MEMORANDUM

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RE: I.R.S. Notice 2001-10

Following is our summary of I.R.S. Notice 2001-10,[1]/ a copy of which is attached. This notice provides a general discussion of split-dollar arrangements and proposes possibilities for future treatment of split-dollar arrangements. It then adopts some interim rules to be used by parties while issues raised by the Notice are being resolved.[2]/

Background Discussion

Equity Split-Dollar Arrangements

The Notice initially concludes that Revenue Rulings 64-328 and 66-110 did not involve equity split-dollar arrangements. 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

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[1]/ To be published in IRB 2001-5 on 1/29/01.

[2]/ The Notice is intended to apply to employment-related arrangements (and the comparable independent contractor, shareholder or partnership arrangement), as well as third party-owned arrangements (with the resultant gift tax consequences) and, presumably, private split-dollar arrangements.

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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 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 subject to Section 83. However, 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. It further finds, "If the employee is the beneficial owner of the life insurance contract from the inception of the arrangement [(i.e., the arrangement is documented as a collateral assignment - or perhaps undocumented - split-dollar arrangement from inception)], there is no transfer of property under Section 83."[3]/

If Section 83 applies, 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.

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[3]/ However, as discussed below, under the interim guidance provided by the Notice, these arrangements could be treated as involving Section 83 transfers, despite this statement.

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", 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 the traditional "economic benefit" analysis 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 presumably as a compensation deduction for the employer).[4]/ Under Section 7872, the parties can arrange to tax the interest element all at once at the outset of the arrangement or each year, by providing that the loan is a term loan or a demand loan.

Summary

As an initial reaction, given the Service's conclusion that if the employee is the beneficial owner of a policy from inception, it could not involve a Section 83 transfer, it appears the most likely result is that equity split-dollar arrangements in which the policy is owned by the employee (or other third party) will be treated as involving an interest-free loan subject to Section 7872. However, as discussed

[4]/ The tax treatment of the arrangement would then depend, among other things, on whether the loan was a term or a demand loan.

below, it appears the Service may attempt to treat the employer as the “beneficial owner” of the policy by virtue of its premium payments, thus potentially 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. For equity arrangements in which the policy is owned by the employer, it seems that the traditional analysis will also apply, coupled with the treatment of any portion of the cash value which eventually is transferred from the employer to the employee as subject to Section 83.[5]/

As discussed in more detail later in this memorandum, it appears that the employee party to an equity split-dollar arrangement, to which Section 83 applies, may receive “credit” for his or her premium payments.

Value of Current Life Insurance Protection

The Notice 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 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

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

protection provided to the employee under a split-dollar agreement, the Notice concludes that those reporting under the old “P.S. 58 rates” would be overstating 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. The Notice recognizes 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. However, in concludes, “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.”

Reverse Split-Dollar

While much of the discussion of Notice 2001-10 is in terms of “possibilities” of future treatment, the Notice is more direct in its discussion of reverse split-dollar arrangements. Within 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 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."[6]

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 equity and other types 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

[6] 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.

the beginning of the arrangement;[7] and (3) "the parties fully account for all economic benefits conferred on the employee in a manner consistent with that characterization."

In accordance with its general position that it will permit parties to essentially choose their characterization of a split-dollar arrangement, the Notice permits parties 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). In this case, the income tax consequences of the loan would be governed by Section 7872[8], there would be no "economic benefit" element to the employee's compensation, 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 issue won't be relevant). The Notice states (as would be expected) that if the employer forgives its right to be repaid its premium payments, that would generate income to the employee.[9] Additionally, distributions from the life insurance policy could be included in the employee's income under Section 72 (presumably without regard to the split-dollar arrangement). The Notice's analysis of the effect of treating a split-dollar

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[7] 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.

[8] The employer would get a corresponding deduction for the interest deemed included in the employee's income.

[9] That would also presumably be true for arrangements characterized as Section 83 transfers.

arrangement as involving an interest-free loan 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 and repaying the employer for its premium payments out of policy values or even with the 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 requires a “transfer” from the employer. It has also been suggested that this statement indicates an intent to tax the equity under Section 83 only in years in which the employer actually makes premium payments (although that interpretation is not clear from the language used in this section).

The income tax consequences described in (4) may be no different than current understanding - 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. However, the intent of this provision may be broader if it relates to treatment of the employer as the beneficial owner of a collaterally assigned policy, with the possibility that the beneficial ownership of the equity could be considered transferred to the employee. Again, regardless of whether the employer is treated as the "beneficial owner" of the policy, finding a transfer event for the policy equity, which could be subject to Section 83, is difficult in a traditional collateral assignment equity split-dollar arrangement.

The uncertainty of the application of these rules to existing equity split-dollar arrangements is 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.[10]/ (Emphasis added.)

This provision appears to provide "grandfathering" to most existing equity split-dollar arrangements, up through the date further guidance from the Service is

[10]/ What type of prospective application is intended isn't clear—all future years of existing transactions or just prior years of those transactions?

published.[11] This provision is less than a general statement that all existing policy equity in every arrangement will not be taxed. For instance, this provision may not protect an employee who accessed the cash surrender value of a policy prior to termination of the split-dollar agreement nor an employee who received policy equity on termination of an endorsement arrangement, nor would it appear to protect 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, the Notice could be read to provide protection against taxation of the equity, until further guidance is provided; if that interpretation is correct, any equity in such an arrangement to the date of that further guidance would be tax-free.[12]

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, perhaps more surprisingly, for purposes of calculating the current life insurance protection provided to the employee by the employer under the split-dollar arrangement, for any portion of the cash value which is treated as having been transferred to the employee under

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11/ This grandfathering could have been clearer -- it could have said that equity existing on the date of further guidance won't be taxed (or even that equity developed under then existing arrangements, won't ever be taxed), but didn't. If this provision means anything, it should grandfather existing equity under collateral assignment arrangements where the equity develops without anyone's action.

12/ It is possible, but less likely, that even the future equity in existing arrangements would also be tax-free.

Section 83. Because an employee will get credit for amounts he or she contributes toward the policy or which are included in his or her income, it may make sense to increase the contributions an employee makes into the policy during the early years, to give the employee an increased ownership interest in the future growth of the cash surrender value.

Finally, the Notice states that if an employer makes a premium or other payment under a split-dollar arrangement and "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 are to be treated as causing 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, not subject to repayment under the split-dollar agreement, rather than as premium payments.[13]/

[13]/ 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.

Value of Current Life Insurance Protection

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 - in that 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." While the Notice stated, generally, that use of the P.S. 58 rates in a reverse split-dollar arrangement caused the employer to overpay for its benefit, it does not make any statement about whether it will challenge the prior use of those rates in those cases.

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.[14/] Therefore, it appears these rates would be available for use by those wishing to value the benefit provided to an employer under a reverse split-dollar arrangement (although the Notice is silent on that point).

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

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[14/] Interestingly, there is no mention of the measure of economic benefit for survivorship policies.

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 - additional, potentially rigorous, qualifications must be met beginning after December 31, 2003, in order to use alternative term rates: (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 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.[15]/

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.

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[15]/ This suggests that alternative term rates won't be available to be used for new policies after the later of those dates.