**MEMO FROM LAWRENCE BRODY and LUCINDA A. ALTHAUSER**

TO: Our Advanced Underwriting Clients

DATE: January 16, 2002

RE: Notice 2002-8

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As a follow-up to our initial memorandum, we prepared this memorandum to describe the implications of and options for split-dollar arrangements entered into at the various times referred to in the Notice. Please refer to our initial memorandum for a more detailed analysis of these issues.

***When are "Arrangements Entered Into"?***

* Throughout the Notice, certain provisions are applicable to "arrangements entered into" prior to a particular date or event. That raises issues as to what is required to enter into an arrangement and whether any change to the arrangement (or even the policy) could effect the ability to hold the date of the arrangement.

* A substantial modification (whatever that might be) of an arrangement entered into before a relevant date would presumably eliminate the status of the arrangement as "pre-relevant date" (assuming the modification was made after the relevant date), although the Notice is silent on this point.

* It is unclear whether an exchange or modification of a policy after the relevant date would affect the status of the arrangement to which the policy was subject as a pre-relevant date arrangement, since it appears to be "arrangements" not policies on which the dates are keyed. However, a substantial increase in face amount could well be viewed as a substantial modification of the arrangement.

* It seems that an arrangement alone, without a policy issued or at least applied for, would not sufficiently bind the parties to create a pre-relevant date arrangement. On the other hand, if it is not possible to have the policy issued or applied for by the relevant date, there seems to be no downside to creating the arrangement before the relevant date so that the parties might at least have an argument for the pre-relevant date status of the arrangement (although if they would not enter into the arrangement without pre-relevant date protection, they should be advised of this risk of such an arrangement).

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*Pre-January 28, 2002 Arrangements*

***	Available Measures of the Current Life Insurance Protection under a Split-Dollar Arrangement**

- The historic P.S. 58 rates, so long as the arrangement provides that those rates "will be used" by the parties to measure the value of the current life insurance protection to the employee (or to the employee and another person). The language relating to the use of the P.S. 58 rates to measure protection provided to the employee seems to indicate that the P.S. 58 rates cannot be used in reverse split-dollar arrangements; one of the drafters of the Notice has confirmed this interpretation.

- The Table 2001-10 rates.

- The insurer's alternate published term rates available to all standard risks for initial issue one-year term insurance, without regard to the stricter requirements, discussed below, for a post-January 28, 2002 arrangement. However, some have questioned whether insurer's will (or, in some states, will be able to) maintain two sets of published term rates; accordingly, it is unclear the extent to which this will prove an advantage over time.

- These measures of the benefit are available until the arrangement terminates.

***	Income Tax Treatment**

- The provisions of the expected proposed regulations, pursuant to which the method of taxing a split-dollar arrangement is dictated exclusively by the formal policy ownership, will not apply, although parties would likely be permitted to follow these provisions if they wished to do so.

- "Traditional" Treatment

Parties will be able to elect to treat (or continue to treat) a split-dollar agreement as one in which the "sponsor" is providing an annual economic benefit to the "benefited person" of an amount equal to the current value of the life insurance protection provided to the benefited person under the arrangement, regardless of the way the arrangement is documented.

There will be no deemed termination of the arrangement and, therefore, no deemed transfer, of any interest in the policy subject to the arrangement so long as the benefited party continues to report the current value of the life insurance protection as an economic benefit and the sponsor retains some economic interest (no matter how small) in the policy—there is no "roll-out."

Unless the parties take advantage of the safe harbor, described below, if the sponsor ceases to have an economic interest in the policy prior to the insured's death (e.g., the arrangement is "rolled-out"), there will be a deemed transfer. The Service would presumably take the position that a deemed transfer occurring upon cessation of the sponsor's economic interest in the policy would be a taxable transfer of policy equity, if the arrangement is an equity split-dollar arrangement, subject to the rules governing transfers between parties related in the way the particular sponsor and benefited person are related.

However, as discussed in our earlier memorandum, "no inference" is to be drawn from this Notice, Notice 2001-10, or any then proposed or final regulations with respect to the income or transfer tax treatment of an arrangement entered into before the date of publication of final regulations. Accordingly, the Service would have to base its argument in favor of equity taxation on the state of the law in existence prior to Notice 2001-10.

If the arrangement is a non-equity arrangement, then its termination prior to the insured's death should involve no deemed transfer (unless and to the extent the sponsor forgives its right to be paid the amounts due it under the arrangement).

- Loan Treatment

Parties may elect to treat (or continue to treat) a split-dollar arrangement as involving a series of loans from the sponsor to the benefited person, again, regardless of the form of documentation.

If there is no or inadequate interest charged on the loan, it would be subject to Section 7872 of the Code.[1]

Most employment-related loans, because they would terminate upon cessation of employment, would be demand loans which, under Section 7872, involve annual deemed transfers (first as interest income to the employer, and then as compensation to the employee) of the foregone interest.

Parties who had historically used the traditional tax treatment for their split-dollar arrangement could convert to loan treatment by treating all payments made prior to the conversion date (less any amounts repaid prior to the conversion) as a loan entered into on the first day of the year in which loan treatment was elected.

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[1] The Service also states that Sections 1271-1275 could apply to a split-dollar/loan transaction, although it seems that in the vast majority of cases, Section 7872 would govern. Furthermore, it may be that the Service included the reference to Sections 1271-1275 simply because, with a term loan, the deemed payment to the employer is treated as original issue discount, and those sections set out in the rules for taxation of original issue discount.

- Safe Harbor—"Grandfathering"

The Notice states, "the Service will not assert that there has been a taxable transfer of property to a benefited person upon termination of" such a split-dollar arrangement, i.e., there will be complete protection from taxation of policy equity if (but only if):

- Prior to January 1, 2004, the arrangement is terminated; or

- All payments made on or after January 1, 2004 are treated as loans from the sponsor to the benefited person and, as of the first day of the year in which loan treatment is elected, all prior payments (not repaid prior to the conversion) are treated as a loans. Essentially, this involves converting the arrangement from traditional tax treatment to loan treatment, in the manner described above.

However, parties to such arrangements are not obligated to terminate or change the treatment of a pre-January 28, 2002 arrangement before January 1, 2004, but if they do not do so, and continue to elect traditional treatment of the split-dollar arrangement, then the rules described above would apply, with no guaranteed safe harbor for any portion of the policy equity. The parties would have the "protection" - whatever that may be - of the "no inference" (so-called "business as usual") language described above and in our prior memorandum.

***Post-January 28, 2002/Pre-"Future Guidance"/Pre-Final Regulations Arrangements***

The provisions of the Notice that discuss the measure of the current life insurance protection state that the interim guidance of the Notice will apply to arrangements entered into "before the effective date of future guidance." Accordingly, it appears that, unlike the tax treatment that will be governed by proposed and future regulations, the measure of the current life insurance protection will be governed by some other form of "future guidance" - perhaps another Notice or a Revenue Ruling, which might be adopted sooner than the publication of the expected regulations.

* **Available Measures of the Current Life Insurance Protection under a Split-Dollar Arrangement**

- The Table 2001-10 rates.

- Until December 31, 2003, the insurer's alternate published term rates available to all standard risks for initial issue one-year term insurance.

- After December 31, 2003, the insurer's alternate published term rates available to all standard risks for initial issue one-year term insurance, so long as: "(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

- Subject to the change with respect to the insurer's alternate rates imposed December 31, 2003, these measures are available until the arrangement terminates.

* **Income Tax Treatment**

- The income tax treatment of a Post-January 28, 2002/Pre-"Future Guidance" Arrangement would be identical to that of a Pre-January 28, 2002 Arrangement, <u>with the exception that the safe harbor described above would not be available</u> (but the "no inference" protection would be).

***Post-January 28, 2002/Post-"Future Guidance"/Pre-Final Regulations Arrangements***

* **Available Measures of the Current Life Insurance Protection under a Split-Dollar Arrangement**

The appropriate measure of the current life insurance protection under a split-dollar arrangement is the only area on which the Service specifically requests comments. Accordingly, the Notice does not specifically indicate what will be available to measure current life insurance protection for these arrangements after "further guidance."

* **Income Tax Treatment**

Until final regulations are published, the income tax treatment of these arrangements would be as described above for post-January 28, 2002/Pre-"Future Guidance" Arrangements.

***Post-January 28, 2002/Post-"Future Guidance"/Post-Final Regulations Arrangements***

* **Available Measures of the Current Life Insurance Protection under a Split-Dollar Arrangement**

The appropriate measure of the current life insurance protection under a split-dollar arrangement is the only area on which the Service specifically requests comments. Accordingly, the Notice does not specifically indicate what will be available to measure current life insurance protection after "further guidance" for these arrangements.

* **Income Tax Treatment**

This analysis assumes that the final regulations will be consistent with the expected proposed regulations described in the Notice, which dictates the use of one of two mutually exclusive regimes.

- Sponsor-Owned (Endorsement Method) Arrangements

The sponsor will be treated as providing an annual economic benefit to the benefited person of an amount equal to the current value of the life insurance protection provided to the benefited person under the arrangement.

A transfer of the policy from the sponsor will be a taxable event and will be subject to the rules governing transfers between parties related in the way the particular sponsor and benefited person are related. For example, if the sponsor and benefited person are employer and employee, the employer will be treated as having made a transfer of the policy to the employee, subject to Section 83 of the Code. It is unclear the extent to which the employee will be deemed to have basis in the policy as a result of amounts previously included in the employee's income.

There will be no deemed transfers of policy equity "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." This may be less generous than the interim guidance, which will not deem a transfer so long as the parties continue to report economic benefit and the sponsor has an economic interest in the policy. Specifically, it seems that under those provisions, the benefited person could access cash values over time, and while the amounts accessed would be deemed transfers, there would not be a deemed transfer of the entire policy. It is not clear whether the result would be the same under the final regulations (assuming they are consistent with the expected proposed regulations).

- Benefited Party-Owned (Collateral Assignment Method) Arrangements

If the benefited party owns the policy, payments made by the sponsor will be treated as a series of loans from the sponsor to the benefited person, so long as the benefited person is required to repay those amounts. If there is no obligation to repay, the sponsor's payments will be treated as transfers to the benefited party in the amount of the payments as they are made and subject to the rules governing transfers between parties related in the way the particular sponsor and benefited person are related.

If there is no or inadequate interest charged on the loan, it would be subject to Section 7872 of the Code, under the rules discussed above with respect to Pre-January 28, 2002 Arrangements.

It is unclear how the loan treatment would practically apply in what would be traditionally called a non-equity split-dollar arrangement. Presumably, there would have to be some determination as to whether the anticipated return on the policy, in the form of increased cash surrender value, constituted adequate interest.

- In general, for these arrangements, the parties' choice of owner will dictate the choice of tax treatment of the split-dollar arrangement. To convert from one form of tax treatment to another, the policy owner would have to be changed; of course, to convert an arrangement from the endorsement method to the collateral assignment method would involve a transfer of the policy and, therefore, would cause any equity to be taxed. Normally, this should not present a problem, unless the new owner of the policy would not be a "permitted transferee" under the transfer for value rules of Section 101.