Changes to the Identity of the Parties to the Arrangement

It is not uncommon for the parties to a split-dollar life insurance arrangement to change over time. An employee receiving current life insurance protection under a split-dollar arrangement may assign this benefit to an irrevocable life insurance trust that then becomes a party to the split-dollar life insurance agreement. Business transactions resulting in a change of ownership and reorganizations often result in a new party assuming the split-dollar life insurance arrangement. Any of these changes, by themselves, should not be treated as a material modification of the split-dollar arrangement.

(vi) Other Modifications Identified by the Service

It is difficult, if not impossible, to identify all the modifications that may be made to split-dollar life insurance arrangements. In addition to setting forth the guidance requested above, the final regulations should provide that the Service will from time to time identify (in revenue rulings, notices, forms, publications, private letter rulings, or other forms of guidance) other modifications that may, or may not, be disregarded in determining whether an arrangement is treated as a new arrangement for purposes of the effective date rule.

Recommendation

Only a change that provides permanent and material additional benefits to an employee, donee or shareholder from the other party to a split-dollar life insurance arrangement should be treated as a "material modification" resulting in a new arrangement subject to the final regulations. An exchange of policies subject to Section 1035 should not result in a "material modification" regardless of whether there is any change to the policy death benefits, provided that the premium payment obligation for the employer, donor or corporation or other entity does not materially increase. New policies added to an
existing split-dollar life insurance arrangement should be treated as part of a new separate split-dollar life insurance arrangement and not as a material modification of the existing arrangement.

F. SPECIAL TRANSFER TAX CONSIDERATIONS

1. Need for clarification regarding the estate tax consequences of the proposed regulations

   **Issue**

   To what extent do the deemed ownership rules for split-dollar life insurance arrangements under the proposed regulations cause the insured to be treated as owning a policy or possessing the incidents of ownership in a policy for purposes of Section 2042 of the Code?

   **Comment**

   The Preamble states that “for estate tax purposes, regardless of who is treated as the owner of a life insurance contract under these proposed regulations, the inclusion of the policy proceeds in a decedent’s gross estate will continue to be determined under Section 2042. Thus, the policy proceeds will be included in the decedent’s gross estate under Section 2042(1) if receivable by the decedent’s executor, or under section 2042(2) if the policy proceeds are receivable by a beneficiary other than the decedent’s estate and the decedent possessed any incidents of ownership with respect to the policy.”

   The definitions set forth in Section 1.61-22(c) begin by stating that the following definitions (which include the definition of “owner”) “apply for purposes of this section.” This section contains two “deemed owner” definitions, one of which may have estate tax ramifications. In a private split dollar arrangement, a donor is treated as the owner of the policy in a non-equity split dollar arrangement between a donor and a donee (for example, a life insurance trust). Accordingly, the donor, who in this instance would be the insured, will be deemed to be the owner of the policy in a non-equity split dollar arrangement.

   Under Section 2042, the ownership of the policy by the insured will cause inclusion of the policy in the insured’s estate. The concern is that, notwithstanding the language in the Preamble, the language limiting the definition to this section is not broad enough and raises concerns regarding the inclusion of the policy proceeds in the estate of insured due solely to the existence of the non-equity split-dollar life insurance arrangement.20

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20 Regulations under Section 2042 provide that the term, “incidents of ownership” encompasses more than mere ownership and reference the economic benefits of the policy. These rights include changing the beneficiary, surrendering or canceling the policy, assigning the policy, revoking the assignment, pledging the policy for a loan and obtaining from the insurer a loan against the surrender value of the policy. These rights, if retained by the insured, would cause inclusion of policy proceeds under Section 2042. Our concern is whether the insured will be treated as policy owner under Section 2042.
Recommendation

It should be made clear that the "deemed ownership" provision in the Section 1.61-22(c) apply for purposes of Sections 61 and 7872 only. Regulations under Section 2042 should provide that the insured shall not be considered to hold incidents of ownership in a policy subject to a split-dollar life insurance arrangement solely because of being considered the deemed owner under the Sections 61 and 7872 of the Code.

2. Arrangements referred to as “private split dollar arrangements” where there is no gift between the parties to the arrangement

Issue

The proposed regulations refer to the parties in a private split dollar arrangement as the “donor” and “donee" without defining these terms.

Comment

It is possible in a private split dollar life insurance arrangement that technically there is no "donor" or "donee" because each party to the arrangement contributes that amount of the premium equal to what they are entitled to under the arrangement. For example, in a non-equity arrangement, one party, who is entitled to the death benefit of the policy, pays that portion of the premium equal to the value of the insurance protection and the other party, who is entitled to the greater of the premiums paid or cash surrender value, pays the remainder of the premium. In this instance, there is no gift between the parties. As a result, there is no donor and donee.

Recommendation

It should be made clear that a private split dollar life insurance arrangement may be created between two parties, neither of which is an employer, corporation or other entity, even though there is no gift made to either of the parties.