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URGENT MEMORANDUM

DATE: January 10, 2001
TO: My Insurance Colleagues
FROM: Jon J. Gallo
SUBJECT: Equity Split Dollar

On January 9, 2001, the IRS released the long rumored (and long feared) split dollar announcement in the form of Notice 2001-10/

The highlights of the announcement are the following:

1. P.S. 58 Rates.

Starting January 1, 2002, P.S. 58 rates may no longer be used. Instead, taxpayers must use the new Table 2001 rates, which are based on Table I of the IRC §79 regulations. The Notice describes the Table 2001 rates as "materially lower than the P.S. 58 rates at all ages."

2. Use of insurer's lower term rates.

Starting January 1, 2004, taxpayers may use the insurer's lower published term premium rates **only if** (i) the insurer generally makes the availability of those rates known to persons who apply for term insurance coverage, (ii) such insurance is regularly sold at such rates through normal distribution channels, and (iii) the insurer does not commonly sell term insurance at higher rates to persons classified as standard risks.

For life insurance policies issued after March 1, 2001, the Service warns that "no assurance is provided" that the insurer's lower published premium rates may be used, even if they meet the tests above, for periods after the later of (i) December 31, 2003 or (ii) December 31 of the year in which further guidance in this area is released by the IRS.

3. Equity split-dollar plans produce income for the employee. The Notice states that the employee's rights in the cash surrender value must be accounted for consistent with the substance of the parties' contractual positions. Those positions must either be that (i) the arrangement is a below-market loan from the employer to the employee, to which IRC Section 7872 applies, or (ii) the arrangement is one in which the employer has acquired a beneficial ownership interest in the life insurance contract through its premium payments and the employee is receiving economic benefits taxable under IRC Section 83. (Notice 2001-10 actually permits a third position. If the employer neither acquires a beneficial ownership interest in the policy nor

has a reasonable expectation or receiving repayment through policy proceeds or otherwise, the payments will be treated as compensation income to the employee under IRC §61. The discussion that follows assumes that the employer intends to recoup the premium payments in some manner and does not intend the split-dollar plan to be used as direct compensation to the employee.)

- a. If the parties consistently treat the equity split-dollar plan as a loan from the employer to the employee, the following tax consequences result:
 - i. The employee recognizes income equal to the interest payments that would have been paid to the employer on the loan. The amount of that interest is determined by reference to the applicable federal rate.
 - ii. The employee does not recognize income based on the value of the insurance protection provided under the plan.
 - iii. The cash surrender value of the policy is not treated as income under IRC Section 83.
 - iv. If the loan is not repaid in accordance with the terms of the arrangement, the employee recognizes income under IRC Section 61.
- b. If the parties do not consistently treat the equity split-dollar plan as a loan, the following tax consequences result:
 - i. The employer will be treated as acquiring an interest in the policy equal to its premium payments.
 - ii. The employee will have compensation income based on the insurance protection provided by the employer using the Table 2001 rate or lower term rate, if applicable, reduced by employee contributions.
 - iii. The employee will have IRC Section 83(a) income to the extent the employee acquires a substantially vested interest in the cash surrender value of the contract, reduced under IRC Section 83(a)(2) for any consideration paid by the employee.

4. Pending publication of further guidance, the IRS will not apply IRC Section 83 to increases in the cash surrender value of policies subject to an equity split-dollar agreement to the

extent that such increase is attributable to interest or other earnings being credited to the policy. This suggests that the Service's position is to limit IRC Section 83 income to premium dollars provided by the employer and to exclude earnings inside the policy from IRC Section 83 treatment. The Service advises that if it changes this position, the change will be prospective only.

What's the impact on split-dollar planning?

With the Notice only a day old, I haven't had that much time for deep reflection. However, the following points seem reasonably clear:

1. Reverse split-dollar based on using the P.S. 58 rates appears to be history. I have not yet had the opportunity to see if using the Table 2001 rates makes sense in a reverse split-dollar context. I'm guessing that they probably don't.

Equity split-dollar arrangements need to be rethought.

3. The Service states in the introduction that it intends the Notice to apply to split-dollar arrangements in other contexts, including gifts. Thus, private equity split-dollar may give rise to deemed gifts of forgiven interest at the applicable federal rate.

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