MEMORANDUM

FROM: Lawrence Brody
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RE: I.R.S. Notice 2001-10

The following is the latest version of our summary and analysis of I.R.S. Notice 2001-10,[1] a copy of which is attached; our analysis and comments appear in italics in the text and in the footnotes. This Notice provides a general discussion of split-dollar arrangements and discusses the need for what it calls "updated guidance," adopts some interim rules to be used by parties while issues raised by the Notice are being resolved and until "final guidance" is provided on these issues by the Service,[2] and asks for comments on the interim guidance. Finally, the Notice revokes Rev. Rul. 55-747 and modifies Rev. Ruls. 64-328 and 66-110.

[1] Published in IRB 2001-5 on 1/29/01.

[2] The Notice is generally stated in employer-employee terms, but is intended to apply not only to employment-related arrangements (and the comparable independent contractor, shareholder or partnership arrangements), but also to arrangements involving gifts, presumably including third party-owned arrangements and private split-dollar arrangements. How some of the Section 83 concepts used in the Notice to tax policy equity will apply in non-employment and gift scenarios is not clear.

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Background Discussion and Need for Updated Guidance

Equity Split-Dollar Arrangements

The Notice initially concludes that Revenue Rulings 64-328 and 66-110 did not involve equity split-dollar arrangements (despite the contrary conclusion reached by some commentators). The Notice then further concludes that under the principles of Revenue Rulings 64-328 and 66-110, "it is necessary to account for the employee's rights in the cash surrender value under an equity split-dollar arrangement in a manner consistent with the substance of the parties' contractual positions."

The Notice proposes two choices for the tax treatment of equity split-dollar arrangements: a loan subject to Section 7872 or a transfer of property subject to Section 83.

Section 83 Transfer

One possibility offered by the Notice for the income tax treatment of an equity split-dollar arrangement would be to treat the split-dollar arrangement as involving one or more transfers of property subject to Section 83. However, in this background discussion, the Notice concludes that for this treatment to apply, the substance of the arrangement must involve the transfer of a beneficial interest in the cash surrender value of a life insurance contract from an employer to an employee.[3/]

[3/] This conclusion appears to be at odds with the holding of the equity TAM, TAM 9604001, and has been one argument made by commentators supporting the notion that the TAM was wrong as it applied to non-endorsement arrangements.

It further finds, "If the employee is the beneficial owner of the life insurance contract from the inception of the arrangement, there is no transfer of property under Section 83."[4]

If Section 83 applies to a split-dollar arrangement, the parties can arrange to tax the equity on a current basis or at termination of the arrangement by providing that the employee's interest is substantially vested or unvested (as defined in the Section 83 Regulations).[5] *Although the employer would be entitled to a deduction for the equity under Section 83(h) (if reasonable compensation), that would be offset by the gain it would recognize on transferring property in which it had no basis as compensation, under Reg. Sec. 1.83-6(b).*

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[4] This statement would appear to apply to and protect from the application of Section 83 an arrangement documented as a collateral assignment—or perhaps unsecured—split-dollar arrangement from inception, where the employee has always been the owner of the policy. However, as discussed below, under the interim guidance provided by the Notice, these arrangements could be treated as involving Section 83 transfers of the employer is deemed to be the beneficial owner of the policy, in spite of the fact the employee is the legal owner of the policy.

[5] In addition, with arrangements subject to a risk of forfeiture, a Section 83(b) election might be argued to shield post-election equity from taxation. How such an election would work in this context, is not clear, since it apparently requires a transfer of property subject to a substantial restriction (which the election effectively waives). When the transfer occurs in split-dollar is the issue, especially if, as discussed below, taxation of the equity during the interim guidance period isn't dependent on vesting but on a transfer event. It would seem that if the transfer occurs at rollout or even every year as the equity develops, such an election would not help; if the transfer occurs on inception of the arrangement (which seems the least likely choice), such an election would appear to avoid taxation of all future equity.

Loan

As an alternate position, the Service states that if there is a "reasonable and bona fide expectation" that the employer will be repaid for its premiums "at a fixed or determinable future date" (presumably including the death of the insured), then an equity split-dollar arrangement may properly be treated as the acquisition by the employee of a life insurance contract with a series of loans from the employer. In such case, this analysis would apply to the exclusion of both the traditional "economic benefit" analysis and the equity taxation theory otherwise applicable to split-dollar arrangements. If a split-dollar arrangement is treated as a loan, the Service concludes that Section 7872 would govern the income tax treatment of that loan, with the unstated interest being treated as compensation income (and a non-deductible interest expense) for the insured (and presumably as a compensation deduction for the employer, if reasonable, and as interest income, washing out its deduction).

Under Section 7872, the parties can arrange to tax the interest element over the term of the loan—all at once at the outset of the arrangement (as original issue discount) by providing it is a term loan, or each year by providing that the loan is a demand loan; most employment-related arrangements would likely be demand loans in any event, because they would be terminable on termination of employment.[6/]

6/ In a term loan the rate is fixed at the outset, but in a demand loan, it varies each year. If the parties want to lock in a rate over the term over a loan at the

Analysis of the Notice's Background Discussion

Given the Service's conclusion that if the employee is the beneficial owner of a policy from inception, it does not involve a Section 83 transfer, it would appear that equity split-dollar arrangements in which the policy has been owned by the employee (or other third party) from inception will be treated as involving an interest-free loan subject to Section 7872. However, as discussed below, Service may nonetheless attempt to treat the employer (or allow the employer to be treated) as the "beneficial owner" of the policy by virtue of its premium payments even in these arrangements, subjecting the arrangement to Section 83.

Regardless of whether it continues to apply for an equity split-dollar arrangement, the traditional economic benefit split-dollar income tax treatment should continue to apply for non-equity arrangements, however documented. For equity arrangements in which the policy is owned by the employer, the traditional economic benefit analysis will also apply, and any portion of the cash value which eventually is transferred from the employer to the employee will be subject to Section 83.[7/]

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outset, but not have the unstated interest treated as original issue discount, they could document the arrangement as an interest-bearing term loan, with the interest payable annually.

[7/] Commentators have always felt that while the Section 83 analysis was difficult to apply to a collateral assignment method equity split-dollar arrangement, it was almost equally difficult to avoid with an endorsement method equity split-dollar arrangement. See Ltr. Rul. 7916029.

The employee party to an equity split-dollar arrangement, to which Section 83 applies, may receive a "credit" against the current value of the life insurance protection for his or her premium payments (or for having been taxed on any employer premium payments) and for any part of the cash value treated as transferred to the employee under Section 83. In addition, for purposes of allocating growth in cash surrender value between the employer and the employee, to the extent a portion of the cash value has been treated as transferred to the employee, it appears that future growth in cash value will be allocated pro-rata between the employee's and employer's respective interests in the cash value. It is also possible that the employee's premium payments (although may be only in excess of the current value of life insurance protection) may give the employee some ownership interest in the policy cash value.

Value of Current Life Insurance Protection

The Notice also states that the rates set forth in Revenue Ruling 55-747 are based on 1946 mortality tables and, as is no surprise, are no longer an appropriate measure of term life insurance protection, and have, in fact, become an upper limit on the value of the life insurance protection provided. While acknowledging that the alternate insurer's published term rates are usually used to measure the value of the life insurance protection provided to the employee under a split-dollar agreement, the Notice concludes that anyone reporting under the old "P.S. 58 rates" would be overstating their income.

The Notice also questions the validity of the alternate term rates provided by insurers as providing an appropriate measure of the economic benefit to an employee under a split-dollar agreement. The Notice cites concerns that rates used to measure economic benefit "may not realistically be available for all standard risks who apply for term insurance." In addition, it notes that it is difficult for either a taxpayer or the Service to confirm that the same rates are available to all standard risks.

Next, the Notice raises the general question of whether the life insurance protection provided to different taxpayers should be valued differently solely because of the differences in the insurers' published term rates. Recognizing that there are differences in the protection provided by different insurers and that such variables would not be considered if a standard rate table were used, it concludes that, "it may be preferable, at least as a general rule, for the value of current life insurance protection provided under split-dollar arrangements . . . to be determined under one or more premium rate tables prescribed for those purposes."[8/]

Reverse Split-Dollar

As a part of its analysis of the appropriate measure for the economic benefit, the Notice concludes that use of the P.S. 58 rates in a "reverse" split-dollar arrangement to measure the employer's share of the premiums "significantly overstates the value of the policy benefits allocated to the employer, such that the

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[8/] As discussed below, the Notice adopts such a table, Table 2001.

employee's share of the premiums is significantly lower than the employee's actual share of the policy benefits." The Notice continues, "No published guidance has authorized reliance on the P.S. 58 rates for this purpose."[9]

It appears that the Notice, by eliminating the P.S. 58 rates and providing new, more current term rates for measuring the economic benefit (as discussed below), is reducing the attractiveness of reverse split-dollar arrangements going forward, without the need to specifically address whether the prior use of the P.S. 58 rates in a reverse split-dollar arrangement was appropriate.

Interim Guidance (Pending the Adoption of Further Guidance)

Tax Treatment of Split-Dollar Arrangements

Pending the issuance of further guidance, with respect to the income tax treatment of both equity <u>and other types</u> of split-dollar arrangements, the Service generally agrees to accept the parties' characterization of the arrangement as long as (1) the "characterization is not clearly inconsistent with the substance of the arrangement"; (2) the parties have consistently followed such characterization from the beginning of the arrangement;[10] and (3) "the parties fully account for all

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[9] The Notice, however, stops short of prohibiting the use of those rates in reverse split-dollar arrangements, and never discusses the tax consequences of their use.

[10] Which means that for new arrangements, the parties' characterization will govern (if the other two requirements are met), but parties to existing arrangements won't be able to choose under which characterization they wish to be taxed.

economic benefits conferred on the employee in a manner consistent with that characterization."[11/]

In accordance with its general position that it will permit parties to essentially choose their characterization of a split-dollar arrangement (subject to the three conditions described above), the Notice permits parties to existing arrangements who have been doing so to continue to treat an employer's payments under a split-dollar arrangement as involving loans from the employer to the employer (which would be, at best, unusual), and for parties to new arrangements to choose that treatment. In this case, the income tax consequences of the loan to the employee would be governed by Section 7872,[12/] there would be no "economic benefit" compensation to the employee, and the cash value of the life insurance policy will not be treated as property transferred to the employee for purposes of Section 83 (i.e., the equity won't be taxable). The Notice modifies Rev. Ruls. 64-328 and 66-110, to the extent they held split-dollar arrangements weren't to be treated as loans.

The Notice also states (as would be expected) that if the employer forgives its right to be repaid its premium payments, that forgiveness would be treated as

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[11/] One commentator has called this a "check the box" approach to the taxation of split-dollar.

[12/] The employer would get a corresponding deduction for the interest deemed included in the employee's income (if reasonable), and would have an offsetting amount of interest income.

income to the employee.[13/] Additionally, the Notice provides that distributions from the life insurance policy during the arrangement could be included in the employee's income under Section 72 (presumably, under the general rules applicable to distributions from policies, without regard to the fact that the policy was subject to a split-dollar arrangement).

The Notice's analysis of the effect of treating a split-dollar arrangement as involving an interest-free loan (including avoiding tax on the equity) seems to be consistent with what commentators had anticipated.

Loan treatment of a split-dollar arrangement is currently available only to parties who have consistently treated the arrangement as involving loans, or for new split-dollar arrangements that are treated as loans from inception. Parties to arrangements not consistently treated as involving loans will be treated as having an arrangement which is not characterized as a loan; thus, non-loan treatment of a split-dollar arrangement is the default.

Parties to a split-dollar arrangement that was not consistently treated as a loan, but who wished to have loan treatment going forward, should be able to achieve that result by terminating the split-dollar arrangement[14/] *and repaying the employer for its premium payments out of policy values or even with the*

13/ That would also presumably be true for arrangements characterized as Section 83 transfers.

14/ As discussed below, however, if the policy has developed equity, termination of the arrangement will, under the Notice's interim guidance, trigger recognition of the equity as income by the employee.

proceeds of a new interest-free (or even interest bearing) loan. If necessary, the employer could then make further interest-free (or even interest bearing) loans to help pay for future premiums.

For parties to a split-dollar arrangement that is not characterized as a loan, the Notice states, "the parties must fully account for all of the economic benefits that the employee derives from the arrangement in a manner consistent with that characterization," so that: (1) "the employer will be treated as having acquired beneficial ownership of the life insurance contract through its share of the premium payments" (which is a necessary assumption if Section 83 is going to apply to the equity generated by a policy owned by the employee or third party), (2) the employee will receive compensation in an amount equal to the insurance protection provided under the agreement, reduced by contributions made by the employee, (3) dividend or other policy distributions to the employee will be included in his or her income (in accordance with the current understanding of Revenue Ruling 66-110), and (4) "the employee will have compensation income under section 83(a) to the extent the employee acquires 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."

The income tax consequences described in numbers (2) and (3) are consistent with the current understanding of the income tax consequences of split-dollar life insurance arrangements. The intended effect of the Service's position in number (1) is unclear—why is the employer's acquisition of beneficial *ownership of the contract significant? Arguably, by treating the employer as becoming the beneficial owner of the policy through its premium payments, the Notice is laying the groundwork for its Section 83 analysis of the taxation of equity, which, since it requires a "transfer" from the employer, also requires the employer have an interest in the policy (a "beneficial" one, at least) which it can transfer.*

The income tax consequences described in (4) may be no different than current understanding—for example, if an employee is a party to a non-equity split-dollar arrangement pursuant to which the cash value of the policy belongs to the employer, and the employer's rights in the cash value subsequently terminate in favor of the employee, either under the terms of the arrangement or as a result of the employer's actions, that cash surrender value will be included in the employee's income under Section 83.[15/] *However, the intent of this provision is apparently broader, since if the employer is treated as the beneficial owner of a collaterally assigned policy because of its premium payments (as implied by number (1)), then the beneficial ownership of the equity could be considered transferred to the employee, so long as he or she has a substantially vested interest in the equity.*[16/] *Again, regardless of whether the employer is treated as the "beneficial owner" of the policy, finding a transfer event for the*

15/ See Ltr. Ruls 7916029 and 8310027.

16/ Again, see the contrary conclusion reached in the Background discussion section of the Notice, described above.

policy equity, which could be subject to Section 83, is difficult in a traditional collateral assignment equity split-dollar arrangement (at least until rollout or some other identifiable transfer event).

The uncertainty of the application of these rules to existing equity split-dollar arrangements may be alleviated by the following provision in the Notice:

> Pending the publication of further guidance, the IRS will not treat an employer as having made a transfer 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 on termination of the split-dollar arrangement. If future guidance provides that such earnings increments are to be treated as transfers of property for purposes of section 83, it will apply prospectively.[17/] (Emphasis added.)

This provision, which is difficult to interpret, appears to provide what could be called "grandfathering" to most existing collateral assignment equity split-dollar arrangements, up through the date further guidance from the Service is published.[18/] *This provision is, however, not a general statement that all existing policy equity in every arrangement will not be taxed (which was the*

17/ What type of prospective application is intended isn't clear—will all future increases in equity in existing transactions be protected from being taxed on a current (non-transfer) basis, or just the equity created in the years before the final guidance in those transactions?

18/ If this provision means anything, it should at least postpone the taxation of existing equity under collateral assignment arrangements where the equity develops without anyone's action, until some transfer event (such as rollout) occurs; that is, in fact, not as much grandfathering of that equity as a possible delay in taxing it (unless there never is a transfer event with respect to it).

hoped-for grandfathering), but does appear to require some sort of "transfer event" to tax the equity, during the interim guidance period.[19] *For instance, this provision could be read to not protect accessing the cash surrender value of a collaterally assigned policy prior to termination of the split-dollar agreement, a transfer of the equity on policy rollout (an employee receiving policy equity on termination of a split-dollar arrangement), nor a modification of a non-equity arrangement pursuant to which policy equity previously belonging to the employer was transferred to the employee. However, for existing collateral assignment equity arrangements, where no transfer event occurs, the Notice could be read to provide that there will be no "deemed" transfers of the policy equity, at least until further guidance is provided.*[20]

As mentioned above, the Notice also states that, at least in the interim, the Service will give "credit" to an employee, both for purposes of calculating any policy equity included in the employee's income and for purposes of calculating the current life insurance protection provided to the employee by the employer under

[19] This interpretation is derived in part from conversations with representatives of the Service who were responsible for this Notice.

[20] This is apparently a different conclusion than that reached in TAM 9604001, which treated yearly increases in policy values as transferred from the employer, even in collaterally assigned arrangements.

the split-dollar arrangement, for any portion of the cash value which is treated as having been transferred to the employee under Section 83.[21/]

Finally, the Notice states that if an employer makes a premium or other payment under a split-dollar arrangement, "does not acquire a beneficial ownership interest in the life insurance contract through such payment" and does not reasonably expect to be repaid for that payment from policy proceeds or otherwise, the entire payment will be treated as compensation to the employee.

As stated above, under the Notice's interim guidance, premium payments made by an employer cause the employer to become a beneficial owner in the policy, so it is difficult to imagine a split-dollar situation under this analysis where the employer pays premiums but does not have a beneficial ownership interest in the contract. Therefore, it appears this provision is intended to address the _Young_ *situation, in which payments made by the employer were treated as interest payments on a loan rather than as premium payments, not subject to repayment under the split-dollar agreement, or to bonus plans documented as split-dollar arrangements.*[22/]

21/ Whether this provision endorses the co-ownership concept as a way of reducing a portion of the equity taxed to the employee (based on the ratios of the policy "owned" by each party) isn't clear.

22/ It could also be interpreted as applying to reverse split-dollar arrangements, although in those situations, the employer would expect to be repaid from the proceeds if the employee died during the term of the arrangement. It has also been suggested that it might be intended to apply to combined split-dollar and deferred compensation arrangements, where the split-dollar advances are

Value of Current Life Insurance Protection

Again, pending the publication of further guidance, the Notice revokes Revenue Ruling 55-747, so that the P.S. 58 tables will no longer be accepted "as a proper measure of the value of current life insurance protection for Federal tax purposes." There is some "grandfathering"—for what it is worth—since, up to and through December 31, 2001, "taxpayers may continue to use the P.S. 58 rates set forth in Rev. Rul. 55-747 for purposes of determining the value of current life insurance protection provided to an employee under a split-dollar arrangement or a qualified retirement plan."

In conjunction with the Notice, the Service published a new Table 2001, which "taxpayers may rely upon" as the measure of current life insurance protection on a single life policy provided under a split-dollar arrangement or qualified retirement plan.[23/]

Therefore, it appears these rates would be available to value the benefit provided to an employer under a reverse split-dollar arrangement (although the Notice is silent on that point).[24/] *The rates in Table 2001 are an extension of the*

"forgiven" as deferred compensation (but there the employer has acquired a beneficial interest in the policy).

[23/] Interestingly, there is no mention of the measure of economic benefit for survivorship policies; if they can be interpolated from the Table 2001 rates, they would be lower than U.S. 38 rates (which are based on the higher P.S. 58 rates).

[24/] As noted above, the lower table 2001 rates may make reverse split-dollar less attractive than the P.S. 58 rates.

Table 1 rates (used for group term policies),and are substantially lower than the P.S. 58 rates (but higher than most—if not all—alternative term rates).[25]

At least until December 31, 2003, taxpayers will also be able to use an insurer's lower published term rates, if they comply with the requirements of Revenue Ruling 66-110, to measure the value of current life insurance protection under a split-dollar arrangement. However, in addition to the requirements of Revenue Ruling 66-110—that the insurance be available for all standard risks for initial issue one-year term insurance and that the rates be published—the following additional, potentially rigorous, qualifications must be met in order to use alternative term rates beginning after December 31, 2003: (1) the insurer must generally make the rates known to persons who apply for term coverage from the insurer, (2) the insurer must regularly sell term insurance at such rates to persons who apply for term coverage through normal channels, and (3) the insurer must not more commonly sell term insurance at higher rates to individuals classified as standard risks.

The Notice also provides that for policies issued after March 1, 2001, there is no guarantee that the alternative term rates may be used by taxpayers to measure

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[25] Note that these rates are higher than the rates which would apply outside of a guaranteed issue group insurance setting.

the value of current life insurance protection after the later of December 31, 2003 or December of the year in which further guidance is provided.[26/]

Request for Comments

The Notice concludes by asking for comments on any of the matters addressed in the Notice or on the tax treatment of split-dollar arrangements in general.

[26/] This suggests that alternative term rates may not be available to be used for new policies after the later of those dates, even if those rates meet the more stringent requirements.