SPLIT DOLLAR INSURANCE, RECENT VALUATION CASES AND NEW PROPOSED REGULATIONS FOR MINIMUM REQUIRED DISTRIBUTIONS

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I. Split Dollar Insurance

In January 2001, the IRS issued Notice 2001-10 to provide guidance on split-dollar life insurance arrangements. The official guidance from the IRS with respect to split-dollar insurance arrangements has been limited over the last several years. After discussing the history of split-dollar life insurance arrangements and the various prior rulings addressing these arrangements, the IRS indicated that the intent of this notice is to provide interim guidance pending consideration of public comments and the publication of further guidance.

In Notice 2001-10, the IRS provides that the characterization and income tax treatment of equity and other split-dollar arrangements will generally be determined under the following six guidelines:

1. The IRS will generally accept the parties' characterization of the employer's payments under a split-dollar arrangement, provided that (i) such characterization is not clearly inconsistent with the substance of the arrangement, (ii) such characterization has been consistently followed by the parties from the inception of the arrangement, and (iii) the parties fully account for all economic benefits conferred on the employee in a manner consistent with that characterization.

2. The IRS will permit an employer's payments under a split-dollar arrangement to be characterized as loans for tax purposes, provided that all of the conditions set forth in paragraph 1 are satisfied. In such cases, the tax consequences of the payments treated as loans will be determined under section 7872, the employee will not have additional

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compensation income for the value of the insurance protection provided under the life insurance contract, and the cash surrender value of the contract will not represent property that has been transferred to the employee for purposes of section 83. However, the employee ordinarily would have additional gross income if the employer's advances were not repaid in accordance with the terms of the arrangement. Moreover, the employee could have gross income under section 72 for distributions actually received under the life insurance contract.

3. In any case in which an employer's payments under a split-dollar arrangement have not been consistently treated as loans in accordance with paragraph 1, the parties will be treated as having adopted a non-loan characterization of the arrangement, and the parties must fully account for all of the economic benefits that the employee derives from the arrangement in a manner consistent with that characterization and with Rev. Rul. 64-328, Rev. Rul. 66-110, and the general tax principles upon which those rulings are based. In general, this means that (i) the employer will be treated as having acquired beneficial ownership of the life insurance contract through its share of the premium payments, (ii) the employee will have compensation income under section 61 equal to the value of the life insurance protection provided to the employee each year that the arrangement remains in effect, reduced by any payments made by the employee for such life insurance protection, (iii) the employee will have compensation income under section 61 equal to any dividends or similar distributions made to the employee under the life insurance contract (including any dividends described in Rev. Rul. 66-110 applied to provide additional policy benefits), and (iv) the employee will have compensation income under section 83(a) to the extent that the employee acquires a substantially vested interest in the cash surrender value of the life insurance contract, reduced under section 83(a)(2) by any consideration paid by the employee for such interest in the cash surrender value.

4. Pending the publication of further guidance, the IRS will not treat an employer as having made a transfer of a portion of the cash surrender value of a life insurance contract to an employee for purposes of section 83 solely because the interest or other earnings credited to the

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cash surrender value of the contract cause the cash surrender value to exceed the portion thereof payable to the employer on termination of the split-dollar arrangement. If future guidance provides that such earnings increments are to be treated as transfers of property for purposes of section 83, it will apply prospectively.

5. In any case in which the employer's payments under a split-dollar arrangement have not been consistently treated as loans, then for so long as the arrangement remains in effect, the IRS will treat the employee as continuing to have gross income under section 61 for any current life insurance protection provided to the employee under the arrangement, except to the extent allocable to premium payments made by the employee (or included in the employee's gross income under paragraph 6) or to any portion of the cash surrender value of the contract that has been treated as a substantially vested transfer of property to the employee under section 83. When such an allocation is required, the IRS will accept a pro rata or other reasonable method for determining that portion of the death benefit allocable to cash surrender value beneficially owned by the employer and that portion allocable to cash surrender value transferred to or purchased by the employee.

6. If an employer makes a premium or other payment for the benefit of an employee under a split-dollar arrangement, and the employer neither acquires a beneficial ownership interest in the life insurance contract through such payment nor has a reasonable expectation of receiving repayment of that amount through policy proceeds or otherwise, such payment will be treated as compensation income to the employee under section 61. See Reg. § 1.61-2(d)(2)(ii)(a); Frost v. Commissioner, 52 T.C. 89 (1969).

In sum, therefore, any payment made by an employer under a split-dollar arrangement must be accounted for as a loan (see paragraph 2), as an investment in the contract for the employer's own account (see paragraph 3), or as a payment of compensation (see paragraph 6).

Furthermore, for purposes of valuing life insurance protection, the IRS has replaced the P.S. 58 rates with a new interim rate table in the notice. The rates in this new table are substantially lower than the P.S. 58 rates. However, taxpayers may continue to use the P.S.

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58 rates for tax years ending on or before December 31, 2001.

II. Recent Valuation Cases

Within a 30 day period, the Tax Court issued three *en banc* decisions relating to the valuation of property transferred to a partnership or the transfer of limited partnership interest for gift and estate tax purposes.

A. J. C. Shepherd v. Commissioner, 115 T.C. 30 (2000)

In this case, the taxpayer and his two children were partners in a pre-existing general partnership. The taxpayer owned a 50% interest in the partnership and each of his two children owned a 25% interest. The taxpayer transferred land and stock to the general partnership without receiving any additional interest in the partnership or a credit to his capital account. The issue in this case was the valuation of the taxpayer's gift to his two children.

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Under the facts of this case, there were five different possible outcomes for valuing the gift from the taxpayer to his children:

1. The taxpayer made a gift equal to the sum of the value of the partnership interest owned by the children after the transfer (apparently, the partnership did not own any assets prior to the transfer), including any discount applicable to such interest.

2. The taxpayer made a gift equal to the sum of the value of the two 25% undivided interests in the property without regard to the existence of the partnership (but subject to any discount applicable to the property).

3. The taxpayer made a gift equal to the sum of the value of the two transferred 25% interests in the property without any discount, or, alternatively, the value of the transferred property less the undiscounted value of taxpayer's retained interest.

4. The taxpayer made a gift equal to the value of the transferred property less the discounted value of taxpayer's retained interest, treated as a direct 50% undivided interest.

5. Taxpayer made a gift equal to the value of the transferred property less the value of taxpayer's partnership interest.

The taxpayer in this case was attempting to obtain the benefit of a discount of the partnership interests in valuing the gifts to his children. However, the Tax Court reached the conclusion that the taxpayer made an indirect gift of the property to his sons and did not make a gift of the partnership interests. Therefore, the value of the gift was valued at the value of a 25% interest in the actual property less a 15% discount which the Tax Court allowed for the undivided interests given in the property.

The Tax Court rejected the taxpayer's contention that the value should be based upon the value of the partnership interests of the sons after the donation because the value for gift tax purposes is the value of the property given, not the value of the property ultimately received.

The moral of this case is that anytime a donor makes a contribution to a pre-existing partnership, the donor should receive an additional interest in the partnership equal to the value of the property contributed to the partnership and then donate that additional interest

in the partnership to the donees. Many practitioners advise avoiding this issue by contributing property to the partnership when the donor or donors are the only partners in the partnership.

B. Estate of Strangi v. Commissioner,115 T.C. 35 (2000)

The limited partnership involved in the Strangi case was created about two months prior to the decedent's death. The decedent contributed approximately $10,000,000 in property to the partnership. The decedent owned a 99% limited partnership interest. The general partner was Stranco, Inc., a corporation in which the decedent owned 47%. The decedent was incapacitated when the partnership was created.

The majority opinion described the issues before the court as follows:

> After concessions by the parties, the issues for decision are (alternatively): (1) Whether the Strangi Family Limited Partnership (SFLP) should be disregarded for federal tax purposes because it lacks business purpose and economic substance; (2) Whether the SFLP is a restriction on the sale or use of the property that should be disregarded pursuant to section 2703(a)(2); (3) whether the transfer of assets to SFLP was a taxable gift; and (4) If SFLP is not disregarded, the fair market value of the decedent's interest in SFLP at the date of death.

With respect to the issue of whether or not the partnership should be disregarded, the court pointed out that the partnership was validly formed under state law with all of the formalities for formation having been performed. Therefore, the court concluded that the entity should be recognized for tax purposes.

With respect to the argument that section 2703(a)(2) applies to the valuation of the partnership interest, the court concluded that neither the language of the statutes nor the language of the regulations supports the IRS interpretation that section 2703(a)(2) requires that the partnership agreement be disregarded.

Furthermore, the court rejected the IRS contention that the decedent made a gift when the partnership was created. The IRS argued that if the decedent gave up property worth in excess of $10 million and received back a limited partnership interest worth approximately $6.5 million, he must have made a gift equal to the loss in value. The court concluded that this case was different from the case in Shepherd because all of the property contributed by the decedent was still reflected in his capital account although at a reduced

value. The decedent owned 99% of the capital interest in the partnership. In this case, the difference between the value of the assets in the hands of the decedent and the value of his partnership interest is attributable to the discount applied to the partnership interest, not a deemed gift.

The court accepted the 31% minority interest and marketability discount proposed by the IRS expert. However, the court commented that the IRS expert may have been over-generous to the taxpayer.

C. Knight v. Commissioner, 115 T.C. 36 (2000)

This case involved a Texas limited partnership in which a husband and wife transferred property to the partnership. Following the transfer of the assets to the partnership, the couple then transferred a 22.3% interest in the partnership to each of two trusts for their children.

The form of the gift in this case was different from the Shepherd in that the partnership was formed by the parents and they subsequently donated interests in the partnership to the donees. The IRS did not raise the indirect gift issue that was the subject of the Shepherd case. Instead, the IRS argued that the entity should be disregarded in valuing the gifts to the donees.

The majority opinion of the Tax Court concluded that the entity was validly formed under state law and therefore should not be disregarded for purposes of valuing the gifts. However, the Tax Court allowed only a modest 15% discount for minority interest and lack of marketability.

III. New Proposed Regulations for Minimum Required Distributions

The IRS has issued new proposed regulations governing the minimum required distributions (MRD's) from retirement plans and IRAs. These new regulations are just proposed regulations (as the prior regulations were) but the new regulations greatly simplify the MRD rules.

The new proposed regulations simplify the MRD rules by the following:

A. Providing a simple, uniform table that all employees can use to determine the minimum distribution required during their lifetime. This makes it far easier to calculate the required minimum distribution because employees would no

longer need to determine their beneficiary by their required beginning date, no longer need to decide whether or not to recalculate their life expectancy each year in determining required minimum distributions and no longer need to satisfy a separate incidental death benefit rule.

B. Permitting the required minimum distribution during the employee's lifetime to be calculated without regard to the beneficiary's age (except when required distributions can be reduced by taking into account the age of a beneficiary who is a spouse more than ten years younger than the employee).

C. Permitting the beneficiary to be determined as late as the end of the year following the year of the employee's death. This allows the employee to change designated beneficiaries after the required beginning date without increasing the required minimum distribution and the beneficiary to be changed after the employee's death, such as by one or more beneficiaries disclaiming or being cashed out.

D. Permitting the calculation of post-death minimum distributions to take into account an employee's remaining life expectancy at the time of death, thus allowing distributions in all cases to be spread over a number of years after death.

The regulations are proposed to be effective for calendar years beginning on or after January 1, 2002. For distributions for the 2001 calendar year, IRA owners are permitted, but not required, to follow the proposed regulations in operation, notwithstanding the terms of the IRA documents. Sponsors of qualified plans may amend the plans to adopt the proposed regulations if desired. A model amendment in included in the proposed regulations (and corrected by subsequent guidance).

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