<u>Note:</u> Final split dollar regulations were issued following publication of Brief 50. This document's discussion of entering into new agreements does not reflect the final regulations.

October 4, 2002

OPTIONS FOR EXISTING EQUITY SPLIT DOLLAR PLANS
Plus
"Should I Recommend Equity Split Dollar Before Final Regulations?"

Introduction

IRS Notice 2002-8, 2002-4 I.R.B. 398, provides two safe harbors regarding the taxation of equity split-dollar plans that are established prior to the publication of the final split-dollar regulations.[1] First, equity is not taxed when a split-dollar arrangement established prior to January 28, 2002 is either terminated prior to January 1, 2004 or converted to a loan by January 1, 2004. Second, equity will not be taxed as long as the cost of the current life insurance protection is paid or taxed, even if the funding party is repaid.

Another option, although not a safe harbor, is to convert a split-dollar arrangement to a loan in 2004 and thereafter, but the Service may assert that the equity is taxed at the time of conversion.

This piece helps financial representatives to analyze equity split-dollar plans established prior to the final regulations. It identifies the various options and their tax consequences in a summary form. It also describes tools that will be helpful in assessing these options.

For plans that have sufficient cash values to repay the funding party and maintain the policy, we generally recommend terminating them before 2004 because under Notice 2002-08 the IRS will not tax this equity. The funding party can be repaid with cash released on a partial surrender, a

[1] The hearings on the proposed regulations are scheduled for October 23, 2002. No one can accurately predict when the final regulations will be published. All plans established after the publication of the final regulations, as well as any existing plans that are "materially modified" (as yet undefined) after that date, will be subject to the final regulations.

policy loan, or any other cash source. Future premiums can be paid in various ways. The policy may also be modified to reduced paid-up status.

The more trying issue is what to do with existing equity split dollar plans whose cash values cannot support repayment to the funding party before 2004. Of course, these plans can be terminated at any time by paying the funding party with a combination of the options described in Chart B below, but our experience is that your clients want to use policy values – not other sources – for this purpose. The IRS, although having no clear litigating position on the subject, has indicated that, for plans terminated in 2004 and thereafter, it would like taxpayers to report any equity as income at termination, and may challenge a nonreporting of equity income. This piece explains the options and potential results for continuing these plans into 2004 and beyond.

Of particular interest is whether to recommend the financing of insurance with equity split dollar between now and when the proposed regulations become final, or what we will call the "interim" period (equity plans set up after final regulations must be treated as a loan, with interest income imputed if the arrangement bears an interest rate less than the applicable federal rate at that time). We devote the final section to exploring the interim opportunities.

Back to plans currently in place. What follows is a three step process which allows you to identify your existing equity plans, understand their design and objectives, and look at the projected premium advance and cash value numbers. Charts A through C summarize options to continue pre-final regulation plans, repay the advancing party, and pay future premiums following a plan termination.

I. <u>Step One</u> – Identify Existing Equity Split-Dollar Plans

A. An equity split-dollar plan is one in which the owner of the policy is typically an employee, a trustee, or a shareholder. The owner has rights to the cash value and death benefit over the premiums paid (i.e., the equity). The owner either pays the portion of the premium equal to the one-year term cost of the death benefit it will receive or reports that amount as income in an employment setting. If a trust or individual unconnected with the business owns the policy, this amount may be either income or a gift or both. Endorsement-type plans are not affected by the equity issues in this piece and are not addressed here.

B. The party advancing all or the bulk of the premium (the funding party), whose recovery is limited to premium advances only, is usually an employer providing an employee a fringe benefit, a corporation providing a shareholder insurance protection or an individual providing premiums under a private or family split-dollar plan.

C. An equity plan is generally established by using the Collateral Assignment Method, Assignment Method, Sole Ownership Method, or Split-Owner Endorsement Method.

D. An existing equity plan, for purposes of this piece, is any plan established prior to, and not materially modified after, the publication of final split-dollar regulations.

II. Step Two – Understand The Design And Objectives Of An Existing Equity Plan

A. Examine all plan documents, including: (1) the split-dollar agreement, (2) policy documents (e.g., the collateral assignment, and assignment), (3) sales illustrations and prior inforce ledgers, and (4) other documents (e.g., corporate minutes and summary plan descriptions).

B. Determine when the parties originally intended to terminate the plan (e.g., age 65) as well as how (e.g., surrender of additions, cash) the policyowner intended to repay the funding party at termination.

C. Determine whether the original design and objectives still apply.

III. Step Three – Run An Inforce Ledger (IFL) Based On The Existing Plan Design And Objectives

A. The IFL In General

A split-dollar IFL will show how the policy will perform based on the current plan design and policy assumptions, and can gauge whether the original objectives of the parties can still be met for the split-dollar plan. For example, it can show when there is sufficient cash value to terminate the plan and maintain the policy.

B. Identify The Amount Of Equity

The IFL can show the amount of equity. For analytical purposes, we identify three equity characterizations:

1. No Equity – The cash surrender values in 2003 do not exceed the premiums paid by the funding party.

2. Insufficient Equity – Although the cash surrender values exceed the premiums paid by the funding party, they are insufficient to terminate the plan by surrendering paid-up additions prior to 2004 and still carry the policy.

3. Sufficient Equity to Terminate the Plan and Maintain Policy – Sufficient cash surrender values exist to surrender paid-up additions and reimburse the funding party (terminating the plan) prior to 2004 and to allow the policyholder to maintain the policy.

C. Illustrate The Taxation Of The Equity

The IFL can now show:

1. No tax on equity at termination, and

2. Tax on equity at termination.

Now let's look at options to continue existing equity split dollar plans.

IV. Options To Continue the Financing of a Policy Subject to an Existing Equity Split Dollar Plan

<u>Chart A</u>

Pre-January 28, 2002, Plans

Options	**Anticipated Results**
1. Convert the plan to a loan	Conversion must occur on or prior to January 1, 2004, to avoid tax on equity under the Notice's safe harbor. The plan can presumably be converted after January 1, 2004, but must be converted before there is equity in the plan to avoid an IRS challenge on equity income. Policy owner is taxed on income equal to imputed interest after conversion to a loan (unless appropriate interest is paid or accrued on the loan), and all prior premiums are treated as a loan in the year of conversion. <u>Comments</u>: 1) *If the funding party is a public company, the impact of this option under the Sarbanes-Oxley Act should be reviewed by counsel.* 2) A conversion made in 2003 will cause prior premiums to be treated as a loan in 2003. Therefore, conversions should be made effective as of January 1, 2004.
2. Continue the plan and report the equity as income at termination	Equity is taxed as income if termination occurs in and after 2004. Value of Economic Benefit ("VEB") is either income or a gift unless paid until termination. <u>Comment</u>: If equity is eventually treated as a transfer to the policy owner who is not the insured (e.g., a trust), it is subject to gift *and* GST taxation.

Options	Anticipated Results
3. Continue the plan and report no equity as income at termination	Policy owner argues prior law to substantiate this position. The IRS may challenge. VEB is income or a gift unless paid as premium until termination. *Comment*: If equity is eventually treated as a transfer to the policy owner who is not the insured (e.g., a trust), it is subject to gift *and* GST taxation.
4. Continue the plan and report or pay the VEB until death	Equity is not taxed. VEB is taxed as income or paid until death. *Comment*: VEB can also be a "deemed" gift if policy is owned by trust.
5. Continue the plan and report the increase in the equity annually	Policy owner reports annual equity increase as income. VEB is taxed or paid as premium until termination. *Comment*: The annual equity increase and VEB can also be a "deemed" gift if the policy is owned by a trust.
6. Transfer Policy to Funding Party (i.e., terminate the plan) and convert to endorsement plan (prior to equity growth)	If cash value is less than premiums advanced, the transferring party may owe the difference to the funding party. If cash value exceeds premium advances, the transferring party can borrow the difference before the transfer.
Note: A modification of an existing equity split-dollar plan may cause the reported or paid VEB to be higher for the plan because the grandfathering VEB rule for pre-January 28, 2002, split-dollar arrangements may no longer apply.	

CHART B

Options To Reimburse Premiums to Advancing Party
1. Surrender part of the policy to repay the funding party. *Note*: The forced-out-gain rule under IRC Section 7702(f)(7) may apply if paid-up additions are surrendered within the first 15 years of the policy.
2. Borrow cash values for repayment.
3. Re-pay with funds other than policy values.
4. The funding party forgives repayment of the advances.
5. Any combination of 1, 2, 3 and 4.

CHART C

Options to Pay Future Premiums After Termination of Plan
1. If Employee or third party owns policy a. Policy values (e.g., dividends) pay premiums. b. Employee pays premium with personal funds. c. Employer bonuses premium to employee. d. In non-employment situations, gifts can be made to the policyholder (e.g., a trust).
2. If Employer owns policy a. Employer pays premium. b. Policy values (e.g., dividends) pay premiums.
Comments: a. Policyholder can take the policy paid-up and then no further premiums are due. b. Policyholder restructures policy (e.g., drops the additional premium) after termination of plan.

Should I Recommend Equity Split Dollar Plans In the Interim?

This is akin to asking whether to recommend financing the purchase of a car or home by temporarily using someone else's money. The answer is "Yes," if the circumstances are right. In our arena, those circumstances are:

1. Your prospect needs permanent life insurance for the death benefit; and

2. Your prospect either doesn't have the funds to pay premiums or doesn't want, for whatever reason, to use those funds.

Consider the current tax climate. *All* equity plans established before final regulations are subject to existing guidance: the Code, revenue rulings and Notice 2002-08. None of this guidance flatly, openly, unequivocally, requires taxpayers to report equity as income. To the contrary, over the decades, the IRS has made no binding attempt to assert or clarify its position. As a result, taxpayers have logically concluded that the inside build-up of cash value now known as "equity" should not, and need not, be reported as income. In addition, Notice 2002-08 provides that equity will not be taxed until plan termination, and that no inference can be drawn as to the income or transfer tax consequences (other than the existing guidance) of any plans begun before final regulations and terminated in 2004 or thereafter.

This demurral allows your prospects to take the same reasoned, responsible tax position for interim plans that they can take for plans established, say, ten years ago but won't be terminated until 2004 or after. In contrast, assuming the final regulations mirror the proposed ones, equity plans set up after final regulations must be treated and taxed as loans, instead of under the current one-year economic benefit taxation rules. This interim period allows your prospects to comply with current economic benefit tax rules while choosing their tax destiny on the equity at plan termination.

But with choice comes risk. Some of the termination or conversion options may be challenged by the IRS. Seasoned counsel *must* be involved to guide your prospects, and we are available to help counsel consider the initiatives, alternatives, and ramifications.

One thing is clear. The equity plan presents opportunities, options and choices that may never appear again.