MEMORANDUM

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RE: Further Thoughts on the Application of I.R.S. Notice 2001-10 to Split-Dollar Arrangements

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This memorandum summarizes our analysis of the impact of the I.R.S. Notice on the tax treatment of equity and other split-dollar arrangements and the measure of the economic benefit in split-dollar arrangements to various types of both existing (as of the date of the Notice, so that they will be subject to the Notice's interim guidance and any grandfathering provided by the Notice) and new split-dollar arrangements.

<u>Our analysis assumes the final guidance ultimately adopted by the Service will be consistent with the interim guidance provided in the Notice</u>.

<u>Existing Split-Dollar Arrangements</u>

1. For existing employment related, <u>non-equity</u> split-dollar arrangements (however documented), there should be no change in the characterization of the arrangement, and existing, compliant alternative term rates should continue to be available to measure the benefit through 2003 (or the end of the year of further

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guidance if later) and thereafter if the Notice's additional requirements for those rates are met.

2. Existing private, non-equity split-dollar arrangements (however documented) should be treated similarly.

3. During the interim guidance period, unless there is a transfer event (such as rollout), existing equity in any equity arrangement won't be taxed (for income or for the equity that develops in the future in gift tax purposes).

4. There is no other grandfathering under the Notice for existing equity or existing arrangements (although the insurance industry will be arguing for both).

5. No existing split-dollar agreement (of any type) can be recharacterized by the parties as an interest-free loan (since it was not so treated from inception), unless the arrangement is terminated by repaying the employer and replacing the arrangement with an interest free or interest bearing loan arrangement.

6. The fact that a third party owns the policy should not change any of the income tax results indicated above, but any income generated by the arrangement to the employee in an employment related transaction (including any equity) will be a gift to the trust, as will any equity deemed transferred in a private split-dollar arrangement.

7. Existing reverse split-dollar arrangements (employment related or private) would appear vulnerable to the argument that there has been an ongoing overpayment by the purchaser of the death benefit, to the extent PS 58 rates were used to measure the insurance protection acquired, with resultant income or gift tax

consequences; they will be required to use the Table 2001 rates instead of PS 58 rates going forward (effective after 2001).

8. There appears to be no reason to terminate or modify existing equity arrangements, since it is possible (but probably not likely) that they may get transactional grandfathering, and any current rollout would be a transfer event under the interim guidance, taxing the equity.

New Split Dollar Arrangements

1. New non-equity split-dollar arrangements should be unaffected by the Notice, except for any change based on the economic benefit measure.

2. New split-dollar arrangements of any type can, based on the parties' intent, be treated either as interest-free loans subject to Section 7872 or as split-dollar arrangements, potentially subject to Section 83 (provided the three requirements of the Notice are met with respect to such characterization).

3. For new employment-related arrangements treated as interest-free loans, there will be no economic benefit taxation to the employee and there will be no equity taxed under Section 83; the measure of the employee's income will be determined under Section 7872.

Under Section 7872, if the rights of the employee are substantially vested and the other requirements for term loans are met, the applicable Federal rate will be determined by the length of term of the loan and fixed at the outset, and all of the income will be bunched in the initial year of the transaction (as original issue discount). If the interest of the employee is not substantially vested or the loan is callable on demand by the lender (or if the arrangement terminates with employment, as most employment arrangements presumably do), the loan will be a demand loan for purposes of Section 7872, requiring use of the current short term AFR (changing each year) to measure the income, and the income will be taxable each year of the arrangement. In either case, the employer will get a corresponding compensation deduction (if the amount is reasonable), and will have an offsetting amount of interest income, at the same time(s).

4. For new shareholder or other non-employee arrangements treated as loans, the premium provider will have interest income, but no offsetting deduction. For new private arrangements treated as loans, the interest will be a gift and a GST transfer, but if the owner is a grantor trust from the deemed lender's point of view, there will be no income generated from the arrangement.

5. For new equity arrangements, whether endorsement or collateral assignment, there appears to be no grandfathering of the taxation of equity under Section 83, if non-loan characterization is chosen. It is unclear what will constitute a "transfer" for purposes of Section 83 under final guidance. Under the interim guidance, there apparently must be some "event" for a transfer, subject to Section 83, to occur; the fact that the employee may be substantially vested in the equity does not seem to matter.

Conceivably, under final guidance, the Service could create a transfer event, subject to Section 83, each year during the arrangement, if the interest to the employee is substantially vested, pursuant to which the equity will be income to the employee and deductible by the employer (if reasonable). If the interest of the employee vests at a future date, the employee's income and the employer's deduction (if reasonable) will be bunched in the year the employee's interest vests. In either case, the employer's deduction will be offset by any gain it recognizes by paying compensation with appreciated property.

It may be possible for the employee to make a Section 83(b) election with respect to the equity in a non-vested arrangement, to tax the equity when it was transferred (or deemed transferred) without regard to the risk of forfeiture; it isn't clear whether such an election must be made at the outset of the arrangement or each year (it depends on when the transfer takes place) or even whether such an election can be made with respect to property like policy equity. Under the interim guidance, if a transfer event is required to tax the equity, how making a Section 83(b) election before the event would help isn't clear.

6. In new third party-owned equity arrangement treated under Section 83, the measure of the income (including any equity taxed to the employee) will measure the gift by the employee to the owner. The timing of the gift will be governed by the timing of the income generated by any equity or the unstated interest -- all in the first year of the transaction or each year it is in existence.

In new third party equity arrangements treated under Section 7872, although the employee will be treated as if he or she had re-loaned the proceeds of the loan to the owner and received back the unstated interest for income tax purposes, if the owner is a grantor trust, there will be no additional income to the employee resulting from the loan retransfer. The unstated interest on the loan to the third party will measure the gift, and the timing of the gift will be determined by the timing of the income.

7. New reverse split-dollar arrangements must use Table 2001 rates instead of P.S. 58 rates after 2001, which will reduce the purported advantage of such arrangements.

8. For policies issued after 3/1/01, the use of alternative term rates after 2003 isn't guaranteed.

9. Alternative term rates for use after 2003, compliant with the Notice, will have to be created by most insurers (because their existing rates won't qualify under the new rules), and will likely be higher than many (or most, or all) than are quoted today.

Planning Thoughts

1. If the Notice means, as we believe, that equity in collateral assignment arrangements won't be taxed in non-loan transactions as it builds up, but only when it is "transferred" at rollout or on some other transfer event, early rollouts might make sense, to limit or avoid taxation of the equity; alternatively, keeping the arrangement in place for life might make sense (to avoid taxation of the equity, at the cost of ongoing economic benefit costs). By requiring a transfer event to tax the equity, taxpayers can control in which year to realize the equity, or avoid it by keeping the

arrangement in force for life (but won't be able to spread it over the term of the arrangement).

2. If policy equity developed up to the point of future guidance (or all equity developed or to be developed) in existing collateral assignment arrangements is grandfathered without regard to transfer events (which seems unlikely), rollouts of these arrangements at some point could make sense (especially if future premiums were no longer required to be paid in cash).

3. The adoption of Table 2001 rates for individual policies may mean survivorship policies can't use US 38 rates to measure the economic benefit, or it may mean (as the authors of the Notice have indicated informally) the rates will be lower, because they are derived from the lower rates in Table 2001.

4. For new equity arrangements, an up-front analysis of how to characterize the arrangement will be critical -- Section 7872 treatment will likely increase the annual income to the employee, but will avoid taxation of the equity; the "cost" of avoiding equity taxation will be a higher ongoing measure of the benefit. How to project to results under each possible treatment will be difficult, especially in variable policies (where projecting equity is impossible) and in demand loan arrangements (where interest rates change each month).

The result could be different for employee owned arrangements, than for third-party owned arrangements; employee owned policies might be more likely to use a Section 83 characterization and use the cash value at rollout to pay the tax, whereas third-party arrangements might choose to measure the gift by the unstated interest and use the untaxed equity to rollout the arrangement early.

5. For new non-equity arrangements, the choice will be based on a comparison of the unstated interest versus the economic benefits over the life of the arrangement, remembering that economic benefits will likely be higher going forward, because of the added restrictions on compliant alternative term rates (and the possible loss of US 38 rates for survivorship policies), or may be lower in the future if survivorship rates can be derived from the lower table 2001 rates.

6. For tax-exempt employer arrangements, equity arrangements governed by Section 83 should not be affected by the Section 457 limits (because of the exception to Section 457 for any Section 83 transfer); arrangements governed by Section 7872 will have to subject the employee's interest to risks of forfeiture or otherwise make them demand loans to avoid taxing all the unstated interest up-front.

7. Third party arrangements taxed under Section 83 will have to consider the transfer tax implications of equity transfers (as some commentators had suspected) in deciding when (or whether) to rollout the arrangement to avoid or limit the transfer taxation of the equity.

8. In shareholder arrangements, especially those involving S Corporations, the inability to offset any dividend resulting from the unstated interest (in a loan characterization) or any equity (in a non-loan characterization) would raise the risk of non-pro-rata dividends, creating a second class of stock in an S Corporation. In

those situations, either an interest-bearing loan (not documented as split-dollar), or non-equity split-dollar might make sense.