

**Western Reserve Life Advanced Marketing**  
**Special Report**

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**WRL Bulletin No. 01-001**

**January 10, 2001**

**Subject: IRS Notice 2001-10**

IRS has released Notice 2001-10 clarifying its position with regard to Split Dollar arrangements. Reproduced below with permission of Stephen Leimberg is his analysis.

**Steve Leimberg's News of The Week Newsletter**

**Subject: IRS NOTICE 2001 - 10 MAJOR EQUITY SPLIT DOLLAR NOTICE!!!**

It is well after midnight and I'm about to go through over 20 pages of rather complex material. So please understand that in the rush to get this extremely important information out to you, my commentary is one of first impression - and I and other members of the LISI team will be providing extensive follow-up.

NOTICE: Because of the great importance of this notice, you have our permission to share it freely and reproduce it - but only in its entirety.

Steve Leimberg

**EXECUTIVE SUMMARY:**

The IRS has issued a Notice that announces it is reviewing (a) the federal income tax treatment of employer-employee split dollar as well as (b) split dollar arrangements involving compensation to non-employees, (c) split dollar economic benefits to corporate shareholders, and (d) split dollar arrangements involving gifts (which I am interpreting as possibly including private split dollar).

The Service stated that Notice 2001-10 is intended to do three things: (1) clarify prior rulings, (2) provide interim guidance until more permanent guidance is issued, and (3) serve as a notice and request for comments from practitioners - which doubtlessly it will receive. In a nutshell, under this Notice, every payment made by an employer in a split dollar arrangement must be treated as either (1) a loan, or (2) an employer investment, or (3) currently taxable compensation income to the insured employee.

**FACTS:**

The IRS begins Notice 2001-10 with a review of the history of the income taxation of split dollar agreements - including the role of Rev. Rulings 64-328 and 66-110. It quickly concludes that none of these directly addresses the modern form of equity split dollar. It defines equity split dollar as an arrangement under which - due to the fact that the employer's interest in the policy's cash value is limited to the aggregate amount of its premium payments - the employee derives the entire economic benefit of any positive return on the employer's investment. (Again, although the ruling speaks to employer-employee relationships, the IRS makes it clear that it believes the same principles govern the income tax treatment of split dollar in other contexts).

The IRS states that the employee is, under the equity split dollar plan described in the paragraph above, deriving a valuable economic benefit which goes beyond the life insurance protection he/she is also receiving. So the Service concludes it is necessary for the covered employee to account for - and pay tax on - that additional benefit. That taxation should follow the contractual positions and actions of the parties.

**SECTION 83 INCOME:**

If the contractual arrangement giving rise to the equity split dollar arrangement is based on an employer-employee relationship and if what the parties intended is a transfer of property (beneficial interest in cash values) from employer to employee, Code Section 83 applies. This could take the form of a single transfer or a series of transfers - depending on the facts. In any event, the employee would have currently reportable income under Code Section 83. Up to this point, it all seems relatively straight-forward. But here's where the fun begins.

**SECTION 7872 INCOME:**

The IRS goes on to say, the substance of the agreement will determine whether or not there has been a transfer of property under Code Section 83. If, from inception, the employee was intended to be the beneficial owner, than the IRS may treat the transaction as a series of loans from the employer to the employee.

Here, the Service states, "Assuming there is reasonable and bona fide expectation the employer will receive repayment of its share of the premiums AT A FIXED AND DETERMINABLE FUTURE DATE (emphasis added), than the arrangement may IN CERTAIN CIRCUMSTANCES (emphasis added) be properly treated as the acquisition of a life insurance contract by the employee with the proceeds of a loan or series of loans from the employer to the employee, secured by the life insurance contract, rather than an arrangement whereby the employer acquires ownership of the life insurance contract and provides economic benefits to the employee thereunder."

The result of such a characterization would be that the split-dollar arrangement would be treated as a "compensation-related below-market loan", i.e. one in which the interest charged was less than the AFR (Applicable Federal) rate. The result is that payments imputed to the "borrower" would be treated as currently taxable compensation income. The Service quickly forecloses the argument that Code Section 7872 (which deals with below-market loans) is inapplicable to split dollar arrangements - if the arrangement in question is in fact a loan.

**CURRENT TAXATION UNDER ONE THEORY OR ANOTHER:**

So at this point, the IRS is saying that the employee's annual increase in wealth under equity split dollar may be taxable currently under Code Section 83 or it may be currently taxable under Code Section 7872 - depending on the intent of the parties as evidenced by the split dollar agreement as well as any other relevant facts and circumstances.

**VALUATION OF INCLUSION:**

The IRS then addresses the antiquated P.S. 58 tables and states that those rates are clearly out of date and inappropriate. They no longer approximate the real cost of term insurance. According to the Notice this has lead some taxpayers to over-report income. And the Service notes, the abuse of the word "may" wording has led some taxpayers to understate income. Specifically, the IRS points to the use of the obviously inappropriate P.S. 58 costs in so called "Reverse Split Dollar" arrangements and states that in reverse split dollar where the P.S. 58 table was used, the value of policy benefits allocated to the employer were overstated - resulting in the understatement of the income the employee should have reported.

**SUBSTITUTE RATES OUT - NEW TABLES IN:**

The Notice then tackles the "substitute" or "alternative" term rates, i.e., the use of one year term policies issued by insurers, the so called "published term rates." The Service expresses concern that such rates may not be realistically available to all standard insureds. (It's saying in a polite way that it didn't like some of the games that were being played). Nor, states the IRS, was there any practical way to prove that all standard insureds could obtain the substitute rate.

Finally, on this issue, the IRS feels it was unfair that the reportable rate could easily vary from taxpayer to taxpayer if different taxpayers were insured by different insurers.

The upshot of the commentary in the preceding paragraphs is that the IRS, to “ease administrative burdens, minimize disputes, and provide greater assurance that similarly situated taxpayers are treated the same,” that for both split dollar and for situations involving life insurance in qualified retirement plans, a new table (or new set of premium rate tables) should be used. That table is described below and will soon be published in LISI archives.

**PICK YOUR POISON:**

So, pending further taxpayer feedback to the IRS and guidance from it, here are the interim guidelines and general rules:

The parties to an equity split dollar agreement can characterize it as EITHER Section 83 income or as a loan (or series of loans) from the employer. O.K. That’s not totally accurate. Actually, Notice 2001-10 says that the parties can characterize the employer’s outlay ANY WAY THEY WANT.

Of course, there’s a BIG BUT:

First, the characterization must be ESSENTIALLY CONSISTENT with the realities of the arrangement.

Second, that characterization must have been FOLLOWED by the parties from the time the split dollar agreement took affect.

Third, the parties must FULLY ACCOUNT FOR ALL ECONOMIC BENEFITS received by the parties - in a manner that follows from the way the parties have characterized (transfer of property or loan) the transaction.

**BELOW-MARKET LOAN TREATMENT:**

If the parties CHOSE to treat equity split dollar as a loan or series of loans - AND if they MEET ALL THREE TESTS described above - than Code Section 7872 will govern. This means:

- (1) No additional income will be charged to the insured employee for the term insurance protection.
- (2) The policy’s cash value will not be taxable to the employee under Code Section 83.

All bets are off, however, and the employee WILL have additional reportable income under these two concepts - if the employee doesn’t pay off the loan according to the schedule in the agreement.

An employee - even if he/she meets all the above tests - can still have additional income - under Code Section 72 - for DISTRIBUTIONS ACTUALLY RECEIVED UNDER THE CONTRACT.

**WHEN LOAN TREATMENT DOES NOT APPLY:**

What if the tests above are not met or if the parties decide what really is occurring is something other than a loan or series of loans? If the parties have not - consistently - treated the arrangement as employer loans, they will be treated as if they chose a “non-loan” treatment.

What’s that mean?

First, the parties must fully account for all the economic benefits the employee receives in accordance with the chosen non-loan - or default non-loan - characterization. (The use of the term, “parties” seems to be placing some reporting responsibility on the employer). Here, Rev. Rulings 64-328 and 66-110 are used - not alone - but TOGETHER WITH the parties’ characterization AND TOGETHER WITH the general tax principles upon which those rulings are based. (That implies to me that the IRS is not about to be hamstrung by taxpayer’s literal reading of the facts in those rulings.)

More specifically, if loan treatment is not chosen or is unavailable:

- (1) The employer will be considered to have obtained beneficial ownership in the policy through its premium payments (presumably regardless of whether or not the employee or third party such as a trust actually and initially applied for the policy), and
- (2) The employee will have currently reportable compensation income each year - under Code Section 61 - for the term insurance coverage (reduced, of course, by premium payments the employee makes), and
- (3) The employee will have currently reportable compensation income each year for any dividends (or similar benefits) received directly or in the form of additional policy benefits - under Code Section 61, and
- (4) The employee will have currently reportable compensation income each year for any substantially vested interest acquired in the policy's cash value (reduced, of course, by any consideration paid by the employee for that interest).

***TIME OUT - MAYBE:***

Until the IRS issues further guidance, it will not treat an employer as having made a currently taxable Section 83 transfer – SOLELY because INTEREST AND OTHER EARNINGS on the policy cash value exceeds the amount repayable to the employer under the policy. If the IRS at some later date decides interest or other earnings are subject to Section 83, THAT income will be taxable only from the date of such guidance and onward. It will NOT be taxable retroactively. (The IRS seems to be saying, it may use Section 83 to cause the employee to be taxable - but ONLY to the extent the employee is enriched with employer dollars - and NOT - unless it changes its mind - taxable on the earnings and interest ON those dollars.)

***TAXATION WHERE TRANSACTION NOT CONSISTENTLY TREATED AS LOAN:***

As long as a split dollar arrangement (apparently ANY split dollar arrangement) remains in effect and it hasn't been consistently treated by the parties as an employer loan, than:

- (1) the covered employee has currently reportable income under Section 61 for the term insurance coverage (technically the net amount at risk) (Reduced by premiums the employee has made toward that coverage or reduced by any taxable income the employee had to report because of dividends received or credited as well as any income reportable under Section 83). (If such an allocation is necessary, the IRS has agreed to accept any REASONABLE METHOD for determining the allocation - or will accept a pro-rata allocation (which will probably be the one selected in most cases for certainty and simplicity). In other words the portion of the death benefit generated by employer and employee dollars can be determined based on relative payments.
- (2) To the extent an employer makes a premium (or other) payment but receives no beneficial interest in the policy nor has a reasonable expectation of receiving repayment (through proceeds or otherwise), the insured employee will have currently taxable Section 61 income equal to the entire payment.

***NEW TABLE:***

Notice 2001-10 revokes Rev. Rul. 55-747. That means P.S. 58 rates are no longer the standard for measuring the economic benefit received by an insured for the net amount at risk payable to the insured's beneficiary.

Exception: P.S. 58 rates can be used as in the past for taxable years ending on or before December 31, 2001.

Table 2001: The Notice provides a new table - with rates substantially lower than the P.S. 58 rates - based on Section 79 regulations. (Extensions are provided for ages below 25 and above age 70).

***SUBSTITUTE RATES STILL POSSIBLE - BUT:***

Even with the new Table 2001, substitute rates, i.e. the insurer's one year published term rates for standard risks, can still be used. In other words, in valuing the net amount at risk, a taxpayer may still substitute for the table rates the insurer's lower PUBLISHED PREMIUM RATES

AVAILABLE TO ALL STANDARD RISKS FOR INITIAL ISSUE ONE YEAR TERM INSURANCE  
- but only if the following “no playing games” tests are met:

First, the insurer must let people who apply for term insurance know about the availability of the lower rates.

Second, the insurer must regularly sell such insurance - at the lower rates - under its regular distribution channels.

Third, the insurer can’t more commonly sell term insurance at higher rates to individuals considered standard risks.

One other little catch: The Notice makes it clear that this ability to chose substitute rates may not last forever. With respect to term contracts issued after March 1, 2001, the IRS makes no assurance that the substitute method will be available after the later of (a) December 31, 2003 or (b) December 31 of the year the IRS publishes further guidance. We’ve been warned!

Bottom line? We’ve got a complex, confusing, potentially harsh, and certainly difficult to explain new ballgame. The IRS has given itself lots of room to interpret things here - and the power to define the word is the power to rule the world.

LISI will be publishing the new tables soon. And we’ll be providing feedback and commentary from some of the top split dollar experts in the country.

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