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Subject: **New Split-Dollar Notice Revokes Notice 2001-10; Safe Harbors Are Provided for Existing Arrangements**

Major References: ***Notice 2002-8, 2002-4 I.R.B. __ (January 28, 2002)***

Prior AALU Washington Reports: *96-9; 01-3; 01-9; 01-53; 01-88; 01-112*

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On January 3, 2002, the Treasury and the Internal Revenue Service released the text of Notice 2002-8, announcing the intent of those agencies to publish proposed regulations providing comprehensive guidance regarding the Federal tax treatment of split-dollar life insurance arrangements. Essentially, these regulations, which will be effective for arrangements entered into after the date of publication of final regulations, will require the taxpayer to treat such arrangements either as transfers, under sections 61 and 83 of the Revenue Code, of economic benefit to the benefited party or as a series of loans from the employer (or other arrangement sponsor) to the benefited party, subject to the imputed interest rules of section 7872 (or, where applicable, the original issue discount rules of sections 1271-1275).

The Notice also revises the standards for valuing current life insurance protection. Significantly, for arrangements entered into before January 28, 2002,

taxpayers may continue (seemingly indefinitely) to use the insurer's lower published premium term rates to measure the cost of such protection.

Most importantly from AALU's standpoint, the Notice affords a great deal of what may effectively be viewed as "grandfathering" protection for existing arrangements in the form of safe harbor transition rules and also states that "no inference" should be drawn from the Notice regarding the appropriate tax treatment of those arrangements under existing law.

Within less than 24 hours after the 2:00 p.m., January 3 release of Notice 2002-8 by the government, AALU arranged for and conducted an 11:00 a.m., January 4 membership-wide teleconference which summarized the new Notice's pronouncements as here reviewed.

From the time the Treasury Department and IRS issued Notice 2001-10 almost a year ago (*see* our Bulletins Nos. 01-3, 01-9, 01-53, 01-88 and 01-112), we have reported on AALU's efforts to persuade them to revoke that Notice and/or to provide significant transactional grandfathering protection for existing split-dollar life insurance arrangements. Notice 2002-8, which revokes Notice 2001-10, and repudiates the approach advanced in 1996 in Technical Advice Memorandum 9604001 (*see* our Bulletin No. 96-9), goes a long way toward accomplishing both of these goals, while potentially (depending on the approach ultimately adopted in final regulations) radically altering the split-dollar landscape for the foreseeable future.

BACKGROUND

Notice 2001-10 provided "interim guidance" designed principally to address issues perceived by the Revenue Service to be raised by so-called "equity split-dollar" arrangements, in which an employer's interest in the cash surrender value of the life insurance contract is limited to the aggregate amount of its premium payments, "exclusive of any earnings component." In the Service's view as expressed in Notice 2001-10, the "equity" aspects of equity split-dollar arrangements are not covered by the "economic benefit" analysis set forth in Rev. Rul. 64-328 which has governed the taxation of split-dollar arrangements for more than 35 years.

Under Rev. Rul. 64-328 (and Rev. Rul. 66-110) split-dollar arrangements are viewed as a form of contractual agreement between an employer and employee to "join in the purchase of a life insurance contract" in which the premiums and the policy benefits are allocated between the employer and employee. The employee receives current life insurance protection and is taxed on the economic value of that protection (as measured either by the "P.S. 58" Table contained in Rev. Rul. 55-747 or the insurer's published premium rates for one-year term insurance) to the extent that it exceeds the employee's share (if any) of the premium payments.

Although Rev. Rul. 64-328 describes two contractual forms - *i.e.,* the endorsement method (under which the employer is formally designated as the owner of the contract), and the collateral assignment method (under which the employee is formally designated as the owner of the contract) - the taxation of the arrangement is the same under either form.

Prior to the publication of Rev. Rul. 64-328, the Revenue Service had characterized split-dollar arrangements as interest-free loans.

INTERIM GUIDANCE

Notice 2001-10, having sought to discard, as inapplicable to equity split-dollar, the traditional theories of Rev. Ruls. 64-328 and 66-110, offered the taxpayer a choice, "pending consideration of public comments and the publication of further guidance," of treating the equity split-dollar arrangement either as a loan, taxable under section 7872, or as a transfer of property (cash value build-up) under section 83 (the general approach adopted in TAM 9604001).

If the parties chose to treat the arrangement (consistently from the date of inception) as a "below market" loan under section 7872, the employee/borrower would have income in an amount equal to the difference between the stated interest rate (if any) and a statutory interest rate (the "applicable federal rate," or "AFR"), and would be deemed to make a corresponding payment of imputed interest to the employer/lender in the same amount. In the case of a compensation-related below-market loan, the imputed payments to the borrower are treated as compensation income.

If the employer's premium payments had not consistently been treated as loans, the parties would be required otherwise to account, under sections 61 and 83 of the Revenue Code, for all of the "economic benefits" of the arrangement. For equity split-dollar plans, this would have meant that the employee would have had compensation income under section 83(a) to the extent that the employee acquired 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. ***However***, the Notice stated that, "pending the publication of further guidance," the employer will not be treated as having made a transfer of the cash surrender value of the policy simply because the cash surrender value exceeds the premiums advanced by the employer. The Notice also promised that "[i]f future guidance provides that such earnings increments are to be treated as transfers of property for purposes of section 83, it will apply prospectively."

NOTICE 2002-8

In addition to its revocation of Notice 2001-10 (and, by inference, TAM 9604001), Notice 2002-8 does the following:

- Restates the modification of Rev. Ruls. 64-328 and 66-110 "to the extent that those rulings indicate that an employer's premium payments under a split-dollar life insurance arrangement may not be treated as loans."

- Announces an intention to publish proposed regulations providing comprehensive guidance regarding the Federal tax treatment of split-dollar life insurance arrangements;

- Outlines rules expected to be included in the forthcoming proposed regulations;

- Provides guidance regarding the valuation of current life insurance protection; and

- Provides effective date and safe harbor rules with respect to existing arrangements.

1. ***Approach of Expected Proposed Regulations***.

In a manner similar to the interim approach of Notice 2001-10, the proposed regulations are expected to tax the parties to a split-dollar life insurance arrangement under one of two "mutually exclusive" regimes. The first of these would tax the arrangement, under sections 61 and 83 of the Code, as a transfer by the employer or other transferor to the benefited party. The second would treat payments by the "sponsor" (i.e., the party providing life insurance benefits to the other party under the arrangement) as a series of loans to the benefited party. If, however, the employee has no obligation to repay the premiums paid by the employer, all such amounts would be treated as compensation income to the employee at the time the premiums are paid by the employer.

There are, however, significant differences from the approach of Notice 2001-10. Most importantly, the proposed regulations are expected to provide that the taxation of the arrangement will depend on whether the employer or the employee is "formally designated" as the owner of the life insurance contract. Thus, if the endorsement method is used, the benefits provided to the employee will be taxed under sections 61 and 83. If the collateral assignment method is used, the arrangement will be characterized as a loan, subject to the rules primarily of section 7872. We note that this approach is at least clearer than the one adopted in Notice 2001-10.

Where the endorsement method is used, the employer will be treated for Federal tax purposes as the owner of the life insurance contract prior to termination of the arrangement. The value of current life insurance protection and other economic benefits provided to the employee, will be taxable under section 61 of the Internal Revenue Code. A transfer (*i.e.,* "rollout") of the life insurance contract to the employee will be taxed under section 83. The Notice makes clear that there will be no current taxation 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 cash surrender value of the contract cause the cash surrender value to exceed the portion thereof payable to the employer." In effect, TAM 9604001 will not be followed.

If the collateral assignment method is used (*i.e.,* if the employee is formally designated as the owner of the contract and is obligated to repay the employer, whether out of contract proceeds or otherwise), the premiums paid by the employer are expected to be treated as a series of loans by the employer to the employee. Under this regime, such loans will be subject to the principles, where applicable, of sections 1271-1275 (regarding the taxation of original issue discount, or "OID") and section 7872 (as outlined above).

Note that, since taxation under the first regime requires ownership of at least a portion of the insurance contract by the employer (*via* the endorsement), that regime likely could not be used by a controlling shareholder to keep the proceeds of the policy - *via* an insurance trust - out of his or her estate, because such ownership would be imputed to the insured shareholder. A controlling shareholder with a split-dollar arrangement, who, in the past, would have used the "restricted collateral assignment" method to keep the proceeds of the policy out of his or her estate, would be forced under the new rules to elect to treat the arrangement as a loan.

The Notice states that the same principles outlined above will apply in "other contexts, "including arrangements that provide benefits in gift and corporation-shareholder contexts." Apart from this oblique reference, nothing is said directly about the potential tax treatment of nontraditional (or non-employment related) split-dollar arrangements, including private split dollar or reverse split dollar.

2. ***Effective Date of Proposed Regulations***.

Notice 2002-8 states that the proposed regulations concerning the Federal tax treatment of split-dollar life insurance arrangements will be effective for ***arrangements entered into*** after the date of publication of final regulations. Thus, the new rules will not apply to transactions now in place. These transactions will instead be subject to a series of transition rules and "safe harbor" provisions, as discussed below.

3. ***More Interim Guidance on the Value of Life Insurance Protection***.

Notice 2002-8 makes several important changes to the rules announced in Notice 2001-10 with respect to the proper method(s) for valuing the cost of life insurance protection under existing split-dollar plans.

First, Rev. Rul. 55-747, 1955-2 C.B. 228 (the P.S. 58 rates), remains revoked. However, ***"for a split-dollar life insurance arrangement entered into before January 28, 2002***, in which a contractual arrangement ***between an employer and employee*** provides that the P.S. 58 rates will be used to determine the value of current life insurance protection ***provided to the employee*** (or to the employee and one or more additional persons), the employer and employee may continue to use the P.S. 58 rates set forth in Rev. Rul. 55-747 to determine the value of current life insurance protection." (Emphasis supplied.) Whether this means that the P.S. 58 rates may continued be used in a non-employment context, or in so-called "reverse" split-dollar is not stated.

Second, for arrangements entered into before the effective date of future guidance, taxpayers may use Table 2001 rates first published in Notice 2001-10 to determine the value of current life insurance protection on a single life that is provided under a split-dollar life insurance arrangement, in a qualified retirement plan, or under employee annuity contracts. The Notice allows taxpayers to make "appropriate adjustments" to these premium rates if the life insurance protection covers more than one life.

Finally and most importantly - for arrangements entered into before the effective date of future guidance - taxpayers may continue to determine the value of current life insurance protection by using the insurer's lower published premium rates that are available to all standard risks for initial issue one-year term insurance. However, the Notice states that "for arrangements entered into after January 28, 2002, and before the effective date of future guidance, for periods after December 31, 2003, the Service will not consider an insurer's published premium rates to be available to all standard risks who apply for term insurance unless (i) the insurer generally makes the availability of such rates known to persons who apply for term insurance coverage from the insurer, and (ii) the insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels." The fact that these standards are not applicable to pre-January 28, 2002, arrangements does not on its face signify a Revenue Service retreat from its practice in some situations of challenging whether this issuer's published premium rates are available to all standard risks (*e.g.*, are non-smoker rates available to all standard risks?)

EXISTING ARRANGEMENTS/SAFE HARBOR RULES

Notice 2002-8 essentially states five "safe harbor" rules that apply to existing arrangements, as follows:

Safe Harbor 1 Continuing Economic Benefit. (Part IV, Par. 2) For split-dollar life insurance arrangements entered into before the date of publication of final regulations, The Revenue Service will not treat the arrangement as having been terminated (and thus will not impute a transfer of the contract from the sponsor to the benefited party) so long as the benefited party continues to report the receipt of the "economic benefit" - which, pursuant to the discussion above, may be computed, for existing arrangements, using the insurer's published one-year term premium rates - under the contract. The Notice further states that "[t]his treatment will be accepted without regard to the level of the remaining economic interest that the sponsor has in the life insurance contract." Although this statement may be read to indicate that this treatment may continue even after all amounts have been repaid to the employer or other sponsor, it may be wiser, for those wishing to rely on this provision, to keep some *de minimus* amount of "remaining" economic interest in the sponsor.

Safe Harbor 2 Report All Premium Payments As Loans. (Part IV, Par. 3) 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, beginning at the time of inception of the arrangement. The Notice states that the Service will not challenge, with respect to taxpayers choosing this option, "reasonable efforts" to comply with the requirements of sections 1271-1275 (OID rules) and section 7872, as to which there are many outstanding questions that presumably will be addressed in the proposed regulations In order to elect this alternative, "all payments by the sponsor from the inception of the arrangement (reduced by any repayments to the sponsor) before the first taxable year in which such payments are treated as loans for Federal tax purposes must be treated as loans entered into at the beginning of that first year in which such payments are treated as loans."

Safe Harbor 3 Termination Before January 1, 2004. (Part IV, Par. 4) For split-dollar life insurance arrangements entered into ***before January 28, 2002***, under which a sponsor has made premium or other payments under the arrangement and has received or is entitled to receive full repayment of all of its payments, the Service will not assert that there has been a taxable transfer of property to a benefited person upon termination (*i.e.*, "rollout") of the arrangement if the arrangement is terminated before January 1, 2004. This is a most important safe harbor, which seems to allow virtually all split-dollar participants to unwind transactions before January 1, 2004 without recognition of income under section 83

Safe Harbor 4 Treatment as Loan After January 1, 2004. (Part IV, Par. 4) The Revenue Service will not assert that there has been a taxable transfer of property to a benefited person upon termination of the arrangement if, for all periods beginning on or after January 1, 2004, all payments by the sponsor from inception of the arrangement (reduced by any repayments to the sponsor) are treated as loans for Federal tax purposes. The parties to the arrangement must report the tax treatment in a manner consistent with this loan treatment, including the OID provisions and section 7872 (the regulations for which we assume the Service is intending to finalize by January 1, 2004); any such payments by the sponsor before the first taxable year (which will, in most cases, begin on January 1, 2004) in which such payments are treated as loans for Federal tax purposes must be treated as loans entered into at the beginning of that first year in which such payments are treated as loans.

Safe Harbor 5 "No Inference" Rule/Reliance on Existing Notices. (Part VI) The Notice states that, with the exception of the new rules for valuing life insurance protection, "no inference" should be drawn from Notice 2002-8 "regarding the appropriate Federal income, employment and gift tax treatment of split-dollar life insurance arrangements entered into before the date of publication of final regulations." Presumably, this leaves both the taxpayer (who does not elect one of the other safe harbors described above) and the Revenue Service free to assert that the taxation of existing split-dollar life insurance arrangements either is, or is not, covered by Rev. Rul. 64-328. Taxpayers, however, also are given the option of relying on Notices 2002-8 and 2001-10 (or reasonable interpretations thereof) for reporting the tax treatment of split-dollar life insurance arrangements entered into before the date of publication of final regulations.

CONCLUSION

Written comments on Notice 2002-8 may be submitted to the Internal Revenue Service no later than April 28, 2002, *i.e.*, 3 months after January 28, 2002, the date that the Notice will be published in the Internal Revenue Bulletin. An additional comment period will be provided when proposed regulations are published. The Service has indicated that it is particularly interested in comments on the appropriate rate structure for valuing the economic benefit of the cost of life insurance protection, including: (i) "whether one or more premium rate tables should be prescribed as the exclusive basis for valuing current life insurance protection for Federal tax purposes", and (ii) [if so],. . . "how such tables should be determined and whether premium rates charged by life insurance companies can be used for this determination."

AALU expects to formulate its response to this request for comments over the coming months, particularly as it applies to the appropriate rate tables to be used in valuing term insurance protection. In addition, as the Revenue Service moves toward proposed, and eventually final, regulations, numerous issues not addressed in Notice 2002-8, principally relating to the application of section 7872 and, where applicable, the OID rules, may require AALU's input. These include (among other possible issues): (i) the characterization of the split dollar arrangement as a demand loan or term loan under various fact patterns, (ii) the determination of whether a loan occurs with each premium payment, or whether premium payments may be aggregated, (iii) the application of the numerous exceptions to the OID rules under various fact patterns, (iv) the interaction of the OID rules, section 7872 and section 264, (v) rules to deal with a situation in which the employer's recovery increases over time, (vi) the application of employee payments (if any) to interest and principal over time, and (vii) the imposition of complex record keeping and reporting requirements on insurers and employers. Other, more general, questions remain concerning the treatment of private and reverse split-dollar arrangements, the recovery, and definition, of basis in contracts at rollout, and the availability of a deduction for the employer under section 83.

We will, of course, continue to publish updates on the meaning of Notice 2002-8, and AALU's response as these issues are addressed. In addition, AALU may convene one or more teleseminars as seems appropriate to best respond to members' inquiries. ***In this regard, we invite our members to telephone, e-mail, fax, or write to AALU's offices, attention Tom Korb, with any questions they have on***

this subject. AALU will do its best to answer those questions on an individual basis if feasible; if not, in a more general format such as the Washington Reports or one or more teleseminars.

Before concluding this Washington Report, we should speak, if only briefly, to the process which governed our exchange of information and arguments with the Treasury and the Revenue Service over the past year. While by no means were all the positions we put forth adopted by those government agencies, there was no time during the process when we were treated with anything less than professional competence and courtesy. To illustrate, AALU is not pleased with the current statement of the "going-forward" rule that is likely to be in place after publication of the final regulations; however, we do not question that the position of the government with respect to this issue was honestly arrived at and was not an unreasoned arbitrary judgment of the regulators. In contrast, when the government officials agreed with the force of our arguments, as in the case of the grandfathering/effective date/transition rules, they had no problem in acceding to those arguments and in publishing rules which reflect our input to a major extent.

For example, it would have been in our interest for the government to grandfather fully the industry's interpretation of Rev. Rul. 64-328 for all time periods prior to the final regulations; however, it was always our judgment that this was an unlikely expectation. We, however, did feel that, given the confidence the industry has in the correctness of its interpretation of the application of Rev. Rul. 64-328 to equity split dollar, it could effectively live with the pre-regulations "no inference" rule which was articulated in the new Notice. That rule, coupled with an effective set of safe harbors, will provide most segments of the industry with a relatively comfortable, if not totally painless way of transitioning from the pre-Notice 2001-10 world to the Notice 2002-8 structure. The government has clearly given us a means (hopefully, upon mature reflection, a practicable and usable means) of adapting to the new reality in this subject.

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