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

more in income for current life insurance protection than they do now, assuming most of them have stopped using the PS 58 table. The PS 58 table clearly was outmoded and over-inclusive. For example, for a taxpayer age 60, the Service, using the PS 58 table, assumed that the annual cost of $1000 of term life insurance protection was $20.73. To meet the challenge of these high rates of income inclusion, life insurance companies came up with their own 1-year term costs for tax purposes, as low as, for example, $1.35. The Service will clamp down on these creative costing programs by requiring life insurance companies to demonstrate widespread use of the term rates before applying them for tax purposes. The Service has also developed its own Table 2001, which taxpayers may use in the current transition period. That Table, for example, places the annual value of $1000 of current life insurance protection at $6.51 for a 60-year-old individual. The spread of these dollar amounts indicates where the Service, and the tax regime, is headed. Again, employers and employees should check the transition rules, especially for policies entered into on or before January 28, 2002, but should be alert to the possibility of increased costs for this aspect of split dollar arrangements.

The Service's basic approach now is to divide split dollar arrangements into two types. Historically those types have been called "endorsement" and "collateral assignment" split dollar. Under the endorsement arrangement, the employer owns the policy and the executive is permitted to designate death beneficiaries and possibly obtain other benefits. The Service proposes to tax these arrangements using the traditional "economic benefit" approach. The economic benefit of the equity piece will be treated as occurring under section 83 when it substantially vests. There are other adverse rules in the proposed regulations, including no deduction to the employer for the employee's inclusion in taxation of the current life insurance protection. These are points we expect will be worked out, and one would hope modified, in the final regulations. As now proposed, the rules make endorsement arrangements, commonly used for funding nonqualified deferred compensation plans (sometimes called supplemental executive retirement plans or SERPs) or in group term carve out plans for executives, particularly unattractive.

The "collateral assignment" arrangements, the more common in our experience, place the ownership of the life insurance policy in the employee, who then assigns to the employer the right to obtain a return of an amount equal to its premiums. The Service proposes to tax collateral assignment arrangements using a loan analysis and applying section 7872 and the original issue discount (OID) rules. If the terms of the arrangement are such that the employer can require repayment of the amount due it at any time, the arrangement will be treated as a demand loan. If the employer will receive the amount due it only at the end of a specified term, the arrangement will be treated as a term loan. Under section 7872, if there is no interest or below-market interest charged, the arrangement will be recharacterized as a loan with interest at the applicable federal rate (AFR), and the interest will be treated as compensation income from the employer to the employee (or, in a shareholder/company loan setting, a dividend, and in a donor/donee setting, a gift).

The advantage of the loan arrangement is that there is no additional taxation for the annual economic benefit or for the equity build-up. The demand loan approach, of course, floats the interest with the market, whereas the term approach provides consistency throughout the loan term. With interest rates very low at this time, the term loan approach likely will be preferred. The demand loan approach likely will not be attractive, partly because of its unpredictability in terms of costs for income tax purposes (and in other contexts, gift and generation-skipping tax purposes). In October, for example, the annual short-term (under 3 years) loan AFR was 2.03%, the rate for a mid-term (3–9 year) loan was 3.46%, and for a long-term loan (over 9 years) 4.90%. The tax cost of these loans can be high as well, because the interest is applied to the total premiums paid by the employer, not simply the annual premium. For example, if an employer pays premiums of $25,000 annually towards the life insurance policy of an executive, after 10 years, the total premiums paid are $250,000 and the deemed compensation in that 10th year is interest on a $250,000 loan.

In terms of transition rules, or grandfathered arrangements, employers and executives will have the opportunity to work through several scenarios and to decide—before 2004—whether to "roll out" the equity in an existing policy, or not. Rolling out the equity (i.e., giving the employee an unfettered right to that portion of the proceeds or the contract) should preclude taxation of that equity in the future under the endorsement method.

And then came Sarbanes–Oxley. This Act, signed into law July 30, 2002, was designed to address perceived abuses by corporate insiders, particularly with respect to accounting practices. In its sweep is a prohibition on personal loans—extended after July 30, 2002—from publicly held companies and other "issuers" to directors and executive officers. With the Service specifically applying the loan approach to collateral assignment split dollar arrangements, these arrangements now appear to have been swept into the prohibited loan category. Most commentators believe this application of Sarbanes–Oxley to be unintended and one that will probably be corrected. Also, it would appear that endorsement arrangements, which do not involve a loan analysis, should not be prohibited. In addition, many believe that arrangements entered into on or before July 30, 2002, should not be affected. However, statements by some members of Congress and the freezing for a period of time by some

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PRO BONO UPDATE: NEW PRO BONO COMMITTEE FORMED

by Richard M. Lipton, Chicago, IL

One of the priorities of my term as Section Chair was to focus on pro bono activities. The current Chair, Herb Beller, has asked me to maintain this focus by heading up a new Pro Bono Committee. I wanted to tell you briefly about the proposed activities of this new committee.

The first meeting of the Pro Bono Committee will be held in conjunction with the Tax Section's meeting in San Antonio in January 2003. The Pro Bono Committee will meet on Saturday, January 25, 2003, at 7:15 am; breakfast will be served. The focus of the meeting will be coordinating the activities of the committee.

I anticipate that there will be two major initiatives undertaken immediately by the Pro Bono Committee. The first involves VITA training. Many tax lawyers would be willing to devote their time and efforts to help less-fortunate individuals prepare their income tax returns. However, most of us have not been trained to do so. To resolve this issue, we are working on obtaining assistance from the Service in providing training (in a 3-hour course) at the meeting in San Antonio; tentatively, we have scheduled training programs on Saturday morning and afternoon in San Antonio. The exact time and place for this training should be covered in the next issue of the *NewsQuarterly*. Once training of Tax Section members is completed, we expect to utilize the Tax Section website as a means to inform members of opportunities to assist in tax return preparation services on a pro bono basis in their communities.

Second, we will be contacting low income taxpayer clinics (LITCs) from around the country in order to determine which ones would want to undertake a mentoring program at the LITCs (or, where appropriate, having Tax Section members actively involved directly pro bono in disputes). Again, if and when any LITCs express interest, this information will be made available through both the *NewsQuarterly* and the Tax Section website.

We also recognize that neither Council nor the Pro Bono Committee will have a monopoly on ideas. If any of you have a suggestion for additional pro bono activities in which Tax Section members could be involved, please e-mail me at RLipton@mwe.com. ■

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insurance companies of premium payment requirements in this context (each premium payment arguably being treated as a "new", post July 30 loan), indicate that "fixing" this problem may not be quick or easy. Publicly traded employers should consider not paying the premiums on policies for directors and executive officers under collateral assignment arrangements until the rules are clarified.

Those who must address existing split dollar arrangements would be well-advised to wait. First, the rules are not clear. The Service has kept up its steady stream of pronouncements, including Notice 2002–59, discussing the tax implications of reverse split dollar and private split dollar arrangements. But many questions remain unanswered. In addition to some mentioned above, issues remain on how to analyze co-owned policies and how to value the benefit in an endorsement policy, for example.

Second, insurance companies must run calculations for employers and executives to determine tax and economic consequences of the different treatments (including a possible rollout of existing equity). Then employers and executives need to decide which treatment they will agree to use and who will bear the cost of the additional tax. There may be a provision in the documents that provides an answer. One thing is clear: employers and executives should not modify existing arrangements if at all possible. A "material modification" could result in taking the arrangement out of the favorable transition rules.

With respect to new split dollar arrangements, again employers and executives alike would be well-advised to wait and see. The employer who has promised executives this type of arrangement, or historically has offered it to executives reaching certain levels and ages, can calculate the cost to the executive of waiting and can pay that amount in a bonus, if need be.

What is clear is that the landscape for split dollar life insurance arrangements has changed dramatically, and that the ground continues to shift under our feet. Employers as well as employees should have an understanding of all the rules, pay careful attention to the development of the final regulations, and exercise caution in taking any steps to change or enter into new arrangements at this time. ■