subsequent income or gain with respect to that property is not compensation income.

Turning to the facts before it, the Service noted that each Founder's rights in its Company A shares were already "transferred to and substantially vested in them" at the time that the lender required that such shares be restricted. The Service thus concluded that "the subsequent imposition of the forfeiture provisions on the founders' Company A shares must necessarily have been accomplished in the absence of a section 83 'transfer' (i.e., the shares were already owned for section 83 purposes), and that, therefore, those provisions had no effect for section 83 purposes." Because it concluded that the Founders already owned their Company A shares for section 83 purposes on the date the restrictions were first placed on the stock, the Service subsequently concluded that the substantial vesting of the Founders' shares resulting from the change of control of Company A was not a "payment in the nature of compensation" for purposes of sections 280G and 4999.

THE IMPACT

How will PLR 200212005 affect the advice of practitioners presented with similar facts? Perhaps not as much as the favorable conclusion might initially suggest. Aside from section 6110(k)(3)'s mandate that letter rulings may not be used or cited as precedent, the letter ruling does not specifically alleviate the initial concerns. None of the potential arguments described above are considered or dismissed. On one hand, since PLR 200212005 serves up ideal facts if the Service were inclined to raise the constructive exchange argument, perhaps some practitioners will get comfortable that this argument is no longer a concern. However, the letter ruling does not specifically consider the argument, so it is difficult to tell whether the Service considered and rejected the argument or simply failed to consider it. In addition, the letter ruling provides no evidence that the Service would not consider raising the more problematic step-transaction argument. Because the letter ruling does not provide dates, we cannot ascertain when the financing occurred relative to the date of Company A's founding, nor what Company A's financial situation was when negotiations with the lender began. In short, PLR 200212005 provides no comfort that a step-transaction argument would not be available to the Service under the right set of facts.

While the conclusion that the subsequent imposition of forfeiture restrictions "must necessarily" have been accomplished in the absence of a section 83 transfer is comforting, further guidance is needed. Until a revenue ruling is issued on this topic, most careful practitioners will continue to plan around the problem. Given the potential trap and ease of cure at the front end, many practitioners will continue to file protective 83(b) elections until more formal guidance is issued.

GOOD NEWS FOR FINANCIERS: THE SERVICE ANNOUNCES A **SAFE HARBOR FOR CAPITAL COST REDUCTION PAYMENTS**

by Wayne A. S. Hamilton, Deerfield Beach, FL

In response to the controversy between the Service and financiers surrounding the proper tax treatment of capital cost reduction (CCR) payments made by purchasers of leased vehicles, the Service has issued Rev. Proc. 2002–36. As discussed in greater detail below, the Procedure offers a safe harbor method pursuant to which the amount of the CCR payment received from a lessee will not be includible either in the finance company's gross income or in the basis of the purchased vehicle. The Procedure also provides the manner in which taxpayers may obtain the Service's automatic consent to change to the safe harbor method of accounting. In a win for both taxpayers and the Service, the Procedure provides audit protection for those taxpayers who may currently have this issue under consideration, and for those taxpayers who switch to the safe harbor method.

BACKGROUND – CCR PAYMENTS

Individuals who lease a vehicle may in some cases make an up-front payment to the dealer. The payment has the effect of reducing the total amount of rent they pay as lessees after the inception of the lease. These payments are commonly referred to as capital cost reduction, or CCR, payments. For federal income tax purposes, most finance companies that purchased leased vehicles from auto dealers did not treat the CCR payments as income. This approach was consistent with the position taken by the Service in the July 1997 Market Segment Specialization Program ("MSSP") paper on commercial banking. However, about two years ago the Service began taking the position in audits that the CCR payment was income to the finance company at the inception of the lease despite the fact that the finance company had no entitlement to and could never receive such payments. The Service also took the position that CCR payments would increase the finance company's basis in the purchased vehicle by the amount of the payment. (*See*, Field Service Advice 200103006 (Sept. 28, 2000); IRS Chief Counsel Memorandum 200048001 (Dec. 1, 2000); IRS Chief Counsel Memorandum 200030931 (May 11, 2000) and IRS Chief Counsel Memorandum 200123047 (March 12, 2001)). In July, 2001 the Service released a revised MMSP paper on commercial banking adopting its new position. The 2001 MSSP paper did not identify any change in laws or regulations as a basis for the new position.

The Service's position had a number of results that were detrimental to finance companies. For instance, finance companies had what was in

effect phantom income, as they had no right to receive the CCR payments. Also, the new position resulted in the mismatching of income and deductions because the increase in the finance company's basis in the purchased vehicle would increase the company's cost recovery deductions, but that increase would occur over a number of tax years, whereas the inclusion occurred in the first year.

REV. PROC. 2002–36 – THE SAFE HARBOR

To avoid further controversy and for administrative convenience, earlier this year the Service issued Rev. Proc. 2002–36. Rev. Proc. 2002–36 gives finance companies that purchase leased vehicles from auto dealers a safe harbor method of accounting for any CCR payments. Under this method, finance companies will not need to include the CCR payments in income or in the basis of the purchased vehicle. (*See* Sections 3 and 5). The Procedure defines CCR payments to include, among other things, not only a cash down payment and the trade-in value of a lessee's used vehicle, but also any prepaid first or last monthly rental payments. (*See* Section 4). However, it does not include security deposits, administrative fees or taxes paid in connection with the lease.

In addition to providing a safe harbor method of accounting, Rev. Proc. 2002–36 also sets forth a procedure by which taxpayers may obtain automatic consent from the Service to change to the safe harbor method of accounting. (*See* Section 7). If a taxpayer changes to the safe harbor method of accounting, the treatment of CCR payments will not be raised as an issue in any taxable year before the year of change, and if the treatment of CCR payments is already an issue under consideration in a taxable year before the year of change, that issue will not be further pursued. (*See* Section 7.04). Taxpayers who are already on the safe harbor method before May 3, 2002, are not required to file an application to change their method of accounting (Form 3115). More importantly, for taxpayers already on this method, the Service will not raise it as an issue, and if the issue has already been raised on audit, the issue will not be pursued further. (*See* Section 6).

Overall, the approach set forth in Rev. Proc. 2002–36 reaches the appropriate result for these common leasing transactions. It is closely aligned with the true economics of the transaction and it does not result in the mismatching of income and deductions. The approach also avoids the significant time and expense involved in disputes over this issue, and should, therefore, be of great benefit to both taxpayers and the Service.

CHANGING RULES FOR **EXECUTIVE LIFE INSURANCE**

by Dianne Bennett, Buffalo, NY

Split dollar life insurance arrangements have been a mainstay of executive compensation for decades. These arrangements, where the employee and employer share—or "split"—the costs and benefits—the "dollars"—of life insurance policies, generally have provided executives with tax-free build-up of retirement or other funds, while at the same time providing current life insurance protection.

Until recently, the Service appears to have ignored the compensatory nature of one of the benefits inherent in most split dollar arrangements: the tax-free build-up of retirement funds. This is a benefit (or at a minimum an extension of a compensatory benefit to the employee) on which the employee is not currently taxed (nor does the employer receive a deduction). A flurry of pronouncements started in 1996 with a controversial Technical Advice Memorandum, which now looks like the proverbial trial balloon (TAM 199604001 (Jan. 26, 1996)). In 2002 alone, the Service has issued three pronouncements: (1) Notice 2002–8 (2002–4 I.R.B. 398 (January 28, 2002)) largely revoking Notice 2001–10, 2001–5 I.R.B. 459 (January 29, 2001), which itself revoked 40- and 50-year old revenue rulings that remain revoked); (2) proposed regulations (Prop. Reg. § 1.61–22, July 3, 2002); and (3) yet another notice (Notice 2002–59, 2002–36 I.R.B. 1 (September 9, 2002)). On top of this, Congress has entered the fray—whether intentionally or not still is being debated—with the Sarbanes–Oxley Act, potentially prohibiting traditional equity split dollar arrangements for executives of publicly traded companies.

Split dollar life insurance has many uses, including so-called "private split dollar" arrangements. All of these arrangements are swept under the new rules. This discussion focuses on the employer/employee context.

The new rules do several things. First, they change the method for determining the value of current life insurance protection, which has been known to most taxpayers as the "PS 58 costs," referring to a table of insurance costs so old that it was based on 1946 mortality tables. Second, they impose clear rules for taxing the benefits in these arrangements. Third, they perhaps prohibit any type of split dollar arrangements for officers and directors of publicly traded companies.

The Service's guidance at this point generally is only proposed, and many questions remain unanswered. However, the Service's general approach is clearer and appears likely to remain in place. In addition, the Service has provided extensive transition rules in its pronouncements. Executives and employers should begin thinking now about their approaches to both existing and new split dollar arrangements; indeed, they should rethink their approach to life insurance of any kind, other than group term.

With respect to the amount of taxation for current life insurance protection, the transition rules are extensive and generally favorable to the taxpayer. For 2004 and beyond, however, at least for split dollar arrangements entered into after January 28, 2002, employees, especially younger ones, can expect to include