SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENTS

INTRODUCTION
For over forty years, many professionals were involved in promoting or recommending split-dollar arrangements designed to minimize or eliminate tax liability associated with purchasing, gifting and funding life insurance premiums. Partly in response to national notoriety of certain estate planning designs for funding large premiums with little to no gift taxes, the Treasury Department ("Treasury") and Internal Revenue Service ("Service") finally published final regulations detailing the income, employment and gift tax consequences associated with split-dollar life insurance arrangements.

Although these historic arrangements resembled "loans," the Service took the position that the arrangements were not loans but instead provided a valuable economic benefit that must be recognized for tax purposes.[1] This economic benefit to the employee was a term insurance premium cost.

The Service published final regulations governing split-dollar life insurance arrangements entered into, or materially modified, after September 17, 2003. These final regulations require split-dollar arrangements to be taxed under one of two mutually exclusive regimes (the "loan regime" and the "economic benefit regime"). The new regulations require, with one exception, employee or third-party owned collateral assignment split-dollar arrangements to be taxed as loans subject to IRC Section 7872 ("loan regime"). Employer or donor owned endorsement split-dollar arrangements, on the other hand, are taxed under the new Section 61 Regulations ("economic benefit regime").

The final regulations follow a series of announcements beginning in January 2001 with Notice 2001-10. Notice 2002-8 was issued in January 2002 and governs tax implications for pre-final regulation split-dollar arrangements.

SPLIT-DOLLAR ARRANGEMENTS DEFINED
A split-dollar life insurance arrangement is any arrangement between an "owner" and a "non-owner" of a life insurance contract where (1) either party pays, directly or indirectly, all or any portion of the premiums on the life insurance policy; and (2) at least one of the parties paying premiums is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums.[2] This broad definition specifically excludes group term insurance arrangements but specifically includes certain compensatory or shareholder arrangements even if the arrangement does not meet all requirements under the general rule.[3]

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[1] Rev. Rul. 64-328
[2] Reg. Section 1.61-22(b)(1)
[3] Reg. Section 1.61-22(b)(2)

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SPLIT-DOLLAR REGIME DETERMINATION

The regime to which a split-dollar arrangement belongs is determined by the policy ownership designation. If the policy is owned by a shareholder, employee, service provider or donee the arrangement will be governed by the loan regime.[4] If the policy is owned by a corporation, service recipient or donor, the economic benefit regime will apply.[5] The regulation gives a special exception for some employee, service provider, or donee owned policies. If the employee, service provider, or donee is listed as the owner of the insurance contract but does not have current access to policy cash values (see "Current Access" below), the employer, service recipient or donor is treated as the owner for tax purposes.[6] This allows an employee, service provider or donee owned arrangement to be taxed under the economic benefit regime (a benefit if the annual economic benefit cost is less than the interest cost).

The person named as the policy owner in the life insurance contract is generally the owner for "regime" determination purposes. The non-owner is any other person that has any interest in the contract. If two or more persons are named as policy owners of a life insurance contract, the person who is the first named contract owner is treated as the owner if each person does not have all of the incidents of ownership with respect to an undivided interest in the contract. If each co-owner has identical incidents of ownership with respect to an undivided interest in the contract, each person is treated as the owner of a separate contract to the extent of such person's undivided interest. If each co-owner has an undivided interest in the contract then neither contract is a split-dollar arrangement.[7]

SPLIT-DOLLAR LOAN REGIME

A split-dollar arrangement is taxed under the loan regime if (1) premium payments are made directly or indirectly by the non-owner to the owner or insurance company; and (2) the payment is a loan under general principles of Federal tax law or a reasonable person would expect the payment to be repaid in full to the non-owner (with or without interest); and (3) the repayment is to be made from, or is secured by, the policy's cash value, death benefit, or both.[8]

If a loan is a below market loan, then Section 7872 applies. However, if sufficient interest is paid on the loan, then IRC Section 7872 does not apply but the general rules for debt instruments apply.[9] Typically, the policy owner is treated as the borrower and the non-owner is treated as the lender. Each premium payment advanced by the non-owner is accounted for as a separate loan for Federal tax purposes. The preamble to the regulation rejects the request that all premium payments in a single calendar year or a single quarter should be treated as a single loan.

The imputed transfers due to a below market interest rate loan must be accurately classified for proper tax treatment. Below market loans can be characterized as compensation, dividends or gifts depending upon the relationship between the parties. If the arrangement is between an employer

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[4] Reg. Section 1.61-22(b)(3)(i)
[5] Reg. Section 1.61-22(b)(3)(ii)
[6] Reg. Section 1.61-22(c)(1)(ii)
[7] Reg. Section 1.61-22(c)(1)(i)
[8] Reg. Section 1.7872-15(a)(2)
[9] Reg. Section 1.7872-15(a)(1)

and an employee, the benefit is taxable as compensation. If the arrangement is between a corporation and shareholder, the benefit is taxable as a dividend. And finally, if the arrangement is between a donor and donee, the benefit is taxable as a gift.[10]
Also, the shareholder, employee or donee can be classified as an indirect split-dollar participant.[11] The shareholder, employee or donee is classified as an indirect participant if a split-dollar loan is made by the lender to the borrower because of the indirect participant's relationship to the lender (e.g. the employer loans money to a life insurance trust created by the employee). This indirect split-dollar loan is restructured as two identical loans (1) a loan from the lender to the indirect participant and (2) a loan from the indirect participant to the borrower.[12] The income and gift tax consequences of each loan needs to be analyzed and reported annually.

TYPES OF BELOW MARKET LOANS

The final Regulation contemplates three types of split-dollar loans: (1) demand loans; (2) term loans and (3) certain term loans treated as demand loans ("hybrid loans"). A demand loan is any loan that is payable in full at any time on the demand of the lender.[13] A term loan is any split-dollar loan that is not a demand loan.[14] Finally, a hybrid loan is a split-dollar loan (1) payable at the death of an individual; (2) conditioned on the future performance of substantial services by an individual or (3) a gift term loan.[15] Hybrid loans are treated as split-dollar *term* loans to determine whether the loan provides sufficient interest, but then the forgone interest, if any, is determined annually. This type of loan is similar to a *demand* loan in that it is calculated annually but uses the applicable federal rate ("AFR") appropriate for the loan's term when the loan was advanced.

BELOW MARKET SPLIT-DOLLAR DEMAND LOANS

A split-dollar demand loan is tested *each calendar year* for sufficient interest.[16] The interest is sufficient if the stated loan rate, based on annual compounding during the year, is equal to or greater than the blended annual rate for the year. The Service publishes the blended annual rate in the July Internal Revenue Bulletin. If the interest is not sufficient, the loan is a below market split-dollar demand loan for the whole calendar year.

Two deemed transfers occur if the loan is classified as a below market split-dollar loan.[17] The forgone interest for the calendar year is treated as transferred from the lender to the borrower and then retransferred as interest by the borrower to the lender. The transfers are deemed to have occurred on the last day of the calendar year and are classified to the borrower as compensation, dividend or gift depending upon the parties' relationship and as interest income to the lender.

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[10] Reg. Section 1.7872-15(a)(1)
[11] Reg. Section 1.7872-15(e)(2)
[12] See example under Reg. Section 1.7872-15(e)(2)(ii)
[13] Reg. Section 1.7872-15(b)(2)
[14] Reg. Section 1.7872-15(b)(3)
[15] Reg. Section 1.7872-15(e)(5)
[16] Reg. Section 1.7872-15(e)(3)(ii)
[17] Reg. Section 1.7872-15(e)(3)(iii)

BELOW MARKET SPLIT-DOLLAR TERM LOANS

A split-dollar term loan is tested *on the date the loan is made* for sufficient interest.[18] The interest is sufficient if the imputed loan amount equals or exceeds the amount loaned. The imputed loan amount is the present value of all payments due under the loan, determined as of the loan date, using a discount rate equal to the AFR in effect on such date. The AFR must be appropriate for the loan's term and for the compounding period used in computing the present value. If the term loan does not have sufficient interest, the loan is classified as below market.

If the term loan is a below market loan, each loan will be characterized as consisting of two portions: (1) the imputed loan amount; and (2) an imputed transfer from the lender to the borrower.[19] The imputed loan amount is the present value of all payments due under the loan, determined as of the date the loan is made, using a discount rate equal to the AFR in effect on that date.[20] The imputed transfer occurs at the time the loan is made and is equal to the excess of the amount loaned over the imputed loan amount. This excess is treated as compensation, dividend or gift to the borrower depending upon the relationship between the lender and the borrower.

The regulation gives an example of a 15-year interest-free loan from a corporation to a shareholder.[21] The premium is $100,000 and the AFR is 7%. The imputed loan amount is $36,244.60 (the present value of $100,000 in 15 years discounted at 7%). Accordingly, the imputed dividend from the corporation to the shareholder is $63,755.40 (100,000 – 36,244.60).

HYBRID SPLIT-DOLLAR LOANS

As stated previously, hybrid loans are treated as split-dollar *term* loans to determine whether the loan provides for sufficient interest, but then the forgone interest, if any, is treated as a *demand* loan and determined annually.[22] This hybrid rule applies to split-dollar loans that are (1) payable at the death of an individual; (2) conditioned on the future performance of substantial services by an individual or (3) gift term loans. The effect of this rule is to treat all or part of the income tax consequences as occurring annually rather than in a lump sum at the loan date. This rule only applies to income tax consequences, not gift tax consequences, for gift split-dollar loans.[23]

CONTINGENT PAYMENT LOANS

Contingent payments are used to determine the yield of a split-dollar loan which in turn is used to determine the accruals of interest for original issue discount purposes and determine whether the loan is a below market loan.[24] For example, a typical split-dollar loan agreement states that the employer's repayment is solely from the cash value of the policy or the death proceeds. In the early

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[18] Reg. Section 1.7872-15(e)(4)(ii)
[19] Reg. Section 1.7872-15(e)(4)(iv)
[20] Reg. Section 1.7872-15(e)(4)(ii)
[21] Reg. Section 1.7872-15(e)(4)(vi)
[22] Reg. Section 1.7872-15(e)(5)(i)
[23] For gift tax purposes, the gift will be measured as a one-time imputed transfer at the date the loan is contracted. For income tax purposes, the loan will be treated as forgone interest on each year during the existence of the loan.
[24] Reg. Section 1.7872-15(j)

policy years, the cash value may be lower than the premium paid. This arrangement is a non-recourse premium loan and classified as a contingent payment loan.

The contingent payment rules do not apply to a non-recourse split-dollar loan if the parties to the arrangement represent in writing that a reasonable person would expect that all payments under the loan would be made. This exception requires that the borrower and the lender sign such writing not later than the last day (including extensions) for filing the Federal income tax return of the borrower or lender, whichever is earlier, for the taxable year in which the lender makes the first split-dollar loan under the arrangement.[25]

OTHER SPLIT-DOLLAR LOAN CONCERNS

- The preamble to the Regulations states that loan treatment will not apply if, because of an agreement between the owner and non-owner, the arrangement does not provide for repayment by the owner to the non-owner.[26]
- There are specific rules for split-dollar loans with variable interest rates.[27]
- Any accrued but unpaid interest on a split-dollar loan that is subsequently waived, canceled or forgiven by the lender is treated as if the interest had in fact been paid to the lender and then retransferred by the lender to the borrower.[28] Also, if the lender waives, cancels, or forgives the interest payment, the amount of interest deemed transferred or retransferred is increased by a deferral charge.[29]
- The final Regulation provides payment ordering rules for payment from the borrower to a lender under a split-dollar loan arrangement.[30]

SPLIT-DOLLAR ECONOMIC BENEFIT REGIME

A split-dollar arrangement is taxed under the economic benefit regime if the donor, employer, service recipient, or corporation is the owner[31] of the life insurance policy and the right to the cash value and death benefit of the policy allocated to the donee, employee, service provider, or shareholder is contained in an endorsement to the insurance contract.[32] This is similar to the traditional endorsement split-dollar arrangements with tax consequences very similar to the pre-final regulation rules.

Any "economic benefits" provided under the endorsement split-dollar arrangement are taxable to the non-owner.[33] The value of the economic benefits is reduced by any consideration paid by the non-owner for the benefit received. The tax treatment of the benefit provided depends upon the

[25] The writing must include the names, addresses, and taxpayer identification numbers of the borrower, lender and any indirect participants. A copy or the writing should be attached to each party's federal tax return for such year.
[26] For example, if the owner and the non-owner enter into a separate agreement providing that the non-owner will make a transfer to the owner in an amount sufficient to repay the purported loan, the premium payment will not be treated as a loan. Presumably the "loaned" premiums are taxable to the employee as bonuses.
[27] Reg. Section 1.7872-15(g)
[28] Reg. Section 1.7872-15(h)
[29] Reg. Section 1.7872-15(h)(1)(i)
[30] Reg. Section 1.7872-15(k)
[31] See discussion under Split-Dollar Regime Determination for definition of "owner"
[32] Reg. Section 1.61-22(b)(3)(ii)
[33] Reg. Section 1.61-22(d)(1)

relationship between the owner and non-owner. If the arrangement is between an employer and an employee, the benefit is taxable as compensation. If the arrangement is between a corporation and shareholder, the benefit is taxable as a dividend. And finally, if the arrangement is between a donor and donee, the benefit is taxable as a gift.

The regulation further states that if the split-dollar arrangement involves a third-party (such as an insurance trust) there are two tax consequences.[34] For example, if a corporation sets up an endorsement split-dollar arrangement between itself and a shareholder's ILIT, the firstt tax consequence is a dividend to the shareholder and the second tax consequence is a gift of the economic benefit from the shareholder to his or her ILIT.

ECONOMIC BENEFITS

There are three elements defined as economic benefits that the owner can provide to a non-owner under the economic benefit regime: (1) the cost of current life insurance protection; (2) the amount of any policy cash value to which the non-owner has current access; and (3) the value of any other economic benefit to the extent not accounted for in a prior tax year.[35]

COST OF CURRENT LIFE INSURANCE PROTECTION

As is with the case of "grandfathered" split-dollar arrangements (pre-final regulation arrangements), the value of current life insurance protection enjoyed by the non-owner is an economic benefit provided by the owner of the life insurance contract.[36] The "cost" of this current life insurance protection is based on a term premium factor published by the Service. The most recent "term premium factor" is Table 2001 that was published in Notice 2001-10 and republished in Notice 2002-8.[37]

The "amount" of the current life insurance protection is the death benefit over the total amount payable to the owner. Stated another way, it is the death benefit endorsed to the non-owner. Typically, this will be the death benefit in excess of the greater of policy cash value or premiums paid.

The date for determining the amount of death benefit is the last day of the non-owner's taxable year unless the owner and non-owner agree instead to use the policy anniversary date. However, once the valuation date is set, it can only be changed with the consent of the Commissioner.[38]

CURRENT ACCESS

The non-owner of the policy is taxable annually to the extent that he or she has current access to policy cash values. Current access is present if any one of the following three is present: (1) the

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[34] Reg. Section 1.61-22(d)(1)
[35] Reg. Section 1.61-22(d)(2)
[36] Reg. Section 1.61-22(d)(3)
[37] Notice 2002-8, 2002-1 C.B. 398
[38] Reg. Section 1.61-22(d)(5)(i)

non-owner can, directly or indirectly, access the policy cash values; (2) the owner cannot access the policy cash values; or (3) the owner's general creditors cannot access the policy cash values.[39]

The non-owner has direct or indirect access to cash value if he or she can withdraw or borrow from the policy. The preamble states that the non-owner also has access if he or she can surrender, assign, alienate, pledge or encumber the cash value.

The cash value is inaccessible to the owner (and therefore taxable to the non-owner) if the owner does not have all rights to policy cash values normally held by an owner of a life insurance policy.

The preamble to the regulation states that the policy cash value is inaccessible to the owner's general creditors if, under the terms of the split-dollar arrangement or by operation of law or any contractual undertaking, the creditors cannot, for any reason, effectively reach the policy cash value in the event of the owner's insolvency. In those states where the law protects the cash value of a life insurance policy from the claims of creditors of the owner, the non-owner seems to be always taxable on the equity even though the non-owner cannot access the cash value and the owner has full access to the cash value.

OTHER ECONOMIC BENEFITS

Any dividends, withdrawals, partial surrender or policy loans going directly or indirectly to the non-owner constitute an economic benefit. The dividends, withdrawal, partial surrender or policy loan is treated as though the cash was paid to the owner of the policy and then paid by the owner to the non-owner.[40]

Once again, the non-owner is taxed in accordance to the relationship with the owner. If the arrangement is between an employer and an employee, the benefit is taxable as compensation. If the arrangement is between a corporation and shareholder, the benefit is taxable as a dividend. And finally, if the arrangement is between a donor and donee, the benefit is taxable as a gift.

POLICY TRANSFER TO NON-OWNER

If policy ownership is changed from the owner to the non-owner, the amount taken into account for income, gift and employment tax purposes is the fair market value to the extent it exceeds the consideration paid by the non-owner and the equity recognized, if any, by the non-owner.[41] The fair market value of the policy is its cash value plus the value of all other rights under the contract other than the value of current life insurance protection.[42] If the policy is transferred in connection with the performance of Services, the tax consequences will be determined under I.R.C. Section 83. If the transfer is a gift, the fair market value is determined under Reg. Section 25.2512-6(a).[43]

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[39] Reg. Section 1.61-22(d)(4)(ii)
[40] Reg. Section 1.61-22(e)(1)
[41] Reg. Section 1.61-22(g)(1)
[42] Reg. Section 1.61-22(g)(2)
[43] Generally, the value of a gift of life insurance is established through the sale by the company of comparable contracts. If a new policy is purchased for another or is transferred as a gift immediately after purchase, its gift value is the gross premium paid by the donor to the insurance company. If a person makes a gift of a previously purchased

DEATH PROCEEDS

The regulation states that the death proceeds are excluded from gross income of the beneficiary under I.R.C. Section 101 "to the extent such amount is allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner or the value of which the non-owner actually took into account.[44]"

The preamble to the regulation states that, in situations where the non-owner neither pays for nor takes into account the current life insurance protection (i.e. the term premium factor – Table 2001), the proceeds are treated as if they were payable to the owner (employer), excluded from the owner's income by I.R.C. Section101 and then distributed by the owner to the beneficiary. The taxation of this deemed distribution depends upon the relationship of the parties.

The death proceeds received by the owner of the policy are excluded from gross income under I.R.C. Section 101 except for any part of the proceeds representing current insurance coverage for which the non-owner paid or accounted for the cost.

BASIS IN THE POLICY

The non-owner has no basis (investment in the contract) before termination of the split-dollar arrangement.[45] However, the non-owner (now owner after policy transfer) receives basis in the contract equal to any equity previously accounted to him or her plus any consideration paid for the policy transfer.[46]

The current life insurance protection attributed to or paid by the non-owner during the split-dollar arrangement does not create basis for the non-owner. The preamble to the regulation states that only the owner of the policy can have basis in the policy while the split-dollar arrangement is in effect. The cost of current coverage cannot create basis in the non-owner, even after the policy is transferred, since the term premium cannot perform a double duty (pay for term coverage and create basis at the same time).

TAX CONSEQUENCES TO THE OWNER

Any distribution of cash to the non-owner as dividends, withdrawals, partial surrenders or specified policy loans will be treated as a distribution first to the owner subject to the income tax rules of IRC Section 72.[47] Any premiums paid, directly or indirectly, by the non-owner to the owner for current life insurance protection or other economic benefit under the policy is included in the owner's gross

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policy, and the policy is single premium or paid-up, its gift value is the single premium which the company would charge currently for a comparable contract of equal face value on the life of a person who is insured's age at the time of the gift. If the gift is of a policy on which further premiums are payable, the value is established by adding the "interpolated terminal reserve" and the value of the unearned portion of the last premium.

[44] Reg. Section 1.61-22(f)(3)(i)
[45] Reg. Section 1.61-22(f)(2)(i)
[46] Reg. Section 1.61-22(g)(4)(ii)
[47] Reg. Section 1.61-22(e)(1)

income.[48] The preamble to the regulation justifies this position on the grounds that the owner is "renting" the current coverage to the non-owner.
The owner's basis in the policy will be equal to the premiums paid by the owner plus the amount of any term premium paid by the non-owner that was included in the owner's income.[49]

Lastly, any economic benefit realized by the non-owner during the existence of the split-dollar arrangement is not deductible by the owner.

CONCLUSION

The Service is still fine tuning many of the split-dollar rules. For example, the Service has requested information on how to calculate the "term premium factor" and what is "fair market value" when transferring a life insurance policy under I.R.C. Section 83.

Few would argue that the final split-dollar regulations were long overdue. The final regulations give clear guidance as to the income and gift tax consequences for most types of split-dollar arrangements.[50] Taxpayers can no longer take the position that a particular rule does not apply to their split-dollar arrangement because of ambiguities in the law.

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[48] Reg. Section 1.61-22(f)(2)(ii)
[49] Reg. Section 1.61-22(f)(2)(ii)
[50] The regulation specifically "reserves" on issuing guidance for partnership split-dollar arrangements