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Report 9

Thursday, January 8

9:00 - 9:45 a.m.
Split Dollar Has Split - So How Do We Finance Premiums Now?
Donald O. Jansen

Reporter: Carol Warnick Esq.

If plans are entered into or significantly modified since September 18, 2003, they are now under the new regime.

There are 2 types of regimes the taxpayer can choose from.

(1) Economic benefit regime (old endorsement split dollar) Premium measures economic benefit, but cash value will be taxed

(2) Or can choose loan regime employee owns entire cash value. Must use higher applicable federal interest rate.

It has been implied there is a demise of split dollar but it is not dead, just more expensive.

Many ways of financing premium payments. Can be simple...just pay the premium out of your pocket., or maybe a family entity can pay the premiums. A trust might be a remaindermen in a GRAT remainder interest can give money to the trust to pay the premiums.

He is going to cover 3 other approaches to financing premium payments.

1. Loan approach -- by employer, by insured, by a third party

2. Using employer money, bonus plan, split dollar, undivided ownership of the policy between employer and employee

3. Sale to a defective trust where assets will produce enough to pay premium and pay back principal to the note

1. Employer loan

Employer has to comply with new split dollar loan regs. But he has to pass some initial hurdles.
1. split dollar arrangement
2. correct ownership of policy
3. have a real, bona fide loan (not a sham loan)

Applies if the employee is the owner or his trust is.

Exception.....page 7 special exceptions
if employer has all the cash value, regs treat it as if the employer owns the policy

Regs say if the employer is direct or indirect source of payment of interest on the loan, interest is disregarded. Example of indirect source of payment in regs. Employee was to pay back loan in a lump sum at maturity date, along with premiums. Also had a deferred comp plan which would pay out the amount of the interest at that same date. If you have an agreement to bonus the money annually, it is an interest free loan.

If no loan, all the money is income on the front end. If employer is going to be the source of the interest or the premium payments, be careful. Do not tie the deferred comp agreement to the loan in any way. Or make it subject to a substantial risk of forfeiture

If employee pays applicable federal interest rate, no consequences.

Demand loan AFR is the blended fed rate published in July of each yr. 1.52% in 2003 usually lowest interest rate but most volatile.

Term loan rates determined differently page 13 short, mid, long term. Higher than demand rate but can lock it in. Can be conditioned upon continued employment by the employee.

If do not charge it you have income and gift tax consequences. Page 13 On a demand loan these are annual.

Term loan pg 14 one-time income and one-time gift tax consequence in the month you enter into the loan.

Pg 15, #5 example in regs 15 yr interest free loan discounted back was a $64,000 dividend to that shareholder in the month which it was entered into.

Pg 15,16 and 17 Special rules tied to life expectancy or conditioned on employment, or a family loan figured as if it were a demand loan if to a life insurance trust would make a front end gift to the ILIT

A loan every time an employer pays a premium different AFRs, etc.

SECOND TYPE OF LOAN
pg 25

Insured loans money to ILIT to hold down the gift, he can loan the money to the trust.

Various loan formats separate loan each year using AFR but if he has the money on a universal life policy, do a single premium loan at the front end compounds the money interest free.

The fly in the ointment are the MEC (modified endowment contract) rules. If you put the premiums in the policy too fast, then for the lifetime of the insured it is taxed as if it were a tax deferred annuity. If you borrow, the income comes out first, basis stays in contract. (pg 26). If you do not need to borrow, or do not need to touch cash value, it is OK. When insured dies, it is still a life insurance policy.

Page 26 income tax consequences spit-dollar loan regime applies. Must pay APR also, when it is the insured loaning money to the trust make it a grantor trust insured pays interest to himself a non tax event.

In order to make it a grantor trust, choose a defect that will get you the right income tax consequences 3 most popular pgs 27, 28, 29

1. Nonadverse party has the ability to add a beneficiary to the trust other than an after born child likes to use a trust protector for this.

2. Power of any person to reacquire trust property and substitute with equivalent value. Must not be done in a non fiduciary capacity again he likes using a trust committee or a trust protector.

3. If the income of the trust maybe applied to pay premium on an insurance policy on the life of grantor or grantor's spouse, then you have a grantor trust. Can you trigger this defect if you have no income in the trust? He also uses another string as well.

What if grantor trust status ends while grantor alive? Tax consequences of outstanding loan? Pg 30 No direct authority. Probably treated as if the grantor transferred the trust assets to the trust on that date and any liabilities of the trust to a third party are treated as money received and will result in gain to the grantor to the extent that the discharge of indebtedness exceeds the basis of the assets in the trust.

What if the loan is to the insured? That is a worry.

What if grantor trust status ends because of death of grantor? Is that a sale or exchange? Do we get a step up in basis? Pg 31 he cites articles in this area opinions vary

Always plan to have the note paid off well within the life expectancy of the grantor so there is no issue.

Gift tax consequences of loaning money to the trust must charge the AFR and have a bona fide loan. Make it clear this is a valid loan with notes, etc. Pay interest each year to show it is a real loan, otherwise it could all be a gift at the front end.

Is inadequate security enough to cause IRS to discount the loan? One theory - 7872 rules. Other theory says 7872 is silent so if you do not have enough security, they might discount it. Frazee v. Commissioner, a 1992 case, took the 7872 approach

Try to have other assets in there to provide security, or have beneficiaries secure the note.

Estate Tax Consequences no problem under 2042 no incidence of ownership - what about 2036? Is it a transfer where the insured retained the right to the income? if you do not have enough security, could be an issue. He suggests maybe a 10% additional gift to the trust.

THIRD TYPE OF LOAN Third party financing

Trust borrows money to pay premiums usually balloon notes....most have interest being paid currently - some allow interest to be accumulated

Where to you get the loans? banks, or specialized institutions

AIG, Bank of Scotland - LIBOR plus a spread of 1 1/4 to 2 1/2 percent

Read your loan documents may say for 15 yrs but have a clause that renews every year and allows them to pull the plug.

3rd party lenders will demand security want the assets in the trust to exceed the loan by 10% - will require outside collateral or guarantees.

Income tax consequences of 3rd party loan. He does not think it is subject to 7872.

Should it be a grantor trust? Most of the time, no. Unless there are other reasons (other assets in the trust and want grantor to pay taxes or with crummey powers.)

If you do make it a grantor trust, same issues apply when it is no longer a grantor trust....aim to have it paid off before grantor dies.

Gift tax consequences. He does not think it is a gift, but if there is a lot of money involved he will have the trust pay a guarantee fee charge what a bank would change for a letter of credit.

He indicated he would go over the rest of his outline in the special session.

9:45 - 10:30 a.m.
When the Kids Won't Play Well Together: Tax-Free Corporate Divisions in Family Succession Planning
Michael V. Bourland

Reporter: Gene Zuspann Esq.

Family business succession planning often involves inter-generational conflicts between subsequent generations. These difficulties are compounded if the business entity form is a corporation. The goal of such divisions is to allow different family members or groups to own and control their own business without causing a tax on the division of the corporation.

Divisions of the family business can often be accomplished under IRC §355.

In his materials and presentation, the "distributing corporation" owns the "controlled corporation" and will distribute the stock of the controlled corporation in the §355 transaction.

Requirements of §355:

-The distribution to a shareholder is with respect to the shareholder's stock

-The distributing corporation must distribute stock in the controlled corporation which the distributing corporation controls immediately before the distribution (80% voting control and 80% of total shares of all other classes of stock)

-The plan cannot be a device for the distribution of earnings and profits of the distributing corporation, the controlled corporation or both

-There is no bright line test

-This is a facts and circumstances test

-Facts to be reviewed - whether the distribution is pro-rata, whether an sale occurs shortly after the distribution, and the nature of and use of the assets in the controlled corporation.

-There must have been an active trade or business for 5 year period ending on the date of distribution. The business must not have been acquired in the 5 year period.

-There must be a significant corporate business purpose. The purpose must be a non-federal tax purpose. It also must not be a shareholder purpose, however the shareholder purpose may be so nearly coextensive with the corporate purpose as to preclude any distinction.

-The dispute between the shareholders must be to such an extent that the corporations business will be affected negatively if the division of the corporation is not carried out.

-There must be a continuity of interest in the controlled corporation by the shareholders of the distributing corporation.

-There must be continuity of the business enterprise - the business enterprise that existed before the division must still exist after the division.

Tax effect of the division

-If §355 met then neither gain or loss are recognized.

-If the requirements are not met, the distributing corporation can recognize gain (but not loss)

-Disguised sale rules - intended to prevent the sale of a corporation carried out the pretext of a tax-free corporate division.

-Distributions part of a prohibited plan.

The controlled corporation will not recognize gain or loss, even if the tax-free corporate division provisions are not followed. The basis of assets in the controlled corporation are a substituted basis in the hands of the distributing corporation.

He then went back to page 5 of the outline to review some diagrams of the various transactions. These consist of one for a pre-succession division, in which the founder is still alive. Some children receive stock in one corporation (the controlled corporation) in exchange for all of their stock in the distributing corporation. The parents also receive part of the stock in the controlled corporation but give up no stock. The result is that the parents now own part of both corporations but the children each own stock in only one of the corporations.

He then reviewed a post-succession division. In this case, some children retain all of their stock in the distributing corporation and some children give up all of their stock in the distributing corporation for all of the stock in the controlled corporation.

Finally, he analyzed the two transactions using the various tests of §355 set out above.

In the past, PLR's were used in advance to protect against the negative results of failing the tests. However, in Rev Proc 2003-48, the Service indicated that it will not longer issue comfort rulings.

Estate Planners points to remember (The outline indicates that "the complex and voluminous nature of the tax law pertaining to tax-free corporate divisions renders an exhaustive understanding of it by estate planners quite impractical.")

-Corporate business purpose

-Be diligent

-Give diplomacy a chance - the cost of doing the division may outweigh the tax benefits of accomplishing it tax-free.

-The division should be incorporated in the current estate plan

The presentation was very well organized and given in a great deal of detail. He ended about 8 minutes early. Although the outline is not as long as many, he covered it in whole.

GENERAL INFORMATION ABOUT INSTITUTE:
Inquiries/Registration:
University of Miami School of Law
P.O. Box 248087
Coral Gables, FL 33124-8087
Telephone: 305-284-4762 / FAX: 305-284-6752
Web site: www.law.miami.edu/heckerling
E-mail: heckerling@law.miami.edu
==
Headquarters Hotel - Fontainebleau Hilton
4441 Collins Avenue
Miami Beach, FL 33140
Telephone (305) 538-2000, FAX (305) 674-4607
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