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The Next Word on Equity Split Dollar Taxation Internal Revenue Service Notice Outlines Further Guidance Limited Grandfathering Provided

Notice 2002-8

Provides Further
Interim
Clarification
Pending
Publication of
Proposed
Regulations
Solicits Comments

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On January 9, 2001, the Internal Revenue Service announced a fundamental change in the way it intended to view equity split dollar arrangements. It also replaced the PS 58 rates with substantially lower rates and imposed new requirements for use of an insurer's one-year term insurance rates. These changes were announced in IRS Notice 2001-10, which provided interim guidance pending consideration of public comments requested in the Notice and publication of further guidance. For a year, the public has awaited the additional guidance promised in Notice 2001-10, and the Service finally issued this guidance on January 3, 2001. Reflecting the philosophies of a new IRS administration different than the one involved in all prior split dollar commentary beginning in 1996, IRS Notice 2002-8 explains not only the adjustments to the taxation of equity split dollar, but outlines the procedures the Service intends to follow in its effort to eventually issue final guidance in the form of regulations to the Internal Revenue Code. The changes in taxation of equity split dollar are outlined below.

Purpose and Overview

This Notice:

- Revokes Notice 2001-10, which was published on January 29, 2001, and provided interim guidance on the taxation of split dollar life insurance arrangements. It also revokes Revenue Ruling 55-747, which contained the PS 58 rates used to value the economic benefit of current life insurance protection provided under a split dollar arrangement or a qualified retirement plan and modifies Revenue Rulings 64-328 and 66-110 to the extent they provided a split dollar arrangement could not be treated as a loan.
- Announces the Service's intention to publish new regulations which will for the first time distinguish between types of split dollar arrangements based entirely on who owns the underlying policy. The first type is an arrangement involving a life insurance policy owned by the party making the advances, who is referred to as the "sponsor" in the Notice, and the second type is an arrangement involving a life insurance policy owned by the party who does not make the advances, referred to as the "benefited party" in the Notice. The

Notice states the expected proposed regulations will treat the first type as arrangements providing a transfer of economic benefits from the sponsor to the benefited party and treat the second type as loans from the sponsor to the benefited party.

- Provides transitional “grandfathering” rules that phase in expected changes in the treatment of split dollar arrangements based upon the date of the arrangement.
- Provides guidance on valuing the economic benefit of current life insurance protection the benefited party receives under a split dollar arrangement, a qualified retirement plan or an employee annuity contract.

Observations: There are two categories of dates critical to our understanding of how the new rules will be administered. The first important category consists of arrangements entered into after the date of the final regulations. The second category consists of agreements entered into prior to the date of final regulations and is further divided into two subsets. One is agreements entered into before January 28, 2002, and the other is those which are all agreements entered into before the date of publication of final regulations.

Expected Proposed Regulations Will Govern Arrangements Entered into After the Date of Publication of Final Regulations

The Notice states the Treasury and the Service intend to issue proposed regulations which will abrogate the rule treating all forms of split dollar arrangements in the same way for federal tax purposes. This rule stating, “the same income tax results obtain if the transaction is cast in some other form resulting in a similar benefit to the employee,” which has applied since the IRS considered split dollar arrangements in Revenue Ruling 64-328, would be replaced by a system which the Notice characterizes as “two mutually exclusive regimes” based on the ownership of the underlying life insurance policy.

The first regime applies to an arrangement involving sponsor-owned life insurance (endorsement-type arrangements where the sponsor is formally designated as the owner of the life insurance policy). This type of arrangement would be treated as involving the transfer from the sponsor to the benefited party of an economic benefit measured by the value of current life insurance protection provided under the arrangement.

For employment-related arrangements, the Notice states the value of current life insurance protection and other economic benefits to the employee would be taxable as ordinary income under IRC section 61 and a transfer of the life insurance policy to the employee would be treated as a taxable transfer of property under section 83. Because any transfer of gain in the policy to the employee would require an actual transfer of the policy or an interest in the policy from the employer to the employee, the application of section 83 to such transfers would appear more reasonable than its application where the policy and all policy values are owned by the benefited party.

Observation: This approach is most like the tax treatment with which we are most familiar, but under past approaches we were allowed to apply to arrangements regardless

of who owned the policy. This regime is most akin to what we knew as endorsement split dollar arrangements in the past.

The second regime applies to an arrangement involving life insurance where the employee or another third party is formally designated as the owner of the policy. Advances made or premiums paid by the sponsor will be treated as loans. The original issue discount (OID) rules of IRC section 1271-1275 (for term loans) and the below market loan rules of IRC section 7872 would apply. No economic benefit costs would apply and no part of the cash value of the policy would be treated as a taxable transfer to the benefited party.

Observation: Unlike the choice given to taxpayers in IRS Notice 2001-10 of using either a loan approach or a non-loan (economic benefit/income) approach, these new rules will treat all advances as loans and expect proper accounting and reporting as such. You can read more about how the loan approach works by referring to the article on the 2001 Notice in the Spring 2001 issue of *Guardian Sentinel*, available on Guardian Online. Please note that it appears there will be no requirement for the benefited party to provide a security interest in the policy to the sponsor in the form of a collateral assignment, but we anticipate many sponsors will still prefer to secure their loan principal with such an assignment against the policy. We are examining the language of the current Guardian split dollar assignments and will make appropriate changes if necessary to reflect the changes expected under these new rules.

If the employee is not obligated to repay the premiums paid by the employer, the amounts would be treated as compensation income to the employee at the time the employer pays the premium.

Observation: Repeating the admonition first stated in IRS Notice 2001-10 but identified there as a “third” type of split dollar, Notice 2002-8 makes clear it is critical for a taxpayer to have proper documentation in the form of a written split dollar agreement. We strongly suggest there be no language in a split dollar agreement referring to even the possibility of forgiveness of the loan principal. The document should state clearly that the loan principal is expected to be repaid, and if possible, include the date the repayment is expected to be made.

The Notice states that the same principles governing split dollar insurance in an employment context would also apply to split dollar arrangements that provide benefits in gift contexts and corporation-shareholder contexts.

Observation: This statement provides us some assurance that the Service will continue to recognize split dollar arrangements outside the employer-employee context, and still leaves a market for policies designed to create liquidity for tax needs owned by third parties, such as irrevocable life insurance trusts.

Grandfather Provisions: Good News For Some And Even Better News For Others

Grandfathering applies to arrangements in existence prior to publication of final regulations. For these contracts, Notice 2002-8 states that the Service will not tax any increase in the employee's equity on an interim basis before termination of the arrangement. This statement tells us the Service does not intend to follow Private Ruling 9604001, which taxed the employee's gain in the contract on an annual basis as it accrued.

More specifically, under Notice 2002-8 three dates are critical in applying the grandfathering rules which phase in the new tax treatment of split dollar arrangements. Different rules apply to arrangements depending upon which category they fall into. We have editorially categorized these dates to more easily understand how these new rules are applied.

Category 1: All Arrangements In Effect Prior To The Publication Of Final Regulations

- A.** Arrangements entered into **before January 28, 2002** (the date Notice 2002-8 is scheduled to appear in the Internal Revenue Bulletin)
- B.** All arrangements entered into **prior to publication of final regulations**, including Category 1A arrangements

In other words, Category 1A arrangements can benefit from the rules applicable to BOTH Category 1A and 1B, but greater protection is provided to Category 1A arrangements if the parties act within the prescribed time limits outlined only for Category 1A.

Rules for Category 1A Arrangements (Entered into Before January 28, 2002)

Notice 2002-8 provides the greatest grandfathering benefits to those arrangements it describes as arrangements entered into before January 28, 2002, where a sponsor has made premium or other payments under the arrangement and has received or is entitled to receive full repayment.

- Notice 2002-8 provides that the Service will not assert the benefited party has received a taxable transfer of property at termination of the arrangement, in other words, the benefited party avoids paying tax on the employee's equity, if the arrangement is terminated before January 1, 2004.

Observation: We in Advanced Planning see this as the "get out while the getting is good" rule. Many alternatives exist to assist the taxpayer in terminating a split dollar arrangement (see the article on exit strategies in the Summer 2000 issue of Guardian Sentinel available on Guardian Online).

- The Notice also provides that the Service will not tax the employee's equity at termination of the arrangement if, beginning on January 1, 2004, the parties treat all payments made by the sponsor from inception of the arrangement (less any repayments already made) as loans. Any

payments made by the sponsor before the first taxable year in which loan treatment is adopted must be treated as loans made at the beginning of that first year. The OID rules of IRC sections 1271-1275 and the below market loan rules of IRC section 7872 will apply. For any arrangement entered into before publication of final regulations, the Service indicated it will not challenge reasonable efforts to comply with the requirements of the OID rules or the below market loan rules.

Observation: For those who wish to continue their split dollar arrangements, the election of loan treatment before 1/1/04 protects the equity from taxation at termination. We strongly urge clients with existing arrangements to make certain they choose one of these two alternatives available ONLY to Category 1A arrangements.

Rules for Category 1B (Any Arrangement Entered Into Before The Date Final Regulations Are Published)

Notice 2002-8 provides great flexibility for arrangements entered into before final regulations are published. The parties to such an arrangement are not required to follow the mutually exclusive regimes mandated for arrangements entered into after final regulations are published, but may choose one of three alternative treatments of the arrangement:

1. Since the Service is not going to force parties with arrangements in existence prior to publication of final regulations to follow the new mandatory regimes, the parties may continue to characterize the arrangement under traditional split dollar principles as the split of the benefits and burdens of the policy between the parties under Rev.Rul. 64-328 as now interpreted by the Service. The Service may, however, assert that when the arrangement is terminated, the benefited party has received a taxable transfer of property. In other words, **it may require tax to be paid on the employee's equity in the contract.**

Observation: This appears to be an attempt to allow taxpayers the ability to construct or continue their split dollar arrangements under the old rules, and take their chances on taxation of employee equity. Having monitored the split dollar rulings and attacks over the past 20 years, the staff of the Advanced Planning Department suggests you have clients construct any new agreement from this point forward under the new rules. Despite the existence of an option to "switch horses in mid-stream" by adopting loan treatment at a later point, the risk of still having the equity taxed at termination of the agreement coupled with the additional attorney's fees required if the agreement is changed at a later date tends to make us believe the prudent action is to encourage the use of the new rules beginning immediately.

2. The Notice states the Service will not treat Category 1 A and/or B arrangements as terminated and thus will not assert there has been a transfer of property to the benefited person by reason of termination of the arrangement so long as the parties treat the life insurance protection as an economic benefit provided to the benefited party. This will be true regardless of the level of the sponsor's remaining economic interest in the life insurance policy.

Observation: In response to a considerable number of comments submitted complaining that the tax upon termination rules outlined in Notice 2001-10 would effectively prevent a

taxpayer from being able to continue a split dollar arrangement until death, we interpret this provision as an effort to allow the perpetual continuation of the split dollar agreement. For example, if an individual wished to use the living values in the policy as supplemental retirement income, he or she could do so, thus reducing the death benefit and resulting economic benefit costs and potentially avoiding income tax on the employee's equity in the contract. The risk exists that the withdrawals and/or loans from the policy can eventually cause the policy to lapse, triggering immediate taxation on ALL gain in the contract. If choosing this option, it would be important to calculate the ongoing costs of continuation by determining the current tax savings from avoiding current taxation of equity against the costs of continuing economic benefit taxation and policy loan interest payments (either from within the policy or without). This option may make more sense for the taxpayer who is already taking income from his or her policy, as opposed to someone who is years away from that action.

3. The parties may convert an existing split dollar arrangement to loan treatment. The parties must treat all payments made by the sponsor from inception of the arrangement (less any repayments already made) as loans. Any payments made by the sponsor before the first taxable year in which loan treatment is adopted must be treated as loans made at the beginning of that first year. The OID rules of IRC sections 1271-1275 pertaining to term loans and the below market loan rules of IRC section 7872 will apply. Notice 2002-8 states that for any arrangement entered into before publication of final regulations, the Service will not challenge reasonable efforts to comply with the requirements of the OID rules or the below market loan rules.

Observation: Although this sounds very similar to the language protecting Category 1A (pre-01/28/02) arrangements from tax on the equity at termination of the arrangement, there is no assurance given that taxpayers in this category (1/28/02 through final regulations) would also enjoy tax-free treatment of equity when the arrangement is terminated. This, however, does not mean the Service will necessarily be successful in an attempt to tax the equity at termination. Further, it is unclear whether a conversion to loan treatment will be considered to be a "termination" of the existing split dollar arrangement and thus trigger tax on the employee's equity.

Since the language explicitly giving protection from taxation on equity at termination is specific with regard to pre-1/28/02 contracts (Category 1A), it is logical to believe **NO SUCH PROTECTION WILL BE GIVEN TO THOSE WITH ARRANGEMENTS EFFECTIVE ON OR AFTER OF 1/28/01.**

Valuing Current Life Insurance Protection Provided To The Benefited Party

Notice 2002-8 also provides interim guidance on the valuation of current life insurance protection. The Notice states, however, this guidance is provided pending the Service's consideration of comments on the valuation of economic benefits and publication of further guidance.

While change is likely in this area, Notice 2002-8 states in general that taxpayers may rely on the Notice for split dollar life insurance arrangements entered into before the date final regulations are published.

Under Notice 2002-8, three dates, which are different than the dates used to create the Categories described above, are critical in valuing current life insurance protection. Different rules apply to arrangements depending upon the date of the arrangement.

- Before January 28, 2002
- After January 28, 2002 but before the effective date of further guidance (please note this is **not** the same as the date of publication of final regulations)
- After the effective date of further guidance (again, **not** the date of publication of final regulations)

Due to an anomaly in the dates, if a taxpayer enters into an agreement precisely on January 28, 2002, the taxpayer must follow the rules outlined under the category for “Before January 28, 2002” with the exception of the use of the PS 58 rates, which that taxpayer may not use in any case.

Rules for Valuing Life Insurance Protection

Arrangements Entered into BEFORE January 28, 2002

There are three choices.

1. The insurer’s published premium rates available to all standard risks for initial issue one-year term insurance may continue to be used where that rate is lower than the Table 2001 rate, even though additional requirements will be imposed for use with arrangements entered into after 1/28/02.

Observation: Again in an effort to recognize precedent, pre-1/28/02 arrangements appear to be allowed to use the issuing company’s alternative term rates, despite the fact the rules will most likely change for arrangements entered into after January 28, 2002. So long as the present alternative term continues to be offered for sale by the issuing company, taxpayers with arrangements dated prior to 1/28/02 will be allowed to use that rate or any other alternative term rate supported by the issuer. Guardian will make every attempt to create an alternative term product available once the issue of requirements is finally settled. Currently, our illustration system includes the rates as prescribed in Table 2001-10 as well as the current one-year and survivor one-year term rates. It has become clear that our in-force split dollar illustration system will need greater enhancement and greater flexibility as the new rules become finalized.

2. The rates in the table set forth at the end of Notice 2002-8 can be used to value current life insurance protection. This table is identical to Table 2001, which was contained in Notice

2001-10, and is also called Table 2001. Table 2001 may also be used to value life insurance protection provided under a qualified retirement plan or employee annuity contract.

Table 2001 rates are used to value insurance on a single life, but Notice 2002-8 states taxpayers should make appropriate adjustments to these rates if insurance covers more than one life.

Observation: This appears to justify the use of Table 2001 rates adjusted to reflect the mortality for two lives.

3. If the contractual arrangement provides PS 58 rates will be used to value the current life insurance protection, and if an employer is providing the current life insurance protection being valued to an employee or to an employee and one or more additional persons, the parties may continue to use PS 58 rates.

Observation: Because use of PS 58 rates is limited to arrangements in which life insurance protection is provided TO an employee, PS 58 rates **MAY NOT** be used to value the life insurance protection in reverse split dollar arrangements.

Arrangements Entered into AFTER January 28, 2002 But Before the Effective Date of Further Guidance

These arrangements cannot use PS 58 rates to determine the economic benefit of current life insurance protection for federal tax purposes even if the contractual arrangement specifies the use of PS 58 rates. These arrangements can value current life insurance protection in one of two ways:

1. The rates in the table set forth at the end of Notice 2002-8 can be used to value current life insurance protection. This table is identical to Table 2001, which was contained in Notice 2001-10 and is also called Table 2001. Table 2001 may also be used to value life insurance protection provided under a qualified retirement plan or employee annuity contract.

Table 2001 rates are used to value insurance on a single life, but Notice 2002-8 states taxpayers should make appropriate adjustments to these rates if insurance covers more than one life.

2. The insurer's published premium rates available to all standard risks for initial issue one-year term insurance may be used until the end of 2003 where that rate is lower than the Table 2001 rate. Beginning in 2004, the insurer's published term rates may be used only if the insurer generally makes the availability of such rates known to persons who apply for term insurance coverage from the insurer and regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels. The Service has said unless the insurer meets these requirements, the insurance will not be considered to be available to all standard risks, and the insurer's published term rates cannot be used.

Observation: While it is unclear at this point what an insurer must do in order to make its rates known or to be considered to regularly sell policies at such rates through its normal distribution channels, it is noteworthy that Notice 2002-8 has dropped the requirement found in Notice 2001-10 that the insurer must not more commonly sell term insurance at higher premium rates to individuals it classifies as standard risks.

Arrangements Entered into After the Effective Date of Future Guidance

Notice 2002-8 does not indicate what rules may apply in valuing current life insurance protection provided under these arrangements.

Observation: It appears decisions in this area will be delayed until after the Service has the opportunity to analyze the comments it has requested from the public in this Notice.

Comments Requested by the Service

Treasury and the Service have requested comments on this Notice. In particular, they specifically request comments by April 28, 2002, on

- the appropriate rates for valuing current life insurance protection,
- the standards that should be required for use of the insurer's published premium rates,
- whether one or more premium rate tables should be prescribed as the exclusive basis for valuing current life insurance protection, and
- if such premium rate tables are prescribed, how such tables should be determined and whether premium rates charged by life insurance companies can be used for this purpose.

Conclusion

IRS Notice 2002-8 although complicated, is considerably clearer than the interim "guidance" offered in Notice 2001-10. Generally speaking, however, the guidance and direction given in the current Notice is extremely favorable, particularly for agreements in existence before January 28, 2002.

It is clear in the future most arrangements will operate as a loan if the employee or a third party owns the policy. In the current interest rate environment, this may result in more beneficial treatment than that resulting when the economic benefit is taxed.

It is now (and in our opinion has always been) more than critical that a well-drafted split dollar agreement outline the terms of the arrangement as well as the ownership of the underlying policies in order to ensure the treatment the taxpayer receives is the treatment the taxpayer expects.

The Service has solicited commentary from the public, particularly with regard to the valuation of the life insurance protection. There will be another opportunity to comment when the proposed regulations are issued.

Please be assured Guardian and the industry organizations representing you are working diligently to formulate appropriate positions regarding the issues appearing unclear as well as proposals related to alternative term rates. As that information becomes available, we will inform you.

Split dollar has survived as a reasonable method of financing the purchase of desired life insurance. By allowing split dollar to survive at all, the Service has clearly indicated its respect for the public policy value of life insurance. Additionally, the actions outlined in the Notice reflect the Service's sensitivity to the promises made to existing policyholders who based their expectations on years of split dollar taxation precedent.

The text of this Notice was emailed to all agency heads on Monday, January 7, 2002. A copy of Table 2001 is available on Guardian Online.

There will be another opportunity to comment when the proposed regulations are issued.

Please feel free to contact the attorneys in the Advanced Planning Department to discuss this Notice and any other questions you may have.