Comments Concerning IRS Notice 2001 – 10

The following comments are 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. Principal responsibility was exercised by Andrew Liazos. Substantive contributions were made by Diane J. Fuchs, Alan Jensen, Robert Abramowitz, Susan Harmon, Tom Quinn and Mike Gunter. The comments were reviewed by Diane J. Fuchs, Chair of the Committee on Employee Benefits. The comments were reviewed by David Raish, as a member of the Section’s Committee on Government Submissions and as a member of the Section’s 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.

Contact Person: Andrew Liazos
McDermott, Will & Emery
28 State Street, 34th Floor
Boston, MA 02109-1775
(617) 535-4038
aliazos@mwe.com

cc: Diane J. Fuchs
Seth H. Tievsky
Thomas R. Hoecker
Kyle N. Brown
Taina E. Edlund
Pamela Baker
Susan Harmon
Wayne Luepker
James Mulder
Robert Abramowitz
Alan Jensen
Tom Quinn
Mike Gunter
Executive Summary

We appreciate the opportunity to comment on the tax issues concerning split-dollar life insurance arrangements ("SDAs") raised by Notice 2001-10 (the "Notice"). We agree that a need exists for updated guidance that reflects contemporary compensation practices, including equity split-dollar life insurance arrangements ("Equity SDAs"), and currently available insurance products. We commend the Treasury and the Internal Revenue Service ("IRS") for eliminating outdated P.S. 58 rates no longer used by most taxpayers.

We recommend that the effective date of the Interim Guidance entitled "Characterization of SDAs" be delayed so that these guidelines can be amended to address critical issues that were not resolved by the Notice.

We suggest that the Treasury consider a special rule whereby cash surrender value ("CSV") under Equity SDAs structured under the collateral assignment method and entered into before the Notice be subject to tax under Section 72 of the Internal Revenue Code of 1986, as amended (the "Code"). Tax would be assessed when the employee withdraws CSV or surrenders the underlying policy; provided, however that treatment under this special rule would not be available from and after the date that the parties make a material amendment to the arrangement.

We recommend that the Treasury and the IRS develop standardized valuation tables ("SDA Tables") to measure the economic benefit provided in the form of death benefit coverage under SDAs, and that the SDA Tables be updated at least every five years.

Comments on Notice 2001-10

The purpose of this letter is to respond to the request for comments set forth in the Notice. The Notice provides Interim Guidance that changes longstanding rules governing SDAs. Additional guidance is needed before taxpayers and their advisors can properly evaluate how to characterize Equity SDAs. Taxpayers with Equity SDAs established before the Notice's publication date who have relied on reasonable interpretations of Revenue Ruling 64-328 should be entitled to grandfather protection consistent with the terms of their written arrangements. Rules for measuring the value of death benefit coverage values under SDAs should reflect actual policy costs consistent with the important goals of promoting clear, objective and uniform standards for measuring and reporting income.
I. Characterizing Equity SDAs

The Notice allows taxpayers to characterize a payment by an employer under an Equity SDA as either a "below-market loan" under Section 7872(e)(1) of the Code, an employer investment in a life insurance policy under Section 83 of the Code, or a payment of compensation to the employee under Section 61 of the Code. The parties' characterization will "generally" be accepted if (i) the characterization is not "clearly inconsistent" with the substance of the transaction, (ii) the parties have "consistently followed" the characterization from the commencement of the Equity SDA, and (iii) all benefits are "fully accounted for" consistent with the characterization elected by the parties.

We commend Treasury and the IRS on its decision to provide taxpayers latitude in characterizing Equity SDAs. Currently, there are no rules for determining when the employer or the employee should be treated as the beneficial owner of an insurance policy for tax purposes. Ensuring predictability as to both the identity of the policy owner for tax purposes and tax treatment of the transaction is essential.

Unfortunately, the characterization election has generated considerable concern and confusion regarding Equity SDAs. The Notice raises but does not answer several important questions regarding how Code Sections 83 and 7872 might apply to Equity SDAs. This ambiguity is exacerbated by the Notice's requirement that any election to characterize an Equity SDA at this time is irrevocable. We are concerned that requiring parties to characterize a transaction without clear tax rules will cause employers to abandon legitimate Equity SDAs that are used to attract and retain employees.

A. Section 7872

We agree that Section 7872, as a policy matter, is an appropriate vehicle for taxing Equity SDAs prospectively when the employee is the beneficial owner of the policy. The employer may be viewed as a lender extending funds (premium payments) to the borrower (the employee), with the borrower being required to return the promised funds on termination of the Equity SDA without making interest payments at the applicable federal rate. The fact that the amounts extended by the employer might only be repaid from policy proceeds is probative as to the nature of the loan (i.e., recourse vs. non-recourse), and not to whether the arrangement constitutes a loan.

How Section 7872 might apply to Equity SDAs should be clarified before taxpayers can reasonably be expected to elect below-market loan treatment. The Notice

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1 This comment refers to the parties under the SDA as the employer and the employee. Similar principles should apply to SDAs in other contexts, except that Section 83 does not apply to private split-dollar life insurance arrangements.

2 We note, however, that treating Equity SDAs as "loans" may be viewed as inconsistent with the legislative history to the Deficit Reduction Act of 1984, which suggests that Congress did not intend to convert pre-existing non-loan arrangements such as Equity SDAs into "loans" for purposes of Section 7872.
states that "[t]he amount, timing and characterization of the imputed payments to the borrower under a below-market loan depend on the relationship between the borrower and the lender and whether the loan is characterized as a demand loan or term loan." We agree with this statement and discuss below how Section 7872 might apply to Equity SDAs.

1. **Difference in Tax Treatment - Demand Loans vs. Term Loans**

   Not all below-market loans are treated the same under Section 7872. Arrangements must be classified as either "demand loans" or "term loans." The difference in taxation between "term loans" and "demand loans" is substantial. A "term loan" results in the lender (the employer) transferring the present value of the foregone interest for the entire term of the loan as compensation to the borrower (the employee) in the year in which the loan is made. In contrast, a "demand loan" results in the lender transferring the foregone interest to the borrower on an annual basis.

2. **Characterizing Equity SDAs as Loans under Section 7872**

   Section 7872 and its proposed regulations suggest that characterization as either a demand loan or a term loan depends upon the specific terms of the SDA. 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. Section 7872(f)(6) provides that any loan that is not a demand loan is a "term loan." Proposed regulations clarify that a "term loan" is repayable at an ascertainable time, including a time that may be determined actuarially.

   Taxpayers need guidance as to whether amounts extended by an employer under Equity SDAs will be treated as "demand loans" or "term loans." 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. It is unclear whether this arrangement would qualify as a "demand loan" or a "term loan." The employee's life expectancy can be calculated actuarially, so the premium recovery right attributable to the employee's death suggests a term loan. However, a recovery of premiums at employment termination may convert the arrangement into a demand loan under Section 7872(f)(5), as the benefits of interest free loan treatment continue only for as long as the employee remains employed. On the other hand, this provision presumably will not convert the arrangement to a demand loan where, as is normally the case, the Equity SDA is transferable to a third person, such as a trust.
3. **Calculating the Period for a Term Loan**

Assuming that the arrangement described in Part 2 above is a "term loan" for purposes of Section 7872, it is unclear how to calculate the length of its term. What actuarial tables can be used for the calculation? Can the tables be adjusted for the employee’s actual health status? Can the employer take into account the possibility that the employee might terminate employment prior to her date of death when determining the period for the term loan?

4. **Identifying the Loans Subject to Section 7872**

We suggest that the IRS provide simplified rules for identifying when below-market loans are made under Equity SDAs for purposes of Section 7872. A literal reading suggests that each premium payment is a separate loan. If each premium payment is considered to be a separate loan and premiums are paid monthly, the employer would be responsible to track compensation on one hundred and twenty separate loans in an Equity SDA that continues for ten years. Consideration should be given to allowing employers to aggregate premium payments during a selected twelve-month period as a single loan for purposes of Section 7872. It would also be helpful to have guidance addressing when and how to determine the applicable federal rate under Section 1274(d) of the Code for each below-market loan.

5. **Employer Interest in Excess of Premium Payments**

We request guidance as to how Section 7872 will apply to Equity SDAs when the employer's interest is not limited to premium payments. 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. Under what circumstances will Equity SDAs that provide for an increase in the employer's recovery right be treated as outside the scope of Section 7872? Can the increased recovery right be taken into account in determining the foregone interest for Equity SDAs that are subject to Section 7872?

6. **Payments by Employee under Existing Equity SDAs**

We request guidance on how to treat payments by the employee towards the premium cost under an Equity SDA. 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. If the employee does pay for a portion of the premium payment, will this amount be treated as a payment of loan interest if the employer has a

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3 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").
right to receive back all of its premium payments? Will premiums paid with loan proceeds be treated as an investment in the contract for purposes of Section 72 of the Code?

7. **Tax Reporting**

The mechanics to report compensation under Equity SDAs should be clarified. Section 7872(f)(9) provides that imputed compensation income is not subject to income tax withholding. However, it appears that the employer is responsible to report the compensation income from a below-market loan. As a practical matter, the employer may need to rely on the insurance company issuing the policy for reporting information. Will the employer be subject to reporting penalties if this information is not provided on a timely basis by the insurance company? Recognizing that the employer might not be able to track loans by itself, will the insurer that issued the policy subject to the Equity SDA be responsible to report income from Equity SDAs treated as a below-market loan?

8. **Gift Tax Implications**

We suggest clarifications regarding how gift taxes might apply to Equity SDAs that are owned by third parties, such as an irrevocable life insurance trust ("ILIT"). 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. If an Equity SDA is extended to an ILIT established by an employee, will the IRS characterize the arrangement as if the employer made a below-market loan to the employee? If so, will the amount of compensation income taxed to the employee be treated as a taxable gift to the ILIT? Does it make any difference in determining gift tax liability if the ILIT is a grantor trust for income tax purposes?

B. **Section 83**

We question whether Section 83 can be a viable approach to tax incremental CSV increases during the term of an Equity SDA as suggested by TAM 96-04-001. Applying Section 83 in this manner raises numerous practical problems for tax administration. As discussed below, it is unclear when a "transfer of property" has occurred due to the requirements under Section 83, the legal ownership structure of Equity SDAs and the nature of permanent whole life insurance contracts. Set forth below are our comments regarding how Section 83 might apply to Equity SDAs consistent with providing clear and objective rules to taxpayers, protecting the integrity of the tax system and reducing tax compliance costs.
1. **Section 83 Requires a Transfer of Property**

Section 83(a) of the Code applies only if "property" is "transferred." Each of these terms has a specific meaning under Section 83 and its regulations. Treas. Reg. 1.83-3(e) provides that "[i]n the case of a transfer of a life insurance contract . . . only the cash surrender value of the contract is considered to be property." Cash is not "property," and presumably cash payments towards premium payments would be outside the scope of Section 83. Property becomes subject to tax under Section 83 upon its "transfer" to or for the benefit of an employee, which occurs "when a person acquires a beneficial interest in such property." These provisions suggest that there cannot be a "transfer of property" from the employer to the employee unless the employer is treated as the actual or constructive beneficial owner of the policy.

2. **Employer as Beneficial Owner of Property**

The legal form of ownership is significant when determining which party - the employer or the employee - is the beneficial owner of property for purposes of Section 83 and Section 7872. Rev. Rul. 64-328 provides that the income tax treatment to the employee is the same under an SDA whether it is structured using the collateral assignment method or endorsement method, at least insofar as treatment of the annual value of the insurance coverage received by the employee. Extending the position of Rev. Rul. 64-328 regarding uniformity of tax treatment to other tax issues, such as the taxation of the inside policy build-up under an Equity SDA or the appropriate tax treatment to the employer, is much less compelling.

Our preliminary analysis suggests that it is difficult to view collateral assignment Equity SDAs as providing the employer with beneficial ownership of the policy and its benefits in most situations. The employer merely has a right to receive repayment of its funds, which is not a property right under the policy. The collateral assignment simply secures repayment of the employer's contract right. The split-dollar documentation and state law both provide that the employee is the owner of a policy, albeit subject to a security interest in favor of the employer.

On the other hand, it appears that Equity SDAs structured using the endorsement method should result in the employer being treated as the policy owner. The employer may use the endorsement method to gain greater control over the policy and its benefits. The employer's creditors may assert rights to all policy cash value notwithstanding the endorsement to the employee. The endorsement may be viewed under state law in some circumstances as only providing the employee rights as a creditor against the employer. We note that treating the employer as beneficial owner of policies subject to an

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4 Other non-tax reasons may exist as well for using the endorsement method. The parties may desire to avoid any appearance of there being a loan transaction between the employer and employee. This may be pertinent in states that prohibit corporations from making loans to officers and shareholders, or where the employer has a lending agreement in place that restricts loans from the corporation to an employee. The endorsement method facilitates use of the policy funds to finance on an informal basis a non-qualified retirement program.
endorsement method Equity SDA would be consistent with previous private letter rulings issued by the IRS. See PLRs 8310027 and 7916029 (finding the rollout of an SDA structured using the endorsement method resulted in taxation under Section 83).

The payment of premiums by the employer does not mean, ipso facto, that the employer is the beneficial owner of the policy. The legal ownership structure of Equity SDAs has significant non-tax consequences. Rights to policy assignment, designation of beneficiaries and investment of cash value (for variable contracts) are affected by legal ownership of the policy. The employer is not entitled to a transfer of the policy and all the incidents of policy ownership in satisfaction of its premium recovery rights; rather, the employer is entitled only to the repayment of its cash expenditure. We also note that payment of premiums is not probative of who has "incidents of ownership" in a life insurance context for purposes of the estate tax.

We suggest that consideration be given to a rule providing that beneficial ownership be presumed to follow legal ownership. That is, if the collateral assignment method is used to structure the Equity SDA, the employee would be presumptively considered the beneficial owner of the policy absent unusual circumstances, resulting in tax treatment under Section 7872. The endorsement method would result in the employer being presumed to be the beneficial owner of the policy, resulting in tax treatment under Section 83. This approach reflects practical realities, facilitates certainty in structuring transactions, and allows the IRS discretion to invoke substance over form principles for abusive situations when the parties do not act consistently with the legal ownership selected for the transaction.

3. Identifying the Transfer of Property in an Equity SDA

We have considerable difficulty identifying what event or events, if any, constitute the "transfer of property" with Equity SDAs before rollout. Assuming arguendo that the employer is the beneficial owner of the policy (under the analysis set forth in Part 2 above), it is difficult to understand how and under what circumstances increases in CSV during the term of the Equity SDA can be transfers of property. As noted above, a "transfer of property" requires a transfer of a life insurance policy with CSV. An employer does not transfer a life insurance policy when retaining ownership. The employer retains ownership of the entire policy even after CSV exceeds the employer's premium recovery amount. We are not aware of any authority under which a life insurance policy can be segregated into multiple pieces of "property" for purposes of Section 83.

We note that an employer's promise to convey equity increases to the employee at some later date is quite similar to a promise to pay deferred compensation under an unfunded arrangement. The employer's promise to the employee would not ordinarily be binding upon the insurer. The employer's promise to pay is set forth in the SDA contract, to which the insurer is not a party. Until the employer transfers cash or an interest in the policy to the employee, the employee's taxable income should be limited to the annual value of the insurance protection the employee receives each year.
The practical realities of plan administration suggest that taxing increases in CSV during the term of Equity SDAs would result in a significant increase in tax compliance expense. Employers and administrators undoubtedly would need to develop sophisticated programming to track changes in CSV. The tracking would need to be quite complicated. Timing rules would also need to be developed to define precisely when CSV would be taxable to the employee. CSV taxed to the employee would presumably generate basis, with future CSV attributable to basis representing tax-deferred earnings. In addition, death benefit coverage attributable the employee portion of CSV would need to be segregated, as it presumably would be tax-free to the employee.

In addition, special rules would need to be made for contracts with fluctuating values. Modern variable life insurance contracts may result in decreases in CSV. Decreases may also result if the Equity SDA allows for the employer to take a premium holiday and use CSV to fund death benefit coverage. These contingencies would require guidance regarding how decreases in CSV should be allocated between the taxable and tax deferred portions of the policy CSV. If a decrease in CSV is allocated to the employee owned portion of the CSV, it would be helpful to have guidance addressing whether this reduction would be a deductible loss.

The only event that appears to result in an unequivocal "transfer of property," assuming the employer has beneficial policy ownership, is rollout of the employer's interest in the policy. A rollout occurs when the employer is repaid its premium advances in a single payment, and the SDA is terminated.5 Treating rollout as the "transfer of property" is consistent with PLRs 8310027 and 7916029, avoids the complicated tracking and allocation issues noted above, and allows for an objective and simple rule to administer.

4. Substantially Vested

We suggest that the Treasury and the IRS provide guidance on the meaning of the term "substantially vested" under the Interim Guidance. Paragraph A.3 of the Interim Guidance provides that an employee will be subject to immediate income tax under Section 83 when the employee acquires a "substantially vested" interest in policy CSV. The term "substantially vested" is not defined. Presumably, this is a reference to longstanding "substantial risk of forfeiture" concepts under Section 83.

Applying "substantial risk of forfeiture" concepts to Equity SDAs raises several questions. Does the employee's lack of access to CSV (i.e., no right to withdraw funds or take policy loans) without continuing to provide services constitute a "substantial risk of forfeiture"? Does it make any difference if the Equity SDA provides that the employer has the right to use CSV for future premium payments or buy paid up additions with CSV? Is the character of income when the CSV becomes substantially vested "wages" for purposes of federal income and payroll tax withholding? Would future appreciation of property

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5 The employer may also be repaid in a series of payments, which is commonly referred to as a "crawl-out."
previously reported as "wages" be eligible for capital gains on withdrawal or policy surrender?

5. Section 83(b) Elections

The mechanics for making a Section 83(b) election should also be addressed. Section 83(b) allows an employee to elect immediate taxation on a transfer of property that is subject to a substantial risk of forfeiture. The election must be made not later than thirty days after the "transfer of property." Presumably, Section 83(b) elections will be allowed with respect to an event that the IRS characterizes as a "transfer of property."

How and when Section 83(b) will apply to Equity SDAs depends, in large part, upon (a) what is considered to be Section 83 "property" (i.e., can there be more than one piece of "property" in a policy), (b) what event or events (i.e., mere increases in CSV or rollout) are considered to result in a "transfer, and (c) what circumstances present a "substantial risk of forfeiture." As discussed above, it is our view that a transfer of property should not occur before rollout for tax policy and practical reasons.

6. Employer Tax

The Notice addresses only employee tax issues. We request guidance regarding the employer's tax treatment upon a "transfer of property" in the context of Equity SDAs.

a. Income Inclusion

It is unclear whether the employer must recognize income when transferring CSV to one of its employees under an Equity SDA. The transfer of appreciated property to satisfy a contractual obligation is normally treated as a taxable sale or exchange. Assuming the employer is treated as the beneficial owner of the policy, the employer's transfer of its CSV to the employee in accordance with split-dollar documents would appear to be a taxable to the employer, at least in part, depending upon whether the transferred CSV was attributable to policy earnings, employer contributions or both.

b. Deduction

Another important question is whether an employer can deduct amounts reported as compensation under Section 83 to the employee. Section 83(h) appears on its face to provide for this result. However, Section 83 regulations also provide that a deduction is only available to the extent that the amount would otherwise be deductible under Section 162 or Section 212. The reference raises the question whether of Section 264 in any way restricts deductibility because the employer has rights as a policy beneficiary. Our view is that Section 264 should not limit deductibility, as the employer would ordinarily have no rights to recover any amounts reported as compensation income by the employee.
7. **Employee Basis in the Policy**

We suggest that the Treasury and IRS provide guidance regarding whether employee payments towards the cost of the premium payments create basis. Section 72(e)(6)(B) provides that a person has a basis in an insurance policy equal to the total consideration paid for the policy. We note that PLR 8310027 appears to have permitted the employee a cost basis for contributions made pursuant to the terms of an Equity SDA. The employee should be able to offset the income or amount realized from any transferred equity to the extent of the employee's basis. Similar basis questions should also be addressed with respect to paid up additions that constitute taxable "additional benefits" to the employee under Revenue Ruling 66-110.

8. **Payment of Death Benefit**

The Notice creates some confusion as to whether death benefits payable from a policy subject to an Equity SDA would be tax-free under Section 101 of the Code. The non-loan characterization of an Equity SDA provides for the income taxation of CSV at some point during the employee's lifetime. If the employee dies before receiving a taxable transfer of the policy's CSV, the Notice can be read to imply that death proceeds attributable to CSV exceeding the employer's premium payments are taxable under Section 13. We suggest clarification that the payment of death benefit proceeds are tax-free regardless of whether there is any policy equity.

9. **Amount of Life Insurance Protection**

We suggest that Treasury and the IRS clarify the meaning of the term "life insurance protection" in the Interim Guidance. Paragraph A.3. of the Interim Guidance provides that the value of life insurance protection provided to the employee by an Equity SDA, reduced by any employee premium payments, is taxable compensation under Section 61. However, the Notice does not address how to calculate the amount of the life insurance protection. The question has arisen with Equity SDAs whether the amount of coverage is only the net amount at risk to the employee under the policy, or all death benefits in excess of the employer's recovery right. For example, assume that a policy with a $1 million face value and $400,000 of CSV is subject to an Equity SDA, and that the employer has paid all policy premiums amounting to $100,000. Is the current life insurance protection $900,000 (total policy death benefits less the employer's premium recovery), or $600,000 (total policy death benefits less policy CSV) for purposes of the Notice?

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As noted above, basis should include, if applicable, any CSV taxed to the employee.
C. Transition Issues

The Interim Guidance under the Notice raises the following transition issues.

1. Electing Loan Treatment for Equity SDAs

It is unclear how parties to an existing Equity SDA can elect loan treatment under Section 7872 if desired. Paragraph A.1(ii) of the Interim Guidance requires that the parties must consistently follow the same characterization from the inception of an Equity SDA when reporting taxable income. This rule would appear to disqualify most, if not all, Equity SDAs from electing loan treatment absent special relief, as most employees have only reported the term portion of annual premium payments as compensation income consistent with Rev. Rul. 64-328.

If a decision is made not to provide grandfather protection for Equity SDAs as discussed in Section II below, we suggest that the IRS consider how taxpayers desiring loan treatment prospectively might qualify under the consistency requirement in the Notice. One approach is to terminate the Equity SDA and have the employee repay the employer its premium payments, possibly out of the policy itself. A new Equity SDA could then be established for the existing policy. This approach is cumbersome, expensive, and problematic in the absence of additional guidance, as the Notice suggests that policy equity would be taxable on termination of the Equity SDA.

Alternatively, it has been suggested informally by Treasury officials that taxpayers could elect loan treatment retroactively by reporting imputed income under Section 7872 for all years remaining open under the statute of limitations. How and when this could be done has not been addressed. In addition, taxpayers will be reluctant to amend their tax returns to obtain loan treatment without assurance that such action is consistent with change in accounting rules under Section 446 of the Code.

2. Taxing Earnings under Equity SDA under Interim Guidance

We suggest clarifying when policy CSV might be taxable prior to payment under the Interim Guidance. Paragraph A.3 of the Interim Guidance provides that an employee will have compensation income when the employee acquires a substantially vested interest in the policy's CSV, reduced by any consideration paid by the employee for her interest in the policy. This statement suggests the Section 83 approach outlined by TAM 96-04-001. However, Paragraph A.4 of the Interim Guidance then states:

[p]ending 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
earning increments are to be treated as transfers of property for purposes of section 83, it will apply prospectively.

The meaning of these provisions when read together is somewhat unclear. Some commentators have suggested that these provisions mean that Paragraph A.3 will not apply to existing Equity SDAs until further guidance is provided. Alternatively, it has been suggested that there can be no tax under Section 83 pending further guidance unless the employer receives a recovery of its premium payments (i.e., a rollout event) or the employee otherwise accesses CSV by a withdrawal or surrender of the policy.7

3. Election Procedures

Guidance should be provided as to how parties should elect tax treatment under the Notice. Is a formal amendment to the Equity SDA required, or is merely reporting taxable income on a consistent basis required? What happens if the parties do not agree on the method to be used for determining tax results? Is it appropriate for Section 83 to be the default tax treatment if the employer and the employee report the transaction inconsistently?

4. Good Faith Failure to Account for Benefits

We suggest that a good faith failure to account for all benefits under an Equity SDA not disqualify the parties from using a mutually agreed upon characterization for the transaction. We agree that the Treasury should not be whipsawed by taxpayers annually changing their method for reporting income from Equity SDAs. However, it seems inappropriate to disqualify the parties to an Equity SDA from applying Section 7872 if, for example, an incorrect applicable federal rate was used to impute compensation income to an employee.

5. Application of Clearly Inconsistent Standard

We suggest that the "clearly inconsistent" standard for reporting compensation be limited to abusive situations. Paragraph A.1(i) of the Interim Guidance provides that the IRS can disregard any characterization of an Equity SDA which is "clearly inconsistent" with its substance. It appears to us that adopting the presumptive standard as described in Section 1.B.2 above addresses most of the problems contemplated by this provision. In addition, loan treatment or Section 83 treatment should not apply when the employer has no intention of recovering its premium payments. See TAM 200040004 (treating loan proceeds under a promissory note as compensation when coupled with a guaranteed bonus equal to the loan repayment amount).

7 Special tax treatment for Equity SDAs in existence prior to the Notice, in addition to the transition rule, is suggested in Section II below.
II. Tax Rules for Equity SDAs Established Prior to the Notice

We suggest that the Treasury and the IRS consider excluding Equity SDAs established under the collateral assignment method before issuance of the Notice from the rules provided in the Notice, and provide special rules for these arrangements reflecting taxpayers' reasonable expectations in light of previously available guidance.

Revenue Ruling 64-328 may reasonably be interpreted to cover Equity SDAs and their taxation. This ruling describes the employer's right in the SDA as "an amount equal to the CSV, or at least a sufficient part thereof to equal the funds it has provided for premium payments." (emphasis added). The highlighted language describes Equity SDAs. The illustration to Revenue Ruling 64-328 supports this interpretation, as the CSV in year five exceeds the cumulative premiums paid by the employer in previous years. General Counsel Memorandum 32941, issued in conjunction with Revenue Ruling 64-328, appears to acknowledge this result by providing that the policy's investment element should not be taxed when it is credited to CSV. Nothing in Revenue Ruling 64-328 states that CSV exceeding total premiums paid is taxable during the term of the Equity SDA, and subsequent rulings (including Revenue Ruling 66-110) do not address CSV accumulations in an Equity SDA.

One alternative is to provide that CSV under Equity SDAs structured under the collateral assignment method and entered into before the Notice would only be subject to tax under Sections 72 of the Code when the employee withdraws policy CSV or surrenders the underlying policy. This approach does not frustrate taxpayer expectations while allowing for taxation of the CSV or loss of valuable death benefits if the employee benefits from the policy equity at any time. A policy surrender or CSV withdrawal would be taxable under Section 72 except to the extent that the employee has basis in the policy. Changing the dividend option to receive a stream of income would subject the dividends in excess of basis to immediate tax. If the employee takes policy loans, there would be adverse economic consequences to the employee upon failure to pay policy interest, including possible lapse of the policy.

Treatment under this alternative should not be available from and after the date that the parties make a material amendment to an existing Equity SDA. Standards for a material amendment could be developed similar to those provided under Section 7702. A

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8 Equity SDAs structured under the endorsement method would be subject to tax on rollout consistent with previous private letter rulings as noted above. No special grandfathering treatment is needed for these arrangements so long as it is determined that incremental increases in CSV will not be subject to tax so long as the Equity SDA is in effect.

9 We understand that some taxpayers have calculated in good faith the CSV increase attributable to employer premium payments and reported this amount as compensation on the employee's IRS Form W-2. Taxable compensation should create basis for the employee when computing any tax under Section 72.

10 Policy loans require the payment of interest. Interest that is not paid under the policy accrues as an additional liability. The effect of compound interest reduces the policy death benefit, and would cause the policy to lapse in severe cases. A lapse of the policy would likely cause the employee to be taxed on the accrued interest and the loan principal.
material amendment would not include a notice by either party unilaterally to terminate the Equity SDA as contemplated by the operative agreements, or an amendment to change an employee's payment rate under the Equity SDA from the P.S. 58 rate to any other method now allowed under the Notice (or any future guidance). The material amendment rule would allow a rollout for a collateral assignment Equity SDA without taxation only if such action could be taken without amending the contract between the parties. An Equity SDA that has been materially amended would be treated as a new arrangement as of the day of the amendment, and therefore subject to the normal rules under the Notice.

III. Standardized SDA Table to Value Economic Benefits

We commend the Treasury and the IRS for replacing outdated P.S. 58 rates. These rates, based on mortality experience from the 1940s, have been used rarely by taxpayers to report income from their Equity SDAs. Replacing P.S. 58 rates also should curb the use of abusive reverse split-dollar arrangements described in the Notice.

We suggest that a uniform table or set of tables ("SDA Table") serve as the exclusive method for valuing death benefit coverage. This approach would simplify tax administration and facilitate timely and accurate reporting by taxpayers. A uniform SDA table would also alleviate burdens placed on insurance companies that issue policies subject to SDAs and eliminate valuation controversies arising under some current practices.

We would like to work with the Treasury and IRS to develop accurate and realistic SDA Tables. The Notice raises a number of excellent questions regarding the development of SDA Tables that are worthy of further consideration. We would like to offer our observations regarding the development of SDA Tables at this time.

A. Reflecting Actual Mortality Expense to Determine Economic Benefit

Further review may be advisable to determine if Table 2001 rates overstate the value of the employee's economic benefit under Equity SDAs. We understand that Table 2001 is based on group insurance rates, which reflect the additional risk insurers incur by automatically covering every employee. The P.S. 58 rates, while outdated, are based on individual term life insurance underwriting costs.

B. Updating SDA Table

It is critical that the Treasury and the IRS commit to update periodically whatever tables are developed, perhaps not less than every five years. Use of outdated tables is unfair, as the economic benefit from SDAs decreases as mortality experience improves over time. It appears to us that five years is an appropriate period of time to update and publish new SDA Tables.
C. Survivorship Table

We suggest that the IRS publish a table that may be used by taxpayers to report death benefit coverage under a second to die, or so called "survivorship" arrangement. Employers currently report income under survivorship SDAs using U.S. 38 tables. We understand that these tables are based upon the now revoked P.S. 58 rates, thereby creating uncertainty as to what is the appropriate method to report the value of term protection under a survivorship SDA. If a survivorship table cannot be published before year end, additional guidance should be provided before year end regarding whether the U.S. 38 tables may continued to be used, and if not, how term coverage under survivorship SDAs should be reported until the IRS publishes final tables.