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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL,

FROM: Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Asset Purchase Agreement with Split-Dollar Life Insurance Arrangement

This Field Service Advice responds to your memorandum dated November 18, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

ISSUE

Whether the portion of the total purchase price allocated to the customer-based intangible/goodwill can be used to structure a split-dollar life insurance arrangement whereby avoiding taxation of the gain realized.

CONCLUSIONS

The amount payable by Management Company for the split-dollar life insurance coverage constitutes an interest-free loan to Taxpayer, the tax treatment of which is governed by I.R.C. § 7872. In addition, each Employee is taxable to the extent of any economic benefits derived from receiving life insurance coverage, as set forth in Rev. Rul. 64-328, 1964-2 C.B. 11. As Management Company is entitled to be repaid for any amounts it will use to purchase the insurance coverage, however, we do not agree with your assertion that the entire amount payable by Management Company under the split-dollar insurance agreement represents consideration received by Taxpayer.

FACTS

Taxpayer is in the business of performing Services and is organized as an S corporation. Taxpayer employs u Employees, who are also equal shareholders of Taxpayer. Pursuant to an Asset Purchase Agreement of Date 1, Taxpayer sold its operating assets to Management Company, which provides administration and management duties in fields relating to Services. In conjunction with Management Company's purchase of Taxpayer's assets, Management Company and Taxpayer entered into a Service Agreement, pursuant to which Management Company agreed to provide Taxpayer with facilities, personnel, and management services, in exchange for a "management fee" equal to v percent of the revenues generated by Employees over the term of their employment agreements. The term of the Service Agreement is x years, after which time it is renewable for five-year terms. The Asset Purchase Agreement and the Service Agreement together relieved the Employees that owned Taxpayer from performing administrative duties, thereby allowing the Employees to devote more time to performing Services. Subsequent to the Asset Purchase Agreement, the Employees retained ownership of Taxpayer.

Pursuant to the Asset Purchase Agreement, Management Company paid $y dollars in cash to Taxpayer. In addition, Management Company and each physician entered into a Split-Dollar Agreement. Specifically, the Recitals portion of the Split-Dollar Agreement provides, in part, the following respective paragraphs:

> [Management Company] desires to maximize its investment and its management fees by inducing [each Employee] to enter into a five-year employment agreement with Taxpayer and not to compete with nor raid the employees and or independent contractors of [Services] practices managed by [Management Company] or its affiliates ...;
>
> In consideration for the [noncompetition agreement], and entering into the Employment Agreement with renewal provisions as provided for in the Service Agreement, [Management Company] shall provide [each Employee] with life insurance protection under a policy that is described in Exhibit A to this Agreement ... by paying all of the premiums due on the Policy for the first five years as an additional benefit to [each Employee] ...;

> [Management Company] requires that the Policy be collaterally assigned to it by [each Employee] in order to secure [each Employee's] personal covenants, as found in the Agreement, and the repayment of the amounts it will pay towards the premiums on the policy

Thus, the Split-Dollar Agreement requires each Employee to enter into five-year employment contracts with Taxpayer, and also to enter into noncompetition agreements for a longer period. The noncompetition agreements preclude each Employee from competing with Taxpayer or "other groups" managed by Management Company that are located within an area surrounding Taxpayer. Management Company is entitled to a portion of any death benefits paid to the Employee's beneficiaries to the extent of the premiums Management Company had paid for the policy. In addition, Management Company is entitled to a return of any premiums it had paid if the policy was surrendered. Thus, although Management Company is paying insurance premiums on the split-dollar policies, it has the right to be repaid those amounts when the Employees either die, cancel, or surrender their policies. The Employees are entitled to the cash surrender value of the policy to the extent that it exceeds premiums paid by Management Company.

Pursuant to the Split-Dollar Agreement, Management Company is required to pay z dollars into a "rabbi trust" for the purpose of paying the life insurance premiums. Management Company immediately funded the trust account with sufficient cash to pay two years' premiums. In addition, Management Company provided the trust with a promissory note, payable in three annual installments, in the face amount of the three remaining premiums. The amount placed in the escrow account is subject to the claims of Management Company's general creditors.

Taxpayer argues that the amount realized from the sale of its assets to Management Company is limited to the y dollars in cash it received. With respect to the amounts paid by Management Company to fund the split-dollar life insurance arrangement, a legal opinion was furnished to each Employee that concluded that the z dollar payable for the Employees' life insurance coverage is taxable to each Employee, and only to the extent of any "economic benefit" received by the Employee, i.e., the value of each year's term insurance protection, less any amounts paid by the Employee.

In contrast, you assert that the total of y dollars and z dollars paid by Management Company should be treated by Taxpayer as amounts realized from the sale of its assets. The z dollars were paid by Management Company for the split-dollar life insurance, purportedly in consideration for the Employees' employment and noncompetition agreements. You base your conclusion on the following two reasons: (1) the amounts paid for the split-dollar life insurance were consideration for the sale of Taxpayer's customer-based intangibles; or, alternatively, (2) the amounts paid for the split-dollar life insurance were consideration for the sale of Taxpayer's goodwill.

LAW AND ANALYSIS

This case raises issues regarding the valuation of Taxpayer's assets and the valuation of Taxpayer's x-year agreement to pay v percent of the revenues generated by Employees in exchange for Management Company's management services. Taxpayer, Management Company, and each Employee have established the split-dollar arrangement as a means of providing each Employee with an economic benefit while minimizing the tax consequences of such a benefit to both the Employees and Taxpayer. By structuring the split-dollar arrangement so that Management Company directly furnishes consideration to the Employees, the parties are attempting to prevent the value of the split-dollar arrangement from being treated as consideration received by Taxpayer for either the sale of its assets or for its agreement to pay v percent of the revenues in question.

Whether any portion of amounts paid by Management Company into the trust funding the split-dollar arrangement is taxable to Taxpayer.

Some portion of the amounts paid by Management Company into the trust will be taxable to Taxpayer if it can be established that such payment was in consideration either for Taxpayer's assets or Taxpayer's agreement to enter into the x-year service contract.

Income must be taxed to the party that earns it. Commissioner v. Culbertson, 337 U.S. 733, 739-740 (1949). In this regard, a taxpayer realizes income if the taxpayer controls the disposition of that which the taxpayer could have retained or received, but diverts to another as a means of procuring the satisfaction of the taxpayer's goals. United Parcel Service of America v. Commissioner, T.C. Memo. 1999-268. In Rev. Rul. 74-32, 1974-1 C.B. 22, the Service addressed a situation where a taxpayer stipulated in a sales contract that the gain from the sale of his property be paid to a third party. The Service, citing Lucas v. Earl, 281 U.S. 111 (1930), concluded in the ruling that the entire gain from the sale is includible in the taxpayer's gross income.

Your submission characterizes the entire amount payable by Management Company pursuant to the split-dollar arrangement as consideration received by Taxpayer pursuant to the asset sale agreement. We agree with your submission generally that Taxpayer has not fully reported the income that it received from Management Company's agreement to fund the split-dollar arrangement, but we are concerned with your conclusion in one respect. As Management Company is entitled to recover the z dollars in premiums payable pursuant to the split-dollar arrangement, no more than the difference between that amount and a discounted value of that amount could be deemed received by Taxpayer.[1]

Despite this concern, we agree with you in rejecting Taxpayer's attempt to characterize the split-dollar arrangement as a loan between Management Company and each Employee, independent of the Service Agreement or Asset Purchase Agreement. It appears that Management Company's agreement to fund the split-dollar arrangement represents additional consideration to Taxpayer, in the form of an interest-free loan from Management Company, either in exchange for Taxpayer's promise to pay to Management Company v percent of its revenues from the Employees, or for Taxpayer's assets. In this regard, the benefits derived by Management Company from the employment and noncompetition agreements will not come directly from each Employee, but from Taxpayer, through a potentially enhanced share of Taxpayer's earnings resulting from such agreements. Consistent with the principles underlying Rev. Rul. 74-32, Taxpayer cannot avoid taxation on this amount by directing Management Company to pay consideration, in the form of a below-market loan, directly into the trust established for the benefit of Taxpayer's employee-shareholders.

Section 7872 governs the manner in which below-market loans are treated for Federal tax purposes. Section 7872 recharacterizes a below-market loan (a loan made in which the interest rate charged is less that the applicable Federal rate) as two transactions. First, there is an arm's length transaction in which the lender makes a loan to the borrower in exchange for a note requiring the payment of interest at the applicable Federal rate; second, there is a transfer of funds by the lender to the borrower ("the imputed transfer") equal to the amount of “forgone interest” on the loan. Thus, in a typical transaction governed by section 7872, the borrower is deemed to receive an imputed payment from the lender equal to the forgone interest, and the borrower is then deemed to have retransferred such amount back to the lender, which is typically treated as a payment of interest deductible by the borrower and taxable to the lender. The timing and characterization of the imputed payment by the lender to the borrower are determined in accordance with the substance of the transaction.

The legislative history of section 7872 indicates that the term "loan" should be interpreted broadly. Any transfer of money that provides the transferor with a right to repayment may be a loan. For example, deposits of all kinds may be treated as loans. H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1018 (1984), 1984-3 (Vol. 2) C.B. 272. In addition, Prop. Treas. Reg. § 1.7872-2(a)(1) provides, in part, that the

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[1] As explained, infra, we conclude that the amount payable by Management Company to the trust represents an indirect interest-free loan by Management Company to Taxpayer, which is subject to section 7872.

term "loan" includes generally any extension of credit and any transaction under which the owner of money permits another person to use the money for a period of time after which the money is to be transferred to the owner or applied according to an express or implied agreement with the owner.[2] The term "loan" is interpreted broadly to implement the anti-abuse intent of the statute. An integrated series of transactions which is the equivalent of a loan is treated as a loan.

Prop. Treas. Reg. § 1.7872-4(g)(1), relating to indirect loans, provides that if a below-market loan is made between two persons and, based on all the facts and circumstances, the effect of the loan is to make a gift or to pay compensation to a third person ("indirect participant"), the loan is restructured as two or more successive below-market loans ("deemed loans") for purposes of section 7872, as follows:

(i) a deemed below-market loan made by the named lender to the indirect participant; and

(ii) a deemed below-market loan made by the indirect participant to the borrower.

Therefore, we conclude that the z-dollar loan from Management Company to fund the split-dollar trust can be restructured as two loans: one loan from Management Company to Taxpayer made in respect of Taxpayer's sale of assets (both tangible and intangible) to Management Company (the indirect participant), followed by a second loan from Taxpayer to its employee-shareholders via the split-dollar trust. The imputed payment associated with the first deemed loan represents additional consideration paid by Management Company for either the Service Agreement or Asset Purchase Agreement. Taxpayer, rather than Management Company, should be regarded as using the proceeds of this loan to in turn make a loan (the second deemed loan) to the split-dollar trust for the benefit of Taxpayer's employee-shareholders.

Section 7872 only applies to the loans enumerated in subparagraphs (A) through (F) of section 7872(c)(1): gift loans, compensation-related loans, corporation-shareholder loans, tax avoidance loans, loans to continuing care facilities, and, to the extent provided for in regulations, any loan with a significant tax effect on the

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[2] We reference the proposed regulations not as litigation authority but as both an interpretation of Congressional intent and a convenience to assist you in assessing the hazards of the case. The Tax Court has recently explained that although proposed regulations constitute a "body of informed judgment," they are accorded no more weight than a litigation position. KTA-Tator, Inc. v. Commissioner, 108 T.C. 100, 102-103 (1997) (quoting Bolton v. Commissioner, 694 F.2d 556, 560 n.10 (9th Cir. 1982)).

Federal tax liability of the borrower or the lender ("significant-effect" loans). Thus, section 7872 only applies where the loan received by the taxpayer (1) is characterized as below market, and (2) falls within one of the categories enumerated under section 7872(c)(1).

Regarding the first deemed loan from Management Company to Taxpayer, the first requirement is met, because the loan from which it is restructured is interest-free. Turning to the second requirement, the deemed loan from Management Company to Taxpayer is neither a gift, compensation-related, between a corporation and its shareholder, nor a loan to a continuing care facility. As regulations under section 7872(c)(1)(E) have not yet been issued, the deemed loan cannot be classified as a significant-effect loan. Thus, we will address whether this loan is a tax avoidance loan.

Section 7872(c)(1)(D) defines a tax avoidance loan as any below-market loan one of the principal purposes of the interest arrangements of which is the avoidance of any Federal tax. Prop. Treas. Reg. § 1.7872-4(e)(1) states that tax avoidance is a principal purpose of the interest arrangements if a principal factor in the decision to structure the transaction as a below-market loan (rather than, for example, as a market interest rate loan and a payment by the lender to the borrower) is to reduce the Federal tax liability of the borrower or the lender or both.

In this case, Taxpayer transferred something of value to Management Company, and directed Management Company to pay consideration for this transfer in the form of an interest-free loan to a trust that funds a split-dollar arrangement for the benefit of Taxpayer's employee-shareholders. Taxpayer could have received this consideration directly from Management Company. Therefore, we conclude that one of the principal purposes of the interest arrangement was the avoidance of Federal income tax, and that section 7872(c)(1)(D) is applicable.

Since we have determined that section 7872 is applicable, we now turn to the question of whether the deemed loan from Management Company to Taxpayer is a term loan or a demand loan. Prop. Treas. Reg. § 1.7872-10(a)(1) provides that for purposes of section 7872, a demand loan is any loan which is payable in full at any time on the demand of the lender (or within a reasonable time after the lender's demand). In contrast, Prop. Treas. Reg. § 1.7872-10(a)(2) provides that a loan is a term loan if the loan agreement specifies an ascertainable period of time during which the loan is to be outstanding. A period of time is treated as being ascertainable if the period may be determined actuarially, e.g., a loan repayable upon the borrower's death. Moreover, Prop. Treas. Reg. § 1.7872-10(a)(3) provides that an acceleration clause that would make a loan due before the time otherwise specified is disregarded for purposes of section 7872. In this case, the interest-free loan from Management Company to Taxpayer is a term loan because the period of time during which the loan is to be outstanding is based upon the life expectancies of Taxpayer's employee-shareholders.

Section 7872(b) provides that for term loans, the borrower is treated as having received an imputed cash payment from the lender, on the date the loan is made, in an amount equal to the excess of the amount lent over the present value of all payments required under the loan. See also Prop. Treas. Reg § 1.7872-7(a)(1). Prop. Treas. Reg § 1.7872-14 provides rules for computing the present value of payments required under the loan. In this case, the imputed payment will be equal to the excess of z dollars over the present value of the z dollars required to be repaid to Management Company.

Furthermore, the imputed payment associated with the deemed loan from Management Company to Taxpayer should be characterized as consideration paid to Taxpayer either in exchange for its assets or in exchange for its agreement to transfer to Management Company v percent of the revenue. Section 7872 treats the borrower of a term loan as repaying this imputed transfer of cash to the lender as original issue discount, with the result that Taxpayer would be treated as paying interest to Management Company at a constant rate over the term of the loan. The amount and timing of these interest payments are determined in accordance with the original issue discount rules set forth in section 1274. Management Company should include such imputed interest payments in income.

Taxation of Split-Dollar Life Insurance

We now turn to the second deemed loan, i.e., Taxpayer's establishment of the split-dollar plan for the benefit of its employee-shareholders.

Section 61(a)(1) provides that gross income means all income from whatever source derived, including compensation for services, including fees, commissions, fringe benefits, and similar items. The definition of gross income is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected. Commissioner v. Smith, 324 U.S. 177, 181 (1945).

Rev. Rul. 64-328 describes a so-called split-dollar life insurance arrangement in which the employer provides funds to pay the part of the annual premiums for life insurance coverage for its employee 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. Consequently, the employee described in the ruling pays a substantial portion of the first year's premiums, and the employee's share of succeeding years' premiums decreases rapidly. 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. According to the ruling, 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, resulting in an economic benefit the value of which must be included in the employee's gross income.

In particular, the ruling concludes that the employee must include in gross income the annual value of the benefit received under the arrangement. 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 any amount paid by the employee. The ruling further states that the one-year term cost of life insurance protection provided through a split-dollar arrangement is determined by using the "P.S. 58 cost" found in Rev. Rul. 55-747, 1955-2 C.B. 228. Rev. Rul. 64-328 revokes Rev. Rul. 55-713, 1955-2 C.B. 23, which regarded a similar split-dollar arrangement for Federal income tax purposes as though the employer made interest-free loans to the employee. Furthermore, Rev. Rul. 64-328 explains that the conclusions set forth therein were the same, regardless of whether a split-dollar arrangement was in the form of an endorsement (where the employer owns the policy), or in the form of a collateral assignment (where the employee owns the policy). In this regard, the ruling additionally states that "[t]he same income tax results obtain if the transaction is cast in some other form resulting in a similar benefit to the employee." 1964-2 C.B. 11, at 15.

Rev. Rul. 66-110, 1966-1 C.B. 12, amplified by Rev. Rul. 67-154, 1967-1 C.B. 11, provides that when an employee receives other benefits under a split-dollar insurance arrangement, such as cash dividends or additional life insurance, the values of these benefits are likewise includible in the employee's gross income. For example, if a dividend is used to purchase additional one-year term insurance for the employee, or paid-up life insurance (in which the employee has a nonforfeitable interest) for a period of more than one year, the employee receives an additional economic benefit, the value of which is equal to the amount of the dividend. 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. Rev. Rul. 66-110 further provides that, if lower, the current published premium rates charged by the insurer for individual one-year term life insurance available to all standard risks may be used for determining the cost of insurance as a substitute for the "P.S. 58 cost" referred to in Rev. Rul. 64-328 and found in Rev. Rul. 55-747.

No definition of a "split-dollar life insurance arrangement" exists for Federal income tax purposes. The basic principle of the revenue rulings involving split-dollar life insurance arrangements is that an employee must include in gross income the amount of benefits provided to the employee under the arrangement. In Rev. Rul.

64-328, current insurance protection is the only economic benefit that the employee receives. In Rev. Rul. 66-110 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 life insurance arrangement for such year, over the amount, if any, provided by the employee for that year.

In this case, although the life insurance arrangement under consideration differs in some minor respects from the arrangements considered in Rev. Rul. 64-328, this arrangement is similar to the ones described in Rev. Rul. 64-328 and results in a similar benefit to each Employee. Similar to the arrangements considered in Rev. Rul. 64-328, Taxpayer in the present case would be treated as making the second deemed loan to pay a portion of the annual premiums on a life insurance policy insuring each Employee. Although each Employee has agreed to collaterally assign an interest in the policy to Management Company to secure Management Company's right to be repaid its premium contributions (from either future death benefits or the policy’s cash surrender value), these collateral assignments could be viewed as securing Taxpayer’s right to be repaid its deemed loan to the Employees; Taxpayer in turn would be viewed as using this amount to repay its deemed loan from Management Company.

If the transaction is restructured into two deemed loans, the deemed loan from Taxpayer to the split-dollar trust would appear to provide each Employee with no more than current life insurance protection during the tax years at issue. If this approach is adopted, Rev. Rul. 64-328 provides that each Employee must include in gross income for each taxable year only the amount equal to the value of the one-year term cost of the life insurance protection provided to the Employee under the arrangement, less the portion, if any, actually provided by the Employee.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

Section 197

Your request also addressed whether Taxpayer sold a customer-based intangible asset and whether the asset that was purchased was the Taxpayer’s entity goodwill or each Employee’s professional goodwill.

Pursuant to telephone conversations with your office, it was agreed that these issues needed additional factual development. In particular, we advised you that, in light of the covenants not to compete and the employment contacts for the Employees, it would be very difficult to recast this as a customer-based intangible asset sale. We have orally advised you of additional documents and information with respect to these issues.

As you develop additional facts, we suggest you consider the principles articulated in the Martin Ice Cream v. Commissioner, 110 T.C. 189 (1998) and the Norwalk v. Commissioner, T.C. Memo. 1998-279, which were cited in your advice request. Those recent cases reveal the Tax Court's view of the entity versus personal goodwill dichotomy presented in this case. We believe that your office should attempt to obtain additional documents and information which will establish that the Taxpayer and not the individual Employees developed and owned the goodwill purchased by Management Company. To the extent you can develop facts and arguments that Taxpayer, and not the Employees, owned the goodwill allegedly sold to Management Company, it will be easier to attack the form of the transaction.

Split-Dollar Issues

[redacted]. Taxpayer can be expected to argue that Management Company is receiving services directly from Taxpayer's employees, and, therefore, Management Company's split-dollar arrangement with Taxpayer's employees should be taxed solely in accordance with Rev. Rul. 64-328 and succeeding split-dollar rulings. Taxpayer may also argue that because Management Company can only be repaid from policy death benefits or cash surrender values, there can be no deemed "loan" from Management Company to Taxpayer. See Rev. Rul. 64-328.

Furthermore, we have concluded that the amounts payable by Management Company for the split-dollar arrangement can be restructured as two deemed interest-free loans: the first deemed loan from Management Company to Taxpayer, followed by a second deemed loan from Taxpayer to its employee-shareholders' split-dollar trust. This argument is derived from a proposed regulation and has not been advanced in litigation. As courts do not consider proposed regulations to be binding authority, there are substantial litigating hazards associated with our position. Despite these, the proposed regulations reflect the Service's interpretation of Congressional intent underlying section 7872, and should assist you in assessing the hazards of the case.

[redacted]

[redacted]

In terms of case development, your submission has argued that all of the amounts payable by Management Company pursuant to the split-dollar agreement constitute consideration received by Taxpayer. [redacted].

If you have any questions, please feel free to contact us.

By: HARVE M. LEWIS
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(Field Service)