

insurance contract (such that the normal rules of the economic benefit regime for equity split-dollar life insurance arrangements will apply). If, immediately after the modification, the employer, service recipient, or donor is not the owner, the employer, service recipient, or donor is treated as having made a transfer of the contract to the employee, service provider, or donee as of the date of the modification. For purposes of these rules, the replacement of a non-equity arrangement with a successor equity arrangement will be treated as a modification of the non-equity arrangement.

3. Taxation Under the Economic Benefit Regime

a. In General

The final regulations retain the basic rules for taxation under the economic benefit regime that had been set forth in the 2002 and 2003 proposed regulations. Thus, the final regulations provide that, for these arrangements, the owner of the life insurance contract is treated as providing economic benefits to the non-owner of the contract, and those economic benefits must be accounted for fully and consistently by both the owner and the non-owner. The value of the economic benefits, reduced by any consideration paid by the non-owner to the owner, is treated as provided from the owner to the non-owner.

The tax consequences of the provision of economic benefits will depend on the relationship between the owner and the non-owner. Thus, the provision of the benefit may constitute a payment of compensation, a distribution under section 301, a capital contribution, a gift, or a transfer having a different tax character. The benefit must be taken into account based on its character. For example, in a split-dollar life insurance arrangement in which an employer provides an employee with economic benefits, the employee would take those economic benefits into account by reporting them as compensation on the employee's Federal income tax return for the year in which the benefits are provided and the employer would take the economic benefits into account by reporting them on the appropriate employment tax and information returns. In a split-dollar life insurance arrangement in which a donor provides economic benefits to an irrevocable life insurance trust, the donor would take those economic benefits into account by reporting them on the Federal gift tax return required to be filed by the donor; the trust, however, generally would not be required to take any action to take the benefits into account because those

economic benefits would be excludable from gross income under section 102.

Non-Equity Split-Dollar Life Insurance Arrangements

Under the final regulations, the tax treatment of a non-equity split-dollar arrangement generally follows the tax treatment of a non-equity split-dollar arrangement under Rev. Rul. 64-328 (1964-2 C.B. 11) and its progeny. The proposed regulations required that the average death benefit for the taxable year be used to compute current life insurance protection. Commentators objected to the use of an "average" death benefit. They explained that the computation of the average death benefit imposed additional administrative burdens on life insurance companies as well as both owners and non-owners. In addition, the commentators stated that the proposed regulations were not clear on how the average death benefit for the taxable year was to be determined. As an alternative, the commentators suggested that the death benefit as of the policy anniversary date would be an appropriate measure of the death benefit for purposes of determining current life insurance protection. In response to these commentators, the final regulations provide that, subject to an anti-abuse rule, current life insurance protection is determined on the last day of the non-owner's taxable year unless the parties agree to use the policy anniversary date. Taxpayers may change the valuation date with the consent of the Commissioner.

Equity Split-Dollar Life Insurance Arrangements

The final regulations generally retain the rules set out in the 2002 and 2003 proposed regulations for the taxation of equity split-dollar life insurance arrangements. Therefore, the value of the economic benefits provided by the owner to the non-owner for a taxable year equals the cost of any current life insurance protection provided to the non-owner, the amount of policy cash value to which the non-owner has current access (to the extent that such amount was not actually taken into account for a prior taxable year), and the value of any other economic benefits provided to the non-owner (to the extent not actually taken into account for a prior taxable year). The owner and the non-owner also must account fully and consistently for any right in, or benefit of, a life insurance contract provided to the non-owner under an equity split-dollar life insurance arrangement.

The final regulations provide that the non-owner has current access to any

portion of the policy cash value to which the non-owner has a current or future right and that currently is directly or indirectly accessible by the non-owner, inaccessible to the owner, or inaccessible to the owner's general creditors. As indicated in the preamble of the 2003 proposed regulations, the IRS and Treasury intend that the concept of "access" be construed broadly to include any direct or indirect right under the arrangement allowing the non-owner to obtain, use, or realize potential economic value from the policy cash value. Thus, for example, a non-owner has access to policy cash value if the non-owner can directly or indirectly make a withdrawal from the policy, borrow from the policy, or effect a total or partial surrender of the policy. Similarly, for example, the non-owner has access if the non-owner can anticipate, assign (either at law or in equity), alienate, pledge, or encumber the policy cash value or if the policy cash value is available to the non-owner's creditors by attachment, garnishment, levy, execution, or other legal or equitable process. Policy cash value is inaccessible to the owner if the owner does not have the full rights to policy cash value normally held by an owner of a life insurance contract. Policy cash value is inaccessible to the owner's general creditors if, under the terms of the split-dollar life insurance arrangement or by operation of law or any contractual undertaking, the creditors cannot, for any reason, effectively reach the policy cash value in the event of the owner's insolvency.

Commentators on the 2003 proposed regulations generally objected to the rule requiring the non-owner under an equity arrangement to include in income the portion of the policy cash value to which the non-owner has current access. Several commentators argued that section 72(e) specifically provides for tax-free inside build-up under a life insurance contract, precluding any taxation of policy cash value to the non-owner prior to a "realization event" (such as rollout of the policy). That argument ignores the plain language of section 72(e)(1), which states that the rules of section 72(e) apply only if no other provision of subtitle A of the Internal Revenue Code (Code) applies. In the case of an equity arrangement subject to the economic benefit regime, the relationship between the owner and the non-owner and the terms of the arrangement between them ordinarily make other provisions of subtitle A applicable, such as section 61(a)(1).

The tax-deferred inside build-up provided by section 72(e) properly