

CCH: In conclusion, do sales to an IDGT still constitute a valid estate planning opportunity?

Mr. Melcher: Definitely! However, in structuring these transactions, we must be aware of the possible arguments that may be raised against them and plan accordingly.

LIFE INSURANCE

Split-Dollar Deadline Approaches

CCH: On September 11, the IRS released the final split-dollar regulations (T.D. 9092). Those regulations apply to any split-dollar life insurance arrangement entered into after September 17, 2003, and to arrangements in existence

The IRS recently adopted final regulations on split-dollar life insurance arrangements. However, according to Lee Slavutin, MD, CLU, practitioners should be most concerned about alerting their clients with split dollar arrangements to opportunities that are set to expire December 31, 2003. Dr. Slavutin is a principal of Stern Slavutin-2 Inc., an insurance and estate planning firm in New York City, and is a member of the CCH FINANCIAL AND ESTATE PLANNING Advisory Board.

on or before that date that are “materially modified” after September 17. What should practitioners be doing in response to the issuance of the final regulations?

Dr. Slavutin: Obviously, practitioners must study the final regulations and, in the future, become

familiar with their provisions. However, rather than concentrate on the final regulations—which basically follow the proposed regulations and will affect “new” split-dollar arrangements—I would suggest that the most important thing practitioners can do right now is to determine what they can do for clients who have existing split-dollar arrangements.

CCH: With respect to those clients who have existing split-dollar arrangements, where should practitioners look for guidance?

Dr. Slavutin: Generally, Notice 2002-8, IRB 2002-4, 398, is the “bible” for existing arrangements. Consequently, I think it is incumbent on practitioners, if they have not already done so, to go back and carefully read Notice 2002-8. In this regard, it should be noted that, Rev. Rul. 2003-105, IRB 2003-40, 1, which accompanied the final regulations, specifically refers to Notice 2002-8 as existing authority that is not being rendered obsolete. With the exception of a couple of related points in the final regulations, Notice 2002-8 provides the starting point for any discussion of existing arrangements.

Material Modification

CCH: How does the concept of “material modification” fit into this discussion?

Dr. Slavutin: It was hoped by many in the insurance industry that the final regulations would provide a clear road map as to what does and what does not constitute a material modification of an existing split-dollar arrangement. Unfortunately, the final regulations fall short on that point. In fact, Reg. §1.61-22(j)(2)(ii) lists nine items that the IRS considers nonmaterial modifications, such as a change in the mode of premium payment (e.g., monthly to quarterly) or a change in the interest rate payable on a policy loan under the life insurance contract. The list deals with ministerial changes, but does not address the more important questions of policy changes or replacements.

Just to illustrate how important the concept of material modification is, let us assume an existing equity split-dollar arrangement based on the following facts. The client has a whole life insurance policy with a \$5 million death benefit as part of an equity collateral assignment split-dollar arrangement (where the policy is owned by the employee or by a trust). Over the years, the company has paid a total of \$600,000 in premiums and the current cash value is \$1.4 million. For arrangements existing prior to the final regulations, all that had to be reported as income was the economic benefit of the term insurance component. However, if an action, inadvertent or not, is construed as a material modification of an existing split-dollar arrangement, the final regulations would apply. We do not know this for sure, but pending future guidance, a material modification could result from an increase or decrease in the death benefit of the insurance policy or from replacement of the existing policy with a new policy.

If the final regulations were applicable, as a result of a material modification, the first question to ask is who owns the policy? As your readers may recall, under the final regulations, ownership determines the taxation regime. Our example assumes that the employee or a trust owns the policy, thus the arrangement falls under the loan regime. Accordingly, the \$600,000 in premiums paid by the employer is considered a loan to the employee. The employee has to pay interest on \$600,000 at whatever the applicable federal rate may be. Even assuming a relatively low rate of four percent, for example, this would amount to \$24,000 in interest payments.

“Entered Into” a Split-Dollar Arrangement

CCH: Prior to the issuance of Notice 2002-8 and again prior to issuance of the final regulations, there was some

talk of individuals who rushed to enter into split-dollar arrangements that would be grandfathered under the existing rules. Is there anything in the final regulations that should concern such individuals?

Dr. Slavutin: One point that may provide an unwelcome surprise for some people is the section of the final regulations dealing with the determination of when a split-dollar life insurance arrangement is considered to have been “entered into” (Reg. §1.61-22(j)(1)(ii)). Under that section, a split-dollar arrangement is considered “entered into” on the latest of the following dates:

- the date on which the life insurance contract under the arrangement is issued;
- the effective date of the life insurance contract under the arrangement;
- the date on which the first premium on the life insurance contract under the arrangement is paid;
- the date on which the parties to the arrangement enter into an agreement concerning the policy; or
- the date on which the arrangement satisfies the definition of a split-dollar life insurance arrangement (as defined in Reg. §1.61-22(b)(1) or (b)(2)).

Although it may be possible to have the agreement signed, the application filled out, and the first premium paid relatively quickly, it has been my experience that actually getting the life insurance contract issued could be problematic. Considering underwriting and other issues, it could take weeks to get that accomplished. Accordingly, many people who may have thought they beat the deadline for the final regulations may be sadly mistaken. In addition, although the criteria above are part of the final regulations, it is possible that the IRS might try to apply the same criteria to an arrangement purportedly entered into prior to the effective date of Notice 2002-8, but where the policy was actually issued weeks later.

Clients with Existing Split-Dollar Arrangements

CCH: Is there a logical first step that practitioners should take with respect to the issue of clients who have existing split-dollar insurance arrangements?

Dr. Slavutin: The very first step would be to identify those clients who have entered into a split-dollar life insurance arrangement. After that, I would suggest that it would be beneficial to divide the split-dollar clients into three main categories. The first category

would be those clients having arrangements involving private (nonpublic) companies that are of the collateral assignment variety. The second category would involve nonpublic companies with the endorsement type of split-dollar arrangements. The third, and final, category would concern public companies

CCH: Of the three general categories, which should practitioners concentrate on first?

Dr. Slavutin: The category covering nonpublic companies and collateral assignment split-dollar arrangements is probably by far the largest. As mentioned previously, in this type of arrangement the employer or a trust is the owner of the policy and there is an assignment of an interest in the policy back to the corporation as collateral for the corporation’s advance of the premiums. Most of these arrangements are also equity arrangements in that the cash value in excess of the premium obligation belongs to the employee or the trust, in the event the arrangement is terminated. For this category, the object is to find the clients who possess “a lot of equity.” Exactly how you define a lot of equity may not be easy because it depends on the facts and circumstances. If we consider the facts of our previous example (\$5 million policy, \$600,000 in premiums paid by the corporation, and a cash value of \$1.4 million), the resulting equity is \$800,000 (\$1,400,000 – \$600,000). I think most people would consider this figure representative of a large amount of equity.

CCH: How significant are the potential ramifications for this category of clients?

Dr. Slavutin: If the appropriate action is taken before December 31, 2003, there is the opportunity to completely avoid any income tax or gift tax on the built-up equity. On the other hand, if the client were to do nothing and, assuming the equity had further grown to \$1 million by the time the arrangement is terminated, the client would have to recognize \$1 million for income tax purposes and may also owe gift taxes if a trust is involved. Just as a reminder, when we talk about termination we are talking about terminating the split-dollar arrangement, not the insurance policy. We do not want to cancel the policy because we are going to assume that the client still needs the insurance coverage.

CCH: Would you estimate that there are a large number of clients in this high equity subcategory?

Dr. Slavutin: Realistically, no. Generally, you are not going to find a lot of cases where there is this huge spread between the cash value and the premiums paid. In most cases, the equity is much more modest. Not

that this is a necessarily a bad thing because it means that practitioners can concentrate on those few clients who can actually receive a substantial tax benefit by taking action prior to December 31, 2003. In fact, many practitioners may find that they have no clients who have equity built up in a split-dollar arrangement sufficient to necessitate such an action.

CCH: You mentioned the date of December 31, 2003, which was the deadline for the transitional rules outlined in Notice 2002-8. Is this still the effective date?

Dr. Slavutin: Yes. Contrary to what some people had hoped, in the press release that accompanied the final regulations, the IRS confirmed that this deadline would not be extended.

CCH: Specifically, what is the choice of actions that can be undertaken by December 31?

Dr. Slavutin: One of three things can be done. The first would be to terminate the split-dollar arrangement, but maintain the policy. The second choice would be to convert the arrangement to a loan. The third choice would be to do nothing and continue the arrangement as is.

If the choice were made to terminate the arrangement, in our example, the \$600,000 in premiums would have to be paid back to the corporation. Considering the equity involved in the example, this could be done by taking a loan or a withdrawal against the cash value. Taking the action in 2003 will protect the equity from taxation. If the same action were taken in January 2004, it would result in income tax on the entire \$800,000 of equity. For someone in the highest federal and state income tax brackets this could be a tax of 40 percent, or \$320,000, as a result of the delay. If a trust were involved, there would also be a gift of \$800,000 on top of the income tax hit. The bottom line is that a failure to act could be very costly.

One could also decide to convert the arrangement to a loan. In that case, all of the previous premium payments would have to be treated as a loan (in our example \$600,000) and interest payments would have to begin on the loan. This particular course of action is a way to effectively buy some time and then, if desired, to terminate the agreement at some point in the future. However, because at least something was done before December 31, 2003, the equity has still been protected from tax.

Finally, it may be desirable to do nothing before the end of 2003 and just let the arrangement remain as is. One reason for following this approach would be a determination that the future viability of the policy could be impaired by withdrawal of the \$600,000. For

example, this might be the case if the insured is elderly and the cost of maintaining the insurance is high enough to require maintaining a large cash value.

A Possible Strategy

CCH: Are there any other strategies that might warrant consideration?

Dr. Slavutin: Most of our clients have entered into split-dollar life insurance arrangements as part of an overall estate planning strategy. Consequently, these arrangements involve ownership of the policy by a trust. At least one strategy that could prove beneficial to this type of client comes in response to the problem encountered as a result of the increasing cost of term insurance as the insured ages. A similar problem ensues in the case of a second-to-die policy after the first party is deceased.

A possible approach involves putting money into the trust through annual gifts, or a larger gift that uses up some of the donor's unified credit amount, or perhaps by way of a strategy that effectively reduces the potential gift tax cost, such as naming the trust the remainder beneficiary of a grantor retained annuity trust (GRAT). Assuming for the moment that we have utilized this approach and in 10 years we have accumulated \$500,000 in the trust. Again assuming there are \$600,000 in premiums due the corporation, then \$500,000 of trust assets can be paid back to the corporation. The split-dollar arrangement can then be converted to a loan and the cost to the insured would only be the payment of interest on a \$100,000 loan. If interest rates remain generally where they are now, this cost would be relatively low. The question is whether conversion of the arrangement to a loan would constitute a termination of the arrangement, thus triggering taxation of the equity. I do not know the answer to that question, but Notice 2002-8 may provide a clue. If you look at Section IV, Paragraph 2, of Notice 2002-8, it reads:

For split-dollar life insurance arrangements entered into before the date of publication of final regulations, in cases where the value of current life insurance protection is treated as an economic benefit provided by a sponsor to a benefited person under a split-dollar life insurance arrangement, the Service will not treat the arrangement as having been terminated (and thus will not assert that there has been a transfer of property to the benefited person by reason of termination of the arrangement) for so long as the parties to the arrangement con-

tinue to treat and report the value of the life insurance protection as an economic benefit provided to the benefited person. **This treatment will be accepted without regard to the level of the remaining economic interest that the sponsor has in the life insurance contract (emphasis added).**

To summarize this portion of the Notice, if there is an existing split-dollar arrangement and two things continue to occur—the economic benefit of the life insurance protection is reported and the sponsor has some interest in the contract—termination of the arrangement will not be assumed by the IRS. Unfortunately, this provision addresses only part of our strategy in that the last sentence indicates that the interest of the employer does not have to be large in order to avoid termination. Because our strategy involves converting the arrangement to a loan, it is clear that the language “... so long as the parties to the arrangement continue to treat and report the value of the life insurance protection as an economic benefit...” would not apply to this strategy. However, in Paragraph 3 of Section IV, the Notice goes on to say “For split-dollar life insurance arrangements entered into before the date of publication of final regulations, the parties to the arrangement may treat premium or other payments by the sponsor as loans.” At least in the latter paragraph, there is nothing to indicate that treatment as a loan would constitute termination. Admittedly, there is no definite answer, but Notice 2002-8 does at least provide some encouragement for considering this strategy.

Endorsement Split-Dollar

CCH: Turning to the next category—endorsement split-dollar arrangements with nonpublic companies—what should the course of action be?

Dr. Slavutin: In this type of arrangement, the company owns the policy and the cash value and endorses over the death benefit to the employee’s beneficiaries or to a trust. These arrangements were generally set up to provide a true death benefit for the employee and, thus, would ordinarily be of the non-equity type. Accordingly, they can continue operating as they have been.

Typically, one of two things will happen with endorsement split-dollar when the employee retires. First, the company could retain the insurance policy and use the policy’s cash value to provide a form of supplemental retirement benefit to the employee. That benefit, as it gets paid out to the employee, would be taxable income. Another possibility is for the company to transfer the policy to the employee.

At that moment in time, the transfer of the policy would clearly be a taxable event.

Public Companies

CCH: Finally, what about split-dollar arrangements with public companies?

Dr. Slavutin: The final regulations added no further insights into the problems presented by the Sarbanes-Oxley Act of 2002 (P.L. 107-204). As you may recall, the Act’s conflict-of-interest provisions prohibit public companies from entering into loans with certain executives and officers (Act Sec. 402(a)). Although that portion of the Act deals specifically with the Securities and Exchange Act of 1934, the potential implications for split-dollar arrangements, particularly collateral assignment split-dollar plans, are unclear. Some commentators had hoped that the final regulations would indicate that, if the parties to a split-dollar arrangement were forced to change the arrangement in response to Sarbanes-Oxley, the change would not be considered a material modification. However, the IRS did not do this and instead indicates specifically, in the preamble to the final regulations, that they would not address any issues dealing with Sarbanes-Oxley, because interpretation and administration of the Act falls within the jurisdiction of the Securities and Exchange Commission.

For some clients this is going to mean that they must make a material modification and suffer the tax consequences in order to avoid the potential reach of Sarbanes-Oxley. But, as one person recently said to me, “if the choice is between a material modification and going to jail, I will not hesitate to choose the material modification.”

Future Guidance

CCH: Do you foresee any additional guidance in the near future on split-dollar related issues?

Dr. Slavutin: We hope there will be additional guidance, possibly in the form of a revenue ruling, on the question of what constitutes a “material” versus a “nonmaterial” modification of an arrangement. In addition, there will have to be guidance on the table of term rates that can be used to value the insurance component.

CCH: How would you summarize what practitioners should be doing for their clients in the coming few weeks?

Dr. Slavutin: I would summarize this into three basic points. First, Notice 2002-8 is still our primary source of guidance on the treatment of existing split-dollar

life insurance arrangements—consider its implications carefully. Second, be very cautious not to do anything that could be construed as a material modification of an existing arrangement because such a modification may trigger the application of a different tax regime. Finally,

practitioners may very well discover that only a small group of their clients will benefit from taking any affirmative action on an existing split-dollar arrangement prior to December 31, 2003. However, for those clients affected there could be a substantial tax saving involved.



BRIEF IDEAS

IRS Acquiesces in *Walton*

The IRS announced, in Notice 2003-72, that it acquiesces in and will follow the Tax Court's decision in *A. Walton*, 115 TC 589, Dec. 54,165, in which the court held that Reg. §25.2702-3(e), Example 5, was an unreasonable interpretation of Code Sec. 2702 and thus invalid. Further, the IRS announced that Reg. §25.2702-3(e) will be revised to reflect that the retained unitrust interest payable to A or A's estate will be treated as a qualified interest for a 10-year term.

In *Walton*, the grantor created two grantor retained annuity trusts under which the grantor retained an annuity for a term of two years. Upon the expiration of the two-year term, the remainder was to be paid to the grantor's daughters, or, if the grantor died during the two-year term, then to her estate. The court concluded, after analyzing the text and legislative history of Code Sec. 2702, that a retained annuity payable for a specified term to the grantor, or the grantor's estate if the grantor dies during the term of the trust, was, contrary to Reg. §25.2702-3(e), Example 5, a qualified interest under Code Sec. 2702.

Tax Court Denies Reconsideration

In *D. Halder Est.*, 86 TCM 427, Dec. 55,314(M), TC Memo. 2003-284, the Tax Court denied the estate's motion to reconsider its earlier decision (85 TCM 1051, Dec. 55,092(M), TC Memo. 2003-84), in which the court concluded that no settlement was reached between the estate and the IRS because there was no meeting of the minds. The estate's counsel took undue advantage of an error contained in a fax sent by

counsel for the IRS. The estate failed to demonstrate a manifest error of fact or law in its motion for reconsideration, thus the court denied the motion.

Additional Tax Imposed on Rollover from TSP

The 10-percent additional tax under Code Sec. 72(t)(1) applied to an early distribution from married taxpayers' federal employees thrift savings plan (TSP) to a university, which one of the taxpayers attended as a student, to pay tuition and education fees (*J. McGovern*, TC Summary Opinion 2003-137). The exception for qualified education expenses, provided by Code Sec. 72(t)(2)(E), did not apply because that exception is limited to distributions from an individual retirement account and does not protect a distribution from a TSP. The Tax Court declined to apply the doctrine of substance over form to the distribution from the thrift savings plan to the university. *J. Larotonda*, 89 TC 287, Dec. CCH Dec. 44,115, was distinguished.

Increased Rollover Amount Allowed

A taxpayer who relied on erroneous information supplied to him on a Form 1099-R when determining the amount of a rollover contribution to an IRA was entitled to increase the dollar limit of the rollover under Code Sec. 408(d)(5)(A) by the portion of the excess contribution attributable to that information (IRS Letter Ruling 200337014). In addition, that amount would not be included in the taxpayer's gross income in the tax year in which distributed to him.