SUPPLEMENTAL COMMENTS CONCERNING IRS NOTICE 2001-10

We previously provided to you comments on IRS Notice 2001-10 in our submission dated April 23, 2001 (the “initial comments”). As requested, we are now providing supplemental comments regarding certain issues raised by the initial comments. This letter, like our initial comments, reflect the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committees on Employee Benefits, Insurance Companies, Estate and Gift Taxes and Small Law Firms and Closely Held Businesses of the Section of Taxation. Andrew C. Liazos exercised principal responsibility, and Max Schwartz, Diane J. Fuchs, Alan Jensen, Steven H. Sholk, Robert Abramowitz, Susan Harmon, Tom Quinn and Mike Gunter made substantive contributions. The comments were reviewed by Diane J. Fuchs, Chair of the Committee on Employee Benefits, by Bruce Pingree, as a member of the Tax Section's Committee on Government Submissions and by Susan Serota, of the Tax Section Council.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Executive Summary

Our initial comments suggested that several issues be considered in connection with issuing final guidance for split-dollar life insurance arrangements ("SDAs"), including SDAs that provide employees a contractual right to policy cash surrender value ("Equity SDAs"). We supplement our initial comments at this time by recommending rules to address issues relating to (A) the treatment and tax reporting of Equity SDAs as "below-market loans" under Section 7872 of the Code,\(^1\) (B) who should be treated as the beneficial owner of a policy subject to an Equity SDA for tax purposes, (C) whether an employee should have basis in a policy subject to an Equity SDA, and (D) the valuation of current life insurance protection under an Equity SDA. For your convenience, we attach as our initial comment as Exhibit A and refer to the paragraph numbering therein.

We have not commented further on whether and how grandfathering rules might be developed and applied to Equity SDAs. There has been significant disagreement on the grandfathering issue, including whether an income tax is properly assessable against an employee covered under a pre Notice 2001-10 Equity SDA before policy cash value has been accessed in any manner. We request the opportunity to comment on any proposed grandfathering treatment that may be developed in the future.

A. Loan Treatment under Section 7872 (paragraph I.A of initial comments)

We suggested in our initial comments that future guidance address several issues regarding how Section 7872, if applicable, might apply to Equity SDAs. Set forth below is our recommended approach to address those issues.

1. Demand Loan vs. Term Loan Characterization (paragraphs I.A.1 and 2 of initial comments)

The provisions set forth in an Equity SDA determine whether the arrangement is a "term loan" or a "demand loan" under Section 7872. Section 7872(f)(5) defines a "demand loan" as any loan payable in full whenever the lender demands repayment. In addition, a demand loan includes a nontransferable loan that conditions the benefits of the interest arrangement on the future performance of substantial services as defined under Section 83 (the "Deemed Demand Loan Rule"). Proposed regulations clarify that a "term loan" is repayable at an ascertainable time, including a time that may be determined actuarially. However, the proposed regulations reserve rules for loans covering a period of time that is not ascertainable. Set forth below is our analysis of how these rules might apply to provisions we commonly encounter in Equity SDAs.

\(^1\) All Section references are to the Internal Revenue Code of 1986, as amended from time to time and the regulations thereunder unless otherwise indicated.
a. Recovery of Premiums by Employer Only on Employee's Death

Many Equity SDAs allow the employer to recover its premiums only upon the employee's death. Equity SDAs that provide for recovery based on the employee's life expectancy are properly treated as term loans under Section 7872 and its proposed regulations. The employee's life expectancy can be calculated actuarially, so the premium recovery right attributable to the employee's death is payable at an ascertainable time.

b. Recovery of Premiums by Employer Upon Earlier of Death or Termination of Employment

A typical Equity SDA provides that the employer may recover its premium payments on the employee's death or, if earlier, the employee's termination of employment. We suggest that this type of Equity SDA be treated as a demand loan whether or not the arrangement qualifies as such under the Deemed Demand Loan Rule, as the period of an employee's employment is not reasonably ascertainable. It is impractical to assign a term for repayment with this type of arrangement - employment relationships are terminable at the behest of either party regardless of whether an employment contract provides for a specified term. Further, because the group of employees typically benefiting under such arrangements is small and their roles in and importance to the organization are so disparate, the development of any group turnover assumption and the selection of a term based on any such assumption are speculative at best.

We note that there could be an adverse impact on the public fisc by treating these arrangements as term loans. Employers would have an incentive to use a term shorter than the actual term when determining compensation income under Section 7872. To the extent that the term of the loan determined by the employer is less than the actual term of employment, the employee will have reported less compensation income than if the loan were treated as a demand loan (assuming that the interest rate remains constant during the period). The lack of objective criteria for selecting any term for a loan, when combined with the material difference in tax result depending on the length of the term, can result in significant audit controversy and widely disparate treatment of these arrangements. This outcome would not be a prudent and efficient use of scarce IRS administrative resources.

We further suggest that Treasury consider promulgating rules for these types of Equity SDAs in connection with contemplated provisions under the proposed regulations to Section 7872. Proposed Regulation Section 1.7872-10(d) reserves provisions to address the proper income tax treatment for loans for a period of time not ascertainable. It appears to us that Equity SDAs that provide for repayment of premiums to an employer based on an employee's period of employment fall within this description.
2. Calculating the Period for a Term Loan (paragraph I.A.3 of initial comments)

Assuming that the Equity SDA described in paragraph 1a. above is a "term loan" for purposes of Section 7872, rules to determine the length of the term should be provided. We suggest that the Service publish a standardized table from which taxpayers may select the term for their loan. The standardized table should be consistent with the life expectancies contained within the final valuation tables used to report death benefits under SDAs.

3. Identifying the Loans Subject to Section 7872 (paragraph I.A.4 of initial comment)

We suggest that all prospective premium payments made within a calendar quarter be aggregated, and that such amounts be considered paid on the last day of such quarter. In addition, with respect to demand loans, premium payments made in prior years that can be recovered in the current year should be treated as made on January 1 of the current year. As we noted in our initial comments, a literal reading suggests that each premium payment is a separate loan.\(^2\) Aggregating premium payments will reduce the number of outstanding loans with respect to any single Equity SDA. Aggregating loans on a quarterly basis using the last day of the calendar quarter will provide the IRS and taxpayers with a level of predictability in ascertaining the correct interest rate while reducing the administrative burden to employers and third-party service providers.

4. Employer Interest in Excess of Premium Payments (paragraph I.A.5 of initial comment)

Many Equity SDAs increase the employer's recovery right by an adjustment factor as compensation for the use of its funds. The adjustment factor used for the increase often is the employer's cost of capital or, in some cases, the applicable federal rate as in effect when the parties established the Equity SDA. Set forth below are applications of our recommended rule for Equity SDAs treated as either demand loans or term loans that provide for each premium payment to be increased by a fixed adjustment factor.

a. Demand Loan

If the Equity SDA is a demand loan, the amount of compensation income to the employee would equal the interest on the outstanding loan using the applicable federal rate less the employer's enhanced recovery right solely attributable to the adjustment

\(^2\) See Prop. Reg. §1.7872-2(a)(3) (stating "each extension of credit or transfer of money by a lender to a borrower is treated as a separate loan").
factor (and not previously taken into account in any prior year). Assuming that the applicable federal interest rate for a demand loan in the current year is five-percent, there would be no compensation income to the employee if the Equity SDA’s adjustment factor is also five-percent. To the extent that the employer has an additional recovery right due to an additional earnings adjustment for prior year premium payments, such amounts would also serve as an offset against compensation income.

b. Term Loan

If the Equity SDA is a term loan, the amount of compensation income to the employee may be determined using a present value calculation reflecting the increased recovery right that the employer would have if the repayment occurred at the end of the term. If the Equity SDA uses a rate of recovery that varies during the term of the loan and the amount of the variation is unknown on the loan date (i.e., policy earnings, mutual fund index), the applicable federal rate would be used as a proxy for determining the adjustment to the employer’s recovery.

For example, assume that a fifty-five year old employee has an Equity SDA that provides the employer a four-percent annual increase to its premiums recoverable on death. The parties would determine the amount that would be immediately recoverable by the employer at the end of the employee’s life expectancy after adjustment for the annual four-percent increase. The loan amount would then be reduced by the adjusted recovery right to determine the compensation income to the employee.

5. Payments by Employee under Existing Equity SDAs (paragraph I.A.6 of initial comment)

Many Equity SDAs require the employee to pay for a portion of the policy premium. It is likely that these agreements will continue to require the employee to pay a portion of the premium (such as the P.S. 58 rate) unless the parties subsequently agree otherwise. Guidance is needed to characterize these payments for tax purposes.

We suggest that any payments made by an employee with respect to a demand loan be treated first as a payment of interest and then as a payment of principal, which is consistent with general commercial practice, the payment ordering rule for original issue discount under Treas. Reg. §1.1275-2(a), and the payment ordering rule for accrued interest under Treas. Reg. §1.446-2(e). We further suggest that with respect to term loans, payments towards the policy that an employee is contractually obligated to make be counted in the present value calculation under Section 7872(b). The employee’s nonpayment of interest when due on a term loan would result in compensation income. Finally, only payments towards principal, whether made by the employer or the employee, create basis under Section 72 for purposes of future distributions.
6.  **Tax Reporting (paragraph I.A.7 of initial comment)**

It appears that employers will be responsible to report compensation income from below market loans under Section 7872. We recommend that failure of an insurance company to provide contractually required information needed for an employer to report compensation income be "reasonable cause" under the penalty provisions of the Code that might otherwise apply to the employer.

7.  **Gift Tax Implications (paragraph I.A.8 of initial comment)**

Many Equity SDAs provide for the employee's irrevocable life insurance trust ("ILIT") as a party. Proposed regulations under Section 7872 provide for a loan to a third-party to be treated as an indirect loan to the employee, followed by a subsequent transfer by the employee to the third-party under certain circumstances. We suggest that if an Equity SDA is extended to an ILIT established by an employee, that the arrangement be treated as a below-market loan to the employee, with any compensation income taxed to the employee treated as a taxable gift to the ILIT, as such treatment would be consistent with the proposed regulation.

B. **Beneficial Ownership (paragraph I.B.2 of initial comment)**

You have asked for our comments regarding whether the employer or the employee should be treated as the beneficial owner of a life insurance policy subject to an Equity SDA. If the employer is treated as the policy's beneficial owner, then Section 83 of the Code may at some point apply to the transfer of the cash surrender accrued under the policy. If the employee is treated as the policy's beneficial owner, then Section 83 of the Code does not apply to any portion of the policy.

We recommend that the method for establishing an Equity SDA determine who - the employer or the employee - should be treated as the owner of the policy for tax purposes. In addition to reflecting the non-tax reasons for different Equity SDA structures as noted in our initial comments, this approach respects the form and economic substance of the transaction.

1. **Creditors’ Rights Under State Law**

The ownership of the policy under state law significantly impacts creditors’ rights to policy cash surrender value. If an Equity SDA is established using the endorsement method, the employer owns the policy and the entire cash surrender value will be available to the employer’s creditors. The employee has no equity to protect in an endorsement split-dollar arrangement from the claims of the employee’s creditors. If the collateral assignment method is instead used to establish the Equity SDA, the employee, rather than the employer, owns the policy, and the employer can recover only the amounts to which it is entitled under the contract. If the agreement provides solely for a
return of the premiums that the employer has advanced, then the excess cash surrender value belongs to the employee after the employer has been paid those advanced premiums. As a result, the employer's creditors have no greater rights than the employer and can obtain from the policy only the interest defined under the contract as owed to the employer. The employer’s rights in and to the cash surrender value of the policy are solely contractual in nature because the employee, and not the employer, owns the policy.  

2. Section 83 Analysis

a. Collateral Assignment

As noted above, the employee is the legal owner of the policy when the collateral assignment method is used to establish an Equity SDA. The employer's interest in the policy is limited to a collateral assignment interest that secures the repayment of the employer’s payment of premiums. Further, the employer does not have a property interest in the policy that it can at any time transfer to the employee. The employee retains all incidents of ownership in the policy. We have not found any authority under Section 83 to support the proposition that the employee’s grant of a security interest provides the employer with a property interest that it can later transfer to the employee when the employer is repaid.

We understand that there is some concern that the employee is not, in substance, the beneficial owner of the policy when too many rights are assigned to the employer. Equity SDAs using the collateral assignment method often grant employees significant rights. Aside from the right to all policy cash surrender value in excess of the employer's security interest, the employee often has the right to change beneficiaries and to make investment elections. Other rights may also include the right to receive distributions on demutualizations, and the right to receive living needs benefits on the employee’s terminal illness.

The creation of an Equity SDA using the collateral assignment method may be viewed as analogous to other creditor-debtor transactions. For example, the security interest granted by a consumer to a commercial lender for an automobile purchase often

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3 From the employee’s perspective, if he or she as the insured and policy owner is insolvent, then the cash value of the policy owned by the employee in a collateral assignment SDA is commonly protected from the claims of his or her creditors under state and federal bankruptcy laws. See, e.g., 11 USC §522(d)(7); ORS 743.046(3); 42 Pa.C.S.A. §8124(c). In the event of the employee’s insolvency, the employer would be entitled as a secured creditor to amounts it has advanced under the agreement with the employee. The excess would be protected under the cited statutes.
grants the lender substantial rights to the automobile. Nevertheless, there is little question that the consumer is the legal and beneficial owner of the automobile notwithstanding the lender's substantial interest in the automobile. Similarly, the employer in a collateral assignment Equity SDA only has the right to receive repayment of its policy premiums, and not the right to receive the actual policy itself unless the employee fails to satisfy the repayment obligation.

Authority suggesting that a debtor-creditor relationship can be recharacterized should not apply to Equity SDAs. A debtor-creditor relationship can be treated as an equity investment if the lender has an economic interest in the debtor. These cases typically involve an equity kicker with rates of return to the creditor based on business performance coupled in some cases with control over the debtor's business. Equity SDAs, by their nature, do not provide any rate of return on the employer's investment other than, in some circumstances, crediting of a commercial rate of interest.

b. Endorsement

A transfer of property may occur when the endorsement method is used to establish an Equity SDA. The employer is the legal owner of the policy under this method and has all rights to the policy's cash surrender value subject to an endorsement in favor of the employee. The endorsement is not unlike an assignment under the collateral assignment method. As an asset of the employer, the policy may be available to satisfy the claims of the employer's creditors.

Our view is that increases in policy cash surrender value should not be treated as transfers of property under Section 83. The practical and policy reasons for not treating accretions of cash surrender value as property transfers are set forth in detail in our prior submission. Regulations under Section 83 also provide further support for this position. A transfer of property does not occur so long as the employer’s creditors have a right to property held by the employer. Treas. Reg. §1.83-3(e). As long as the employer’s creditors have no lesser right to attach the policy's cash surrender value than the employee, increases in cash surrender value should not be treated as property transfers under Section 83.

We agree that the “rollout” of an endorsement method Equity SDA does result in a transfer of property taxable under Section 83. Upon a rollout, the employee has full legal and beneficial ownership of the policy. The employer has no residual interest in the policy. The measure of taxable economic benefit to the employee equals the policy's cash surrender value on rollout.

C. Employee Basis in Policy Premiums

We suggested in our initial comments that guidance be provided to address whether employee payments towards the cost of premium payments be recognized as
creating basis in the policy to the extent that Section 83 applies. If employee contributions create tax basis in the policy, then an employee would only be taxed on equity in excess of the aggregate premium payments made by the employer and the employee. For the reasons discussed below, the provisions under the Code and its regulations suggest that employee contributions be allowed to create basis in the policy.

Section 72 provides that a policyholder has basis in an insurance policy to the extent of the policyholder's "investment in the contract." Section 72(e)(6) defines a policy owner’s “investment in the contract” as of any date as:

the aggregate amount of premiums or other consideration paid for the contract before such date, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under...[federal] income tax laws.

Thus, the starting point in determining a policy owner’s "investment in the contract" is the aggregate premiums paid by the policy owner, plus any other considerations paid if an existing contract had been purchased by the policy owner. This amount will be reduced by any dividends previously received, any loans that have not been repaid and any other amounts received which were not previously included in gross income (e.g., withdrawals). Any portion of total premiums paid which is attributable to other benefits, such as disability income, waiver of premium, accidental death protection, also reduce the investment in the contract. See Wong Wing Non v. Commissioner, 18 T.C. 205 (1952). However, income realized by an employee due to death benefit coverage under a qualified retirement plan increases the participant's "investment in the contract" held by the plan.

Two private letter rulings are the only authority that we are aware of that directly address whether employee premium payments create basis in a policy subject to an Equity SDA. In PLR 8310027, the Service allows an employee to reduce income recognized from the rollout of a policy subject to an endorsement method Equity SDA by the employee's total premium payments. It appears that these employee premiums also offset the economic benefit received by the employee from the policy. However, the second ruling, PLR 7916029, may be read to suggest that employee premium payments do not create basis in an insurance policy subject to Section 72.

It appears to us that PLR 8310027 reaches the result required under Section 72 and its regulations. Nothing in Section 72 provides that only a portion of a premium payment made by or on behalf of the employee is allowable as an "investment in the contract."
contract." In addition, it is difficult to reconcile why imputed income to a participant under a qualified retirement plan would create basis while actual contributions by an employee to (or imputed income to an employee from) an Equity SDA would not. As noted above, regulations under Section 72 provide basis for imputed term life insurance costs to a participant under a qualified retirement plan.

It might be suggested that this treatment results in a dual benefit, as the employee contributions create basis within the policy and offset the annual economic benefit to the insurance protection provided to the employee under the Equity SDA. However, this benefit appears contemplated by the statute, as Section 72 does not provide for the policy's "investment in the contract" to be reduced by the term portion of the insurance premium. Further, the employee contributions are being made with after-tax dollars.

D. Valuation of Current Year Life Insurance Protection

We continue to view that a uniform table should serve as the sole method for valuing death benefit coverage under a SDA. Adoption of a uniform table will greatly simplify tax administration for the IRS, employers, employees, and the life insurance industry. It will also lead to more timely and accurate tax reporting. Adoption of a uniform table of rates as the sole method for valuing death benefit coverage under a SDA will also make it unnecessary for an insurer to demonstrate that it regularly sells term life insurance through normal distribution channels.

Use of a single table would not be either a new or unique concept. Rate tables have long been in use in valuing the cost of group term life insurance. In addition, the IRS recently issued proposed regulations concerning minimum distributions under section 401(a)(9) for pension plans and IRAs. The proposed changes greatly simplify the required minimum distribution calculations. One of the changes included in the proposed regulations is the adoption of a uniform table to be used in determining the minimum distribution. Similarly, the adoption of a table as the sole method to measure the value of death benefit coverage provided by a SDA would produce a uniform result for similarly situated taxpayers.

We do have two concerns with the use of a uniform table to value current life insurance protection. The first is whether Table 2001-10 (or any other single table) will be periodically updated to reflect current mortality experience. It is of critical importance that adoption of a uniform table be accompanied by a commitment of the IRS and Treasury to periodically update the table, perhaps as often as every five years. Reliance upon outdated tables, such as PS 58 rates, is unfair, especially as the economic benefit from SDAs decreases as mortality experience improves over time.

6 See Table I under Treas. Reg. 1.79-3.
Second, any new guidance on valuation of current life insurance protection should be applicable only to SDAs entered into after the effective date of the new guidance. SDAs, like most arrangements involving cash value life insurance, are entered into with the expectation that they will continue for a significant period. Taxpayers should not have the tax consequences of the arrangements frustrated once they have entered into them.