MEMORANDUM

TO: Advanced Underwriting Advice Clients

FROM: Lawrence Brody, Esq.
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DATE: August 21, 2002

RE: Treasury Notice 2002-59—The Treasury Crack Down on "Inappropriate" Split-Dollar Arrangements

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As I'm sure you know by now, on Friday, August 16, 2002, the Treasury and IRS issued Notice 2002-59, a copy of which is attached, to, in their words, "stop the spread of an abusive tax avoidance transaction using split-dollar life insurance." As the Treasury announcement which accompanied the Notice indicates, the Notice deals with those split-dollar arrangements where the parties attempt to avoid taxes by using "inappropriate high" current term rates, prepayment of premiums, or other techniques to "understate the value of taxable policy benefits," including what are usually known as so-called "reverse" split-dollar arrangements.

The Notice begins by providing the IRS view on the background of valuing current life insurance protection under split-dollar arrangements. The background discussion in this Notice reviews Rev. Ruls. 64-328, 66-110, and 67-154, as well as the provisions of Notice 2001-10, Notice 2002-8, and the proposed Regulations. In discussing Notice 2001-10, this Notice indicates that the 2001 Notice expressed concern relating to the use of the PS 58 rates by some taxpayers to understate the economic benefits provided under some split-dollar arrangements, a practice which the 2001 Notice said had never been authorized by any published guidance.[1/] The background discussion of this Notice also reviews the provisions of Notice

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1/ Although the 2001 Notice didn't say so, most commentators assumed that concern was directed at reverse split-dollar arrangements.

2002-8 on the measure of the economic benefit, and indicates that despite the fact that the PS 58 rates were essentially revoked by Notice 2002-8, there was a "narrow" exception made for their continued use, where they were required by a given arrangement to be used to measure the value of the benefit provided to the employee. Finally, the background discussion of this Notice indicates that although the proposed Regulations provide no guidance on the valuation of current insurance protection, a footnote to the preamble further limited that narrow exception for the continued use of PS 58 rates, by indicating that taxpayers could not use the PS rates for "reverse" split-dollar arrangements nor for split-dollar arrangements outside the compensatory context.

Notice 2002-59 indicates that the Treasury now knows that (at least in part based on the New York Times front page article) that under certain split-dollar arrangements "some of which are referred to "reverse" split-dollar," one of the parties which has the right to current life insurance protection (because that party purchased it from the other party) uses "inappropriately high" current term rates, premium prepayment arrangements, or other techniques to confer benefits other than current life insurance protection on the other party to the transaction. The Notice indicates that the use of those techniques to understate the value of those other policy benefits distorts the income, employment or gift tax consequences of the arrangements and "does not conform to, and is not permitted by, any published guidance." The Notice concludes that parties to a split-dollar arrangement can use the premium rate table or the insurer's lower premium rates only for the purpose of valuing current life insurance protection when and to the extent that protection is conferred as an economic benefit by one party on another, determine without regard to consideration or premiums paid by that other party. Accordingly, the Notice concludes that if one party has a right to current life insurance protection, "neither the premium rates in Table 2001 nor the insurer's lower published premium rates may be relied upon to value

such party's current life insurance protection…", without citing any authority for that proposition.[2/]

The Notice gives an example of a donor paying the premiums on a policy subject to a split-dollar arrangement between the donor and a trust under which the trust has the right to the current life insurance protection.[3/] In that example, the Notice indicates that the current life insurance protection has been confirmed as an economic benefit by the donor on the trust and therefore, the donor can value that life insurance protection either under the Table 2001 rate or the insurer's lower alternative term rates. However, in the next example, where a donor pays the premiums on a policy under a split-dollar arrangement between the donor and the trust, the Notice states that if "…the donor (or the donor's estate) has the right to current life insurance protection under the policy,[4/] neither the premium rates in Table 2001 nor the insurer's lower published premium rates may be relied upon to value the donor's current life insurance protection for the purpose of establishing the value of the policy benefits conferred upon the trust for federal tax purposes."

The Notice also indicates that similar results obtain, in either scenario, if the trust pays for a share of the policy benefits provided under the split-dollar arrangement—that is, in a private split-dollar arrangement, the trust's contribution offsets the otherwise reportable gift by the donor, and in the private reverse split-dollar situation, the trust's contribution offsets

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2/ As has been pointed out, there is a difference between not providing official guidance on an issue and officially prohibiting a solution to that issue—which until now has not happened (and arguably at least, still hasn't happened, given that this is only a Notice).

3/ What we would call "traditional" split-dollar.

4/ What we would call "reverse" split-dollar.

whatever benefits the donor is deemed to have conferred upon the trust; in neither case does such a contribution change the analysis of those examples.

Again, this Notice was clearly "inspired" by the *New York Times* article describing the Blattmachr/Spectrum private, endorsement (in the promoters' words), reverse (in other commentators' words) split-dollar arrangement, and was intended to address that transaction. However, the Notice clearly applies to any type of "reverse" split-dollar arrangement, whether donor/donee, corporate/shareholder or employer/employee. It reiterates the Treasury's view of current law, that there never has been any guidance on how to measure the "value" of life insurance protection "purchased" under a reverse split-dollar arrangement, but that neither the Table rates nor the alternative term rates can be used to do so. Accordingly, the Notice will likely be applied retroactively, rather than prospectively, both to private reverse split-dollar transactions and to other reverse split-dollar transactions.

Interestingly, the Notice does not attempt to provide guidance on how to measure the value of life insurance purchased under a reverse split-dollar arrangement; it merely restates the law that there is no guidance that authorizes the use of either the PS 58 rates (for years before 2002), the Table 2001, any future uniform term factors provided by the Service, nor the insurer's alternative term rates to measure that benefit. In effect, Treasury has indicated that each case will be determined on its "facts and circumstances," to determine if the donor, corporation, or employer "overpaid" for the insurance protection it purchased.[5/] The Notice's reference to premium prepayments clearly indicates that the Service views that premium prepayment

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5/ In an informal discussion with one of the drafters of the Notice, he indicated the mortality expense charged in the policy might be an appropriate measure of the cost of the death benefit purchased in a given case.

accounts, often used when reverse split-dollar transactions are designed to "levelize" the table rates over the term of the arrangement, also overstate the amount paid by the purchaser of the insurance, but again without providing guidance on how to value the effect of such a levelizing arrangement.

Finally, the Notice makes clear that the transactions the Notice applies to are those transactions where the party having the right to the life insurance protection uses a technique to confer policy benefits other than current life insurance protection on the other party, and understate the value of those benefits to the other party. The Notice clearly contemplates application of its rules to what we know as reverse split-dollar arrangements—where one party to the arrangement buys (or, as has been suggested over the years, rents, leases or otherwise acquires) the death benefit for a period of time, almost always paying a table rate, well in excess of either the carrier's alternative term rate or the actual cost of the death benefit being acquired. The Notice makes clear that whether a transaction is called "reverse split-dollar" (or not) isn't relevant in determining whether the Notice applies—the Notice will apply any time one of the parties is buying life insurance protection of a policy owned by the other party; the use of labels won't avoid the application of the Notice's rules.

Some commentators have already indicated that they believe the Notice is directed at all split-dollar arrangements ("reverse" or otherwise), and that the IRS will somehow try to apply the rules of this Notice (or perhaps the rules of a future notice) to attack the use of unrealistically low (as opposed to high) alternative term rates.[6/] In fact, the follow-up article in the New York Times indicated that several tax experts interviewed for the article thought that

6/ Both Notices, as you will recall, "fix" the alternative term rate issue by imposing additional requirements for their use after 2003.

Treasury was going to go beyond the specific technique the Notice was aimed at and was "declaring that all tax avoidance techniques that rely on using two different insurance rates are invalid." I don't disagree with this comment, but given the background against which this Notice was published, I would hesitate to read too much into the possibility that it will apply outside of the reverse split-dollar area.