January 19, 2001: More Split Dollar - Questions & Answers on Notice 2001-10

Since the recent publication of Notice 2001-10 (the "Notice") many questions have been raised to which the answers are unknowable or unclear at this time. Unfortunately, obtaining correct and reliable answers is difficult since the Notice offers interim guidance to be followed only until further guidance is issued. April 30, 2001 is the IRS' cutoff date for receiving comment and criticism from interested parties on the Notice. Therefore, further guidance should be provided after April 30, but exactly when is not known. Nevertheless, until that guidance is provided, here are some suggestions:

- Most of our illustration systems can already illustrate taxation of equity either as it accrues or at rollout. Further, the interim Table 2001 rates and other appropriate term rates, if not already on the illustration system, will be added as soon as possible. Given the uncertainty over when and how equity could be taxed and the multiple cut-off dates under which differing term rates may apply, it is the responsibility of counsel for the client to decide how split dollar should be illustrated and which term rates should be used. Copies of the Notice are available to aid counsel in that decision.

- For in force split dollar cases, it is advisable to contact clients and alert them as to the publication of the Notice and the need to contact their tax or legal advisor about its applicability to their situation. Their situations may have to be reviewed to determine if their objectives can still be met in light of the possible changes. In particular, clients should understand that, depending on plan design the measure of reportable economic benefit currently being used might change on either January 1, 2002 or January 1, 2004. Further, clients should understand that policy equity might be taxed in whole or in part, but exactly what amount and when, is dependent on the IRS' further guidance.

- For new single life cases that would ordinarily use a collateral assignment split dollar design, consider loaning the premium per the IRC Sec. 7872 below-market loan rules. A properly designed "demand" loan may be more economical than a taxable equity collateral assignment split dollar if the discounted present value of loan interest is lower than the discounted present value of the reportable economic benefit coupled with the discounted present value of taxable equity. Bear in mind, however, that if a loan format is chosen and the Notice is not withdrawn or favorably amended, it could not later be switched to split dollar. Also be advised that some employers, such as broker-dealers (per 12 C.F.R. 220 ("Reg. T")) and financial institutions (per 12 C.F.R. 221 ("Reg. U")), will have to satisfy additional lending requirements if the loans are to an employee for the purchase of variable life insurance policies. Such employers must see their legal advisor for more detail.

- For new second-to-die cases, a taxable equity collateral assignment split dollar design may be preferable to an IRC Sec. 7872 below-market loan for the opposite reasons as previously discussed: the discounted present value of the reportable economic benefit, recalculated to reflect two life expectancies, coupled with the discounted present value of taxable equity may be lower than the discounted present value of loan interest. Nevertheless, it bears repeating that if a split dollar design was chosen, per the Notice it could not be later switched to a loan.

- Endorsement split dollar is also a viable alternative to taxable equity collateral assignment split dollar whether or not the life insurance policy is also to be used to informally fund a nonqualified deferred compensation plan. With endorsement split dollar, since the business owns all of the cash value, the arrangement should not be characterized as an IRC Sec. 7872 loan below-market loan. Please note, however, that the Notice specifically makes no assurances that any policy issued after March 1, 2001 will be able to use anything other than the Table 2001 or its replacement as the measure of the reportable economic benefit after the later of December 31, 2003 or December 31 in the year in which further guidance is provided.

- *Most importantly:* all clients must seek the advice of their tax counsel with respect to all split dollar issues. We cannot provide tax or legal advice.

To further your understanding of some of the issues involved, some of the more important questions are repeated below. Where no answer is possible, a discussion of the arguments is included. You are strongly urged to read them in conjunction with our January 10, 2001 update and the actual Notice before proposing split dollar and when dealing with existing split dollar cases.

What will be the measure of the economic benefit for split dollar policies issued on or after March 1, 2001?

The Notice revokes the use of PS 58 rates after January 1, 2002 and substitutes for them the lower Table 2001 rates. It further changes the criteria for the use of alternative term rates such that some term rates presently being used in split dollar may no longer qualify. But, most importantly for new business, the Notice makes no assurance that life insurance policies issued after March 1, 2001 and used in split dollar arrangements will be able to use any rates other than the Table 2001 rates. In other words, if the Notice is not withdrawn or amended favorably, split dollar designs on policies issued after March 1, 2001 will only be able to use the Table 2001 rates, or their published replacement, as the reportable economic benefit.

If equity were taxable, when would that occur?

Equity is understood to mean any portion of the cash value in excess of the employer's aggregate premiums that is or becomes a beneficial interest of the employee. The IRS takes the position that equity has always been taxable; that no prior authority supports its non-taxation. Specifically, the IRS in the Notice states "…the employee will have

compensation income under section 83(a) to the extent that the employee acquires a substantially vested interest in the cash surrender value of the life insurance contract…."

Therefore, it seems clear that the IRS intends to tax the equity in split dollar. In TAM 9404001 the equity was taxed each year as it accrued. In the Notice, however, the IRS recognizes that there is some confusion over when the transfer of equity occurs for purposes of taxation under IRC Sec. 83. As a result, they have asked for comment on when equity should be taxed. IRS spokespersons explain that in the interim they do not intend to tax equity as it accrues, they will tax it at rollout apparently on the assumption that at rollout the "…employee acquires a substantially vested interest in the cash surrender value of the life insurance contract…." They caution, however, that this is an interim approach that may change after further guidance is provided.

Will existing equity split dollar designs be grandfathered from equity taxation?

The Notice states that equity will be taxed "prospectively." IRS sources state that prospectively does not mean grandfathering. In fact, since the IRS apparently has always viewed equity as being taxable, there is nothing to grandfather. But the term prospectively is confusing: If equity is taxed at rollout, will all equity be taxed, even if some of it accumulated prior to a cut-off date? If equity is taxed as it accrues, will it only be future accrual or will it include accruals on equity existing prior to a cut-off date? And if past accruals escape taxation, will they taxed anyway at rollout? There are no answers to these questions as yet and there may not be until further guidance is provided.

Can existing split dollar designs be re-characterized as IRC Sec. 7872 below-market loans?

The Notice simply states that the arrangement can only be one of three things: a loan, split dollar in which reportable economic benefits and equity will be taxable, or as compensation (e.g., executive bonus). Once the arrangement is characterized as a loan it cannot be later switched to split dollar, and vice versa. It is the substance of the transaction that controls. Since the substance of existing split dollar cases is not a loan, it would seem that they could not be changed to a loan, assuming a loan was more economically attractive. This is an interpretation of the Notice that could change with further guidance from the IRS.

Does the Notice apply to private split dollar?

Although the Notice consistently references the employer/employee relationship when discussing the tax treatment of split dollar, the preamble states "…[the] Treasury and the IRS believe the same principles generally govern the Federal tax treatment of split-dollar arrangements in other contexts, including arrangements that provide compensation to non-employees and economic benefits to corporate shareholders and arrangement involving gifts." Therefore, it seems reasonable to conclude that the Notice applies to private split dollar arrangements.

How should second-to-die rates be calculated?

The Notice offers no guidance on what rates to use as the reportable economic benefit for second-to-die life insurance policies used in split dollar and in fact, asks for comment and suggestions. Therefore, until such specific guidance is provided, the reasonable approach appears to be to feed the applicable single life rate (e.g., Table 2001 or other term rates) for each insured into the so-called "Greenberg-to-Greenberg letter calculation" in order to produce a second-to-die rate. Accordingly, our illustration systems will follow this procedure when calculating the reportable economic benefit for second-to-die policies.

For assistance and additional information you can contact us at advanceddesigns@pacificlife.com.

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