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INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Index NO.: 61.09-31

Control No.: CC:EBEO:BR5- TAM-78156-96
Taxpayers' Names:

Taxpayers' Address:

Taxpayer Identification Number:

Years Involved:

Date of Conference:

"This document may not be used or cited as precedent. Section 6110 (j) (3) of the Internal Revenue Code."

Legend:

Corporation =

A =

B =

Insurance Company =

age x =

age x+1 =

Issue:

Whether the proper premium rates were used to determine the cost of insurance in connection with "split dollar" life insurance arrangements.

Facts:

A and B are executives of Corporation. Two life insurance policies owned by Corporation are at issue in this memorandum. Both

policies were issued by Insurance Company. A is the person named as the insured on one of the policies and B is the insured of the other. The entire cost of the premiums for both policies is paid by Corporation. Corporation has entered into separate agreements with A and B whereby the death benefits paid under the policies will be split between Corporation and the executives in a manner set forth in the agreements.

The policy on A's life is a flexible premium variable whole life policy with a face amount of $1.1 million. Upon A's death, Insurance Company will pay insurance proceeds to Corporation in an amount equal to total premiums paid or advanced by Corporation in connection with the policy. The remaining insurance proceeds will be paid to A's spouse. Under the terms of the policy, the amount of the proceeds to be paid upon A's death is based on a formula that includes the policy's face amount and its "policy account."

The policy on B's life is a participating whole life policy with a face amount of $500,000. Dividends payable may be taken as cash, used to pay premiums or provide paid-up additional whole life insurance, or left in the policy to accumulate with interest. Upon B's death, Insurance Company will pay proceeds to Corporation in an amount equal to total premiums paid or advanced by Corporation in connection with the policies to Corporation. The remaining insurance proceeds will be paid to B's spouse.

For purposes of calculating the value of the current insurance protection to A and B, Insurance Company and/or its agent supplied Corporation with premium rates applicable to a "Yearly Renewable Term Plan for Three Years." A memorandum from Insurance Company to its agency managers concerning these rates states in relevant part:

> This term policy is renewable annually to the end of the third policy year. There is no conversion privilege. The policy has a minimum face amount of $50,000. It is available on an annual premium basis only and is non-participating.
>
> Premiums are guaranteed. There are two premium bands: a low band for policies with face amounts up to $199,999 and a high band for policies with face amounts of $200,000 and above. There are separate male, female, and unisex rates. The unisex rates are for the employer-sponsored market only. The policy fee is $50. This fee should be added to the first-year premium to determine the actual economic benefit for split-dollar and pension plan sales. Standard and Class S premium rates are displayed in Exhibit I. (Class S rates are applicable to insureds who are smokers.) This exhibit should be retained since there will be no rate leaflet.
>
> Only regular underwriting is available. The policy is

not available on a preferred, classified, or substandard basis.

Internal Revenue Service rulings permit the use of an insurer's yearly renewable term premium rates available to all standard risks in lieu of PS 58 rates. Agents may use these first-year term rates in single-life split-dollar sales illustrations.

Separate sales illustrations for the policy itself are not available.

The rates in the various tables attached to the memorandum are by issue age and by policy year. For each issue age, increasing rates are provided for policy years 1 through 3. The rates for policy year 2 are higher than those for year 1 at the next issue age. Similarly, the rates for policy year 3 are higher than those for year 2 at the next issue age. For instance, under the unisex standard high-band table, the annual rates per $1,000 of insurance at issue age x are $3.18 in policy year 1, $4.86 in policy year 2, and $7.19 in policy year 3. At issue age x+1, the rates are $3.43 in policy year 1, $5.37 in policy year 2, and $7.99 in policy year 3.

Insurance Company or its agent calculated for Corporation the amounts includible in the income of the executives using the high-band standard unisex rates. The estimates for all policy years are based on the executives' ages, but use the rates for policy year 1 for all years. For example, in the year of issue, calculations are based on a rate of $3.18 for A who was age x. Calculations for the following year are based on a rate of $3.43 (the rate for policy year 1 at issue age x+1), rather than $4.86 (the rate for policy year 2 for an individual whose policy was issued at age x). The calculations included, at least for the first two years, the $50 policy fee.

Law and Analysis:

Rev. Rul. 64-328, 1964-2 C.B. 11, considers a so-called "split dollar" arrangement in which the employer provides the funds to pay the part of the annual premiums equal to the increase in the policy's cash surrender value each year, and the employee pays the balance, if any, of the annual premiums. The employer is entitled to receive, out of the proceeds of the policy, an amount equal to the policy's cash surrender value, or at least a sufficient part thereof to equal the funds it has provided for premium payments. The employee has the right to name the beneficiary of the balance of any proceeds payable by reason of the employee's death. The effect of the arrangement is that the earnings on the investment element in the contract are used to provide all or a portion of the cost of the employee's insurance protection, an economic benefit the value of which must be included in the employee's gross income. The Service

states in that ruling that in a situation in which the economic benefit to the employee is a continuing annual benefit so long as the split dollar arrangement is kept in force, the amount to be included annually is the annual value of the benefit received by the employee under the arrangement. Under the arrangement described therein, the ruling holds that the value of the benefit received by the employee is an amount equal to the one-year term cost of the life insurance protection to which the employee is entitled from year to year, less the portion, if any, provided by the employee. The ruling further holds that the cost of life insurance protection as shown in the table contained in Rev. Rul. 55-747, 1955-2 C.B. 228, may be used to compute the one-year term cost.

Rev. Rul. 66-110, 1966-1 C.B. 12, amplified by Rev. Rul. 67-154, 1967-1 C.B. 11, provides that in the arrangement described in Rev. Rul. 64-328 current insurance protection is the only economic benefit that the employee receives and consequently only the value of that benefit is referred to as being includible in the employee's income. However, the employee may receive other benefits, such as cash dividends or additional life insurance, the value of which would likewise be includible in the employee's gross income. The amount includible in the employee's gross income each year is equal to the excess of the total value of all the benefits received under the arrangement for such year, over the amount, if any, provided by the employee for that year. The ruling provides, with respect to dividends payable under a policy, that if the dividend is distributed to the employee, the amount of the dividend must be aggregated with the other benefits received by the employee under the arrangement for purposes of determining the amount includible in the employee's gross income. Similarly, if the dividend is used to purchase for the employee additional one-year term insurance, or paid-up life insurance (in which the employee has a nonforfeitable interest) for a period of more that one year, the employee receives an additional economic benefit, the value of which is equal to the amount of dividend. If, in the case where the dividend is used to purchase additional paid-up life insurance for a period of more than one-year, the employer retains the right to the cash surrender value of such additional insurance, the annual value of the additional insurance coverage is includible in the employee's income in the same manner as set forth in Rev. Rul. 64-328.

Rev. Rul. 66-110 further provides that in any case where the current published premium rates per $1,000 of insurance protection charged by an insurer for individual one-year term life insurance available to all standard risks are lower than those set forth in Rev. Rul. 55-747, such published rates may be used in place of the rates set forth in that revenue ruling for determining the cost of insurance in connection with individual policies issued by the same insurer and used for split dollar arrangements.

Rev. Rul. 67-154, supra, considers whether it is proper to substitute an insurer's published one-year term insurance rates for

those set forth in Rev. Rul. 55-747 where the insurer's published rates are applicable only under a dividend option whereby term insurance may be purchased with dividends on existing policies, and are lower than the premium rates charged by the insurer for other individual one-year term life insurance policies. The Service states in that ruling that in referring to rates that may be substituted for those in Rev. Rul. 55-747, Rev. Rul. 66-110 contemplates gross premium rates charged by an insurer for initial issue insurance, available to all standard risks. Dividend option rates are not available to all standard risks since "an individual seeking to purchase only a basic policy of term insurance could not obtain it at those rates." Accordingly, such rates may not be substituted for the rates set forth in Rev. Rul. 55-747.

Applying the above principles to the split dollar life insurance arrangements entered into by Corporation with A and B, the executives must include in income each year an amount equal to the excess of the total value of all the benefits received under the arrangements for such year, over the amount, if any, provided by the employee for that year. The documents sent to us indicate that for the years involved, all benefits received by A and B due to premium payments by the Corporation, earnings on the investment portion of the policy, as well as dividends paid under the policy, were in the form of current insurance protection. Thus, for each year involved A and B must include in income the one-year term cost of the life insurance protection to which each is entitled (total death benefits payable under the policy for the year involved minus the portion of death benefits payable to Corporation). Pursuant to Rev. Rul 64-328, the one-year term cost of the life insurance protection is generally determined using the rates in the table contained in Rev. Rul. 55-747 (often referred to as the "PS 58 cost" or "PS 58 rates"). However, rates that comply with Rev. Ruls. 66-110 and 67-154 may be substituted for determining such cost. The revenue agent maintains that the rates furnished by Insurance Company do not satisfy the requirements of Rev. Ruls. 66-110 and 67-154, so that they cannot be used in place of the rates set forth in Rev. Rul. 55-747. We agree.

Rev. Rul. 66-110 requires that the insurer's rates used as a substitute for the PS 58 cost be current published one-year individual term rates available to all standard risks. Pursuant to Rev. Rul. 67-154, the requirements of Rev. Rul. 66-110 will not be met unless an individual seeking to purchase only a basic policy of initial issue term insurance could obtain it at those rates. The rates used by the Insurance Company to calculate amounts to be included in A and B's gross income fail these requirements for a number of reasons. First, the rates are not one-year term rates; they are three-year duration rates. Second, the rates are not available to all standard risks since they apply only to nonsmokers. In the life insurance industry, nonsmokers are generally considered either a preferred risk or a subclass of the standard risk classification (with smokers being another subclass of the standard

risk classification). Thus, because these rates are not available to standard risk smokers, they are not available to all standard risks. Also, the rates used apply only to policies of $200,000 or more, so that they are not available to individuals seeking to purchase only a basic policy of term insurance of less than that amount. In addition, the rates used are only available for the employer-sponsored market and are not, therefore, available to standard risk individuals who do not have an employer sponsor. Finally, the file contains no indication that these rates have been published, as required by Rev. Rul. 66-110, to ensure their trustworthiness for use as a substitute for the PS 58 rates.

In the request for technical advice, the agent has expressed concern that Insurance Company has furnished Corporation with premium rates that do not comply with the requirements of Rev. Rul. 66-110. Neither Insurance Company nor the insurance agent who sold the policies to Corporation have participated in this technical advice request. Therefore, we decline to make any conclusions in this memorandum with respect to penalties imposed under the Internal Revenue Code that might apply to insurance companies and/or insurance agents who furnish incorrect substitute premium rates to taxpayers for purposes of calculating amounts to be included in gross income by reason of participating in a split dollar life insurance arrangement.

Conclusion:

The premium rates furnished to Corporation by Insurance Company cannot be used as a substitute for the rates set forth in Rev. Rul. 55-747 because they are not the insurer's current published one-year initial issue individual term rates available to all standard risks.