Uses of Life Insurance for the Closely-Held Business

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FOR THE CLOSELY-HELD BUSINESS

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I. INTRODUCTION

With the prevalence of insurance products growing and the necessity for them questioned in light of the new estate tax repeal law possibly eliminating the estate tax, this outline will explore the need for life insurance by a closely-held business and its owners. In working on this outline, the topic I have found to be of most interest to many people, and the technique that is used most often in the widest variety of situations, was split dollar arrangements. These arrangements are being used in retirement planning, business succession planning, as well as estate tax planning and have now been called into question after recent developments in the law. As a result, I address the split dollar area close to the beginning of the outline and address the remaining uses of life insurance in the business context thereafter.

II. INSURANCE PRODUCTS AND PRODUCT ISSUES

There are a variety of insurance products available in the market place and these products are changing daily. Even more importantly, in light of the uncertainty of the estate tax system and the current weakness of the economy and declining interest rates, the features and assumptions behind each type of policy should be examined more closely and, perhaps, disregarded. In addition, after the events of September 11, 2001, the carrier’s financial strength should be considered as well, to ensure it can survive to pay these death benefits. The ability to obtain the same or better coverage should always be considered and reassessed throughout the life of the policy.

Finally, the owner’s capacity for risk should be taken into account. When a policy is purchased for estate tax protection or to meet contractual obligations under a buy-sell agreement, the capacity for risk is generally not high. However, the definition of risk may change. The risk is usually thought of as pertaining to the size of the premium and how long it might be paid, however, a better measure of risk may be the ability of the policy to adjust to changing circumstances, both for the economy and for the owner.

The main types of policies that are available are as follows:
A. Term Life Insurance.

1. True term life insurance is pure insurance in that the premium represents the cost to the insurance company to provide life insurance on the insured for a certain period, at his or her age and state of health, plus an amount for administration costs and profit. As time passes, the premiums rise, which reflects the increasing age (and higher mortality rate) of the insured. Term insurance may be renewable, wherein the insured will not have to satisfy the insurance company’s underwriting requirements each year.

2. “Level term insurance” is a variation of term insurance, in which the period of coverage is for a longer period and the premiums remain “level” for the entire period. In order to provide for this “leveling” of premiums, the owner is paying a higher premium (higher than a one-year term policy premium) at the outset. These excess amounts are used to cover the latter part of the period of coverage when the insured’s higher mortality rates result in the premiums that would normally exceed the level premium. These products are being offered in periods of 20 to even 40 years, in some cases.

3. If life insurance protection is needed for a limited duration, term insurance usually will be the most economical choice. For those clients who are concerned that they will pass away prior to the repeal of the estate tax in 2010 (or don’t believe the estate tax will be repealed, but may be reduced to levels that are substantially lower than present levels), term life insurance will allow them to maintain life insurance coverage possibly at the lowest cost, while adopting a “wait and see” attitude for the next ten years. On the other hand, if the life insurance protection is needed for a longer period, permanent insurance may prove more economical, since the amount of the annual premium under most permanent policies will not increase, unlike the premiums of the term policy after the coverage period ends.

4. When considering term insurance, always consider the advisability of “convertible” term, in which the insured can convert his or her term policy to whole life without having to undergo another medical exam. As such, if during the period of coverage the insured becomes unable to obtain new insurance, he or she can convert to a whole life policy before the end of the period when the term premium will rise.

B. Whole Life Insurance.

1. In whole life insurance, premiums are higher than with level term policies because, after deducting the actual risk element of the premium (and administration costs), the balance is set up as a reserve on the books of the insurance company.

2. This reserve is invested as part of the insurance company’s investment portfolio and is credited with earnings each year. As an institutional investor, the company may obtain higher returns than the individual investor, and this should be reflected in the earnings. These earnings create the “cash value” of the policy, which the
owner may either (i) use to pay the premiums, (ii) withdraw from the policy, or (iii) use as collateral for a loan, usually from the insurance company. If retained in the policy, the cash value will continue to grow as a result of the payment of premiums and earnings.

3. If the policy is surrendered, the cash value, less any outstanding loans, is paid to the owner.

4. Whole life also provides greater certainty about the cost of the insurance over the insured’s expected life. Although investment performance and other costs will have an effect on the earnings, the insurance company guarantees a minimum return on the cash value, and the annual premium cannot be increased. For clients who believe there will always be an estate tax or have long-term liquidity requirements, such as stock purchase obligations, financial support or need the cash value to support, for example, a split dollar arrangement or for borrowing at retirement, the whole life policy provides the greatest security and certainty. The higher institutional investor return can also be attractive as interest rates fall and the stock market remains bearish.

5. Whole life policies use a fixed premium that the insurance company considers sufficient to endow at the guarantees. The guarantees may not be necessary if the policy is purchased during a period of low interest rates, but the owner has no choice about the guarantees. This should be taken into account when deciding between whole life and another type of policy such as universal or variable, which have no guarantees, and are more flexible than whole life policies.

C. Combination Whole Life and Term.

1. It is possible to purchase a policy, a portion of which is term life insurance (whose premiums are initially lower), and a portion of which is whole life. As the insured grows older, the term portion becomes more expensive, but the earnings on the whole life grow as well, which can be used to meet the increased premium costs. Many times these products are used to keep the total premium low due to gift tax concerns.

2. In addition, the policy can have provisions for additional premiums or a paid-up additions rider.

D. Universal Life Policy.

1. A universal life insurance policy also combines the features of term insurance and whole life. After deducting the risk element and administration expenses, the balance of the premium is placed in an account maintained by the insurance company, which is credited with interest at a rate determined by the insurer based on some recognized index, such as a Treasury note index or the insurer’s general portfolio.

2. The policy owner may add to the account by paying larger premiums or stop making payments altogether, within certain limits. The account will
continue to be charged for the risk element of the life insurance and administration costs. As long as there is money in the account for these expenses, the coverage will continue. Once the money is gone, the policy will lapse.

3. Cash values will increase more quickly in universal then in whole life because the insurance company recovers its costs from the premium more quickly in a whole life policy.

4. Where actual returns are less than what was anticipated, the death benefit may be reduced or it can be reduced or increased by the policy owner. As such, in recent years universal life with guaranteed minimum rates of return became popular. With present interest rates so low, however, a guaranteed minimum does not provide very much value to the policy; although, on the other hand, policy holders will probably not be required to pay higher premiums than what they are paying now to keep the policy in force, since investment returns are at their lowest levels in years. Death benefit amounts will differ depending on the option chosen by the owner, who can usually select either a fixed death benefit or a death benefit equal to a specified amount plus the cash value of the policy.

5. Universal policies are useful for business owners who are just starting out, when available cash flow is low. The policy can begin to develop cash value quickly with lower initial premiums that can be increased as cash flow increases and/or the owner is nearing retirement age. In addition, the cash value can be built up as a “war chest” for the business, if needed.

E. Variable Insurance.

1. With variable insurance, the premiums (or a single premium) purchase term insurance and the balance is placed in a segregated account that is invested in at least five investment funds (such as equities, bonds or a mixed portfolio) chosen by the policyholder.\(^1\) The number of funds is a result of the requirement for diversification.\(^2\) The amount of the cash value or the death benefit will be determined by the investment performance of the funds and the options chosen by the owner. For example, some variable policies offer a guaranteed interest option.

2. Usually the policy holder can change the death benefit within certain limitations, which allows the owner to emphasize the death benefit (for estate tax or business succession goals) or the growth in the cash value (for retirement goals), and the owner can choose the type of investment and degree of market risk. As such, with all the uncertainties of any investment, it can be used to provide for liquidity at death, but is more useful as an investment to be utilized during lifetime by maximizing the cash value accumulation. However, variable products can make planning uncertain because either the cash value or the death benefit is subject to change.

3. It is through variable insurance products, generally private placement variable life insurance, that “accredited”\(^3\) investors (or qualified purchasers\(^4\)) are utilizing investments such as hedge funds for greater return, especially in light of
income-tax-free internal cash value build up, and tax-free distributions through partial surrenders and loans (unless a MEC is used, which is discussed below), available for life insurance. An added benefit of these investments is that if held in an off-shore insurance trust, creditor protection\textsuperscript{6} may be available for the assets.\textsuperscript{6} The tax-free nature of the product (as a result of the insurance wrapper) is important, since hedge fund managers tend to trade actively, often incurring short-term capital gains, and investors often want to move from one fund to another without incurring income tax.\textsuperscript{7}

4. Finally, since the variable product uses segregated funds, unlike whole life and universal products, the accounts will be protected from the claims of the insurance company’s creditors.

F. Variable Universal Insurance.

This is a combination of the two types of policies, in which segregated accounts are used and the available investments are more varied than what is available in universal policies. Premiums and death benefits can be adjusted by the owner, as is the case in universal policies.

G. Survivorship Insurance.

1. Survivorship insurance, which now may be in the form of any of the policies discussed above, pays a death benefit at the death of the survivor of the insured individuals. The most common form is between husband and wife, but it is not restricted to the spousal relationship. The annual premium for a survivorship policy, when both insureds are alive, is lower than on a policy with the same death benefit insuring only one life because the life expectancies of two (or more) people are longer than one life expectancy, and, as such, premiums are expected to be paid over a longer period of time. However, the premiums will increase substantially at the death of the first insured. This increased cost can be addressed either by paying higher premiums at the outset, or buying a first-to-die rider that will pay a lump sum at the death of the first insured.

2. Survivorship policies may contain exchange rights that allow the insured to exchange the policy for separate policies on the life of each insured upon a triggering event. That triggering event could be the dissolution of a business, if the insureds were partners or shareholders, divorce, if the insureds were married, or even a change in the estate tax law.

3. Survivorship insurance’s greatest utility is if one of the insureds is in poor health. Many of the techniques described herein can still be utilized with affordable premium rates if this is the case, because the good health of the other insured will support the premium. The major drawback to this type of insurance is the need to wait for the death of both insureds before the death benefit is paid, unless a first-to-die rider is purchased.
H. Group Term Life Insurance.

1. This is employer provided insurance, which is usually (but not necessarily) a single policy that covers a group of employees. If a policy meets certain requirements under the Code, the economic value of the first $50,000 of coverage each year is excluded from the employee's income. The economic value of the balance of any coverage is taxed to the employee using a table contained in the regulations. The employer obtains a deduction for the premiums it pays to provide the coverage. If the employee's interests in the insurance are convertible to a single policy and irrevocably assignable, the insurance may be assigned to an irrevocable life insurance trust, and after a three-year period, if the insurance trust is properly drafted, it will not be includable in the insured's estate.

2. Companies usually provide this type of insurance because employees expect it, but as term insurance, the cost of providing the $50,000 coverage on members of the group will get more expensive as the group grows older. It can cover only employees (not non-employee owners) and its provisions are inflexible. Finally, if a company is bankrupt, the coverage is lost, as the policy is an asset of the company.

I. How to Compare Policies.

1. The following is the information needed to understand the existing whole life policy.

   a. The current policy statement from the insurance company. This will confirm the type of policy, the premium, the current guaranteed and total cash value and death benefit, the current dividend amount and how it's applied.

   b. The original sales illustration will show how the policy was expected to perform.

   c. An in-force illustration will show how the insurer projects the policy will perform in the future. It will show premium outlay, dividends, and guaranteed and total cash values and death benefits. The in-force illustration should be run at the current dividend scale and then at a reduced dividend scale, if necessary. (The economy may render a reduced dividend scale meaningless if the current dividend scale is very low.) Both illustrations should show the initial rate of return (IRR) on the death benefit at all years.

   d. When analyzing a whole life policy, the owner will want to see how far the policy is from self-sufficiency.

2. The following is the information needed to evaluate the whole life/term blend alternative.
a. An illustration that shows the necessary premium and its projected duration to maintain the policy.

b. Determine whether the term portion is paid by separate premium or by dividends.

c. As with the whole life illustration, the illustration should show the IRR on the death benefit at all years, which should be run at the current dividend scale and, if necessary, a reduced dividend scale.

3. Information needed to evaluate a universal life policy.

a. An illustration that assumes the current death benefit and infusion of additional premiums.

b. Another illustration should show how the policy will perform at a reduced rate of return, if necessary. By seeing the impact of a lower return on the planned premium, the owner can determine how conservatively he should fund the policy.

c. Are there any guaranteed bonus interest credits, mortality refunds or other means of awarding persistency?

d. What are the death benefit guarantees and extended maturity provisions?

4. Information needed to evaluate a variable policy.

a. An in-force illustration for the existing policy, including premiums, distribution pattern, rate of return, and the average cost of funds.

b. A breakdown of all policy charges and their duration.

c. Information about the funds, about policy holder services, allocation/reallocation of premiums, and transfers among accounts.

III. TAXATION OF LIFE INSURANCE

A. Life insurance proceeds are not taxable income under Section 101(a)(1) of the Code unless there is a transfer of the policy for value, which is discussed below.

B. The build up of the cash value of the policy is also tax-free under Section 7702(g). The build up in cash value can result in an alternative minimum tax in a C corporation as a part of the corporation's adjusted current earnings, which is an AMT
preference item. However, the alternative minimum tax has been repealed for corporations with $5,000,000 or less in gross receipts for the corporation's first “three-taxable-year period” and for corporations with $7,500,000 or less in gross receipts for all succeeding three-taxable-year periods.

C. Generally, withdrawals against the policy are tax-free to the extent of the owner's investment in the contract, which equals the total amount of the premiums paid on the policy minus any amounts received under the contract income tax-free. Any amounts withdrawn that are in excess of the investment in the contract are taxed as ordinary income.

1. Policy loans are not treated as distributions.
   a. Loans do not reduce the owner's investment in the contract.
   b. Interest paid on loans incurred to purchase a single premium life insurance contract is not deductible, or to purchase any other personal life insurance policy under Section 163(h). See below for discussion of corporate owned life insurance.

   a. Under Section 7702A(a), a MEC is a contract that dates from June 21, 1988 and fails the “seven pay test”.
   b. If the accumulated amount that is paid under the contract at any time during the first seven years of the contract equals or exceeds the sum of the net level premiums which would have been paid on or before such time if the contract provided for paid up future benefits after the payment of seven level annual payments, the contract fails the seven pay test.
   c. If a contract is a MEC, distributions, including loans and dividends paid in cash, from the contract are taxable as ordinary income at the time received to the extent that the distribution exceeds the investment in the contract, however, the gain is recognized, first, before the return on the investment portion.
   d. The portion of the distribution that is taxable may also be subject to a 10% excise tax under Section 72(v)(1). The excise tax is imposed on taxable distributions made before the policyholder attains the age of 59-1/2 unless the distributions are due to the policyholder's disability or is part of a series of substantially equal periodic payments made for the life of the taxpayer or the joint lives of the taxpayer and his or her spouse.

D. Policy dividends paid or credited before the maturity or surrender of a contract are treated as a return of the investment in the contract. To the extent the dividends exceed the investment in the contract, the excess is taxed as ordinary income.
1. The tax treatment remains the same whether the dividends are taken in cash, applied against current premiums, used to purchase paid up additions to life insurance or left with the insurance company to accumulate interest.

2. Policy dividends are amounts paid by mutual insurance companies and are usually paid because the company has experienced favorable mortality, income and/or loading experience.

3. If the owner takes the policy cash values in the form of an annuity, the annuity is taxed under Section 72, which allows the owner to defer the immediate recognition of the entire gain and instead spread the recognition over the annuity period.

E. Surrender of policy: To the extent of the investment in the contract, the proceeds from a policy surrender are non-taxable. The excess of such amounts is ordinary income.

1. If there is an outstanding loan upon surrender, it will be a deemed distribution of the loan proceeds and taxable to the extent the distribution exceeds the investment in the contract.

2. No deduction is allowed for losses incurred upon the surrender or lapse of a policy.

3. If the owner takes the distributed policy cash values in the form of an annuity, the annuity is taxed under Section 72, which allows the owner to defer the immediate recognition of the entire gain and instead spread the recognition over the annuity period.

F. Maturation of a policy: A policy “matures” on the date calculated by the insurance company to be the date all insureds would have died and the insured is still alive. The amount received or value of the policy over the investment in the contract is ordinary income.

G. Sale of the policy: Upon the sale of a policy, the excess of the amount received minus the owner’s investment in the contract is taxable. The Service takes the position that loss will not be recognized because the policy is personal in nature. If the policy is exchanged in a transaction where Section 1035 does not apply (see below), the taxable income would equal the value of the policy received minus the owner’s investment in the original contract.

1. Amount received will also include the amount of outstanding loans.
H. If a policy is transferred in a taxable transaction, such as a taxable
distribution from a corporation, there will be gain to the extent the policy’s fair market
value exceeds the owner’s investment in the contract.

1. The fair market value of a policy with continued policy
obligations will be the sum of the interpolated terminal reserve plus the value of the
unearned premium.\(^{23}\)

2. The value of a single premium or paid up contract is the
single premium which the insurer would charge currently for a comparable contract of
equal face value on the life of a person who is the insured’s age at the time of the sale,
which is its replacement cost.

3. In a split dollar arrangement, the value of the policy is the
interpolated terminate reserve plus the value of the unearned premium, reduced by any
amounts that must be repaid by the employer under the plan.

4. Even if the policy has a continued premium obligation, if
there has been a change in the insured’s health, the value of the policy would be it’s
replacement cost.

5. The value of the policy received in exchange for services
under Section 83 is its cash surrender value.\(^{24}\)

I. Exchange of policies.

1. There will be no gain or loss recognized on the exchange of
certain types of policies for “similar” types of policies under Section 1035, provided that
the policies are on the lives of the same insured. The owner’s basis in the new policy is
the same as the old policy.\(^{25}\)

2. The taxpayer is treated as receiving “boot” to extent that
debt on the old policy exceeds the debt on the new policy. If boot is received by the
owner, gain will be recognized.\(^{26}\) The extinguishment of a policy loan will be treated as
boot.\(^{27}\) If the loan is continued on the exchanged policy, there will be no boot.\(^{28}\)

J. Premium payments.

1. Premiums paid on personal life insurance are non-
deductible.\(^{29}\)

2. See below for premiums paid on corporate owned life
insurance.
K. What is life insurance for tax purposes?

1. For policies issued after December 31, 1984, the contract must be a life insurance contract under Federal and state law (which generally means it distributes mortality risks among a pool of insureds) and meet one of the two alternative tests under Section 7702(a). An actuary is necessary to ensure that one of the tests is met.

   a. Cash accumulation test: The cash surrender value cannot at any time exceed the net single premium which would be paid at any time during the contract to fund the future benefits (generally the death benefits) under the contract.

   b. Guideline premium corridor test: The sum of the premiums paid under the contract cannot at any time exceed the sum of the guideline level premiums, or, if larger, the guideline single premium. These guideline premiums are the amounts of either such premium necessary to fund the death benefit set forth in the policy.

IV. TRANSFER FOR VALUE ISSUES

A. Under the transfer for value rules of Section 101(a)(2), life insurance proceeds in excess of the owner’s investment in the contract will be taxed as ordinary income if there has been a transfer of the policy or any interest in the policy for valuable consideration. It does not apply to the initial purchase of the policy.

B. Transfers for value includes the sale of the policy and the transfer of rights to the policy proceeds for consideration but does not include a pledge of a policy or collaterally assigning the policy. It also includes transfers of policies subject to loans. Transfers are broadly defined and include naming someone as a beneficiary of a policy for valuable consideration and reciprocal designations of beneficiaries. In Monroe v. Patterson, the mutual promises of co-owners in a buy-sell arrangement to transfer life insurance policies amounted to transfers for value.

C. There are five exceptions under Section 101(a)(2). If a policy is transferred for valuable consideration, but the transfer fits within one of these exceptions, the death benefit will not be subject to income tax.

1. Carryover basis. If the basis in the hands of the recipient is determined, in whole or in part, by reference to the original owner’s basis, the transfer for value rules will not apply. This exception can protect part-sale, part-gift situations where the transferor’s basis is greater than the consideration paid by the transferee (including gifts of policies with outstanding loans (a transfer for value), so long as the basis is greater than the loan amount). Tax-free transactions, such as contributing policies to an entity, transfers to spouses under Section 1041, and transfers in a tax-free corporate reorganization will also be protected.

2. Transfers of a policy to the insured is exempt from these rules, even if the policy is sold to the insured.
3. Transfer to a partner of insured. There is no *de minimus* rule on how much of a partnership interest the partner has to own. This exception, since there is no corresponding exception for co-owners of a corporation or beneficiaries of a trust, means that a partnership is the best vehicle for holding multiple policies in a cross-purchase agreement.

4. Transfer to a partnership in which the insured is a partner. The requirement imposed by the Service that a valid partnership needs a business purpose should be kept in mind under this exception. Recently, however, the Service ruled that the transfer of a policy from a trust to a limited partnership in which the insureds were limited partners would not constitute a transfer for value, and the limited partnership was a valid partnership.\(^3\)

   a. This exception should include limited liability companies ("LLC"s)\(^3\). A recent private letter ruling addressed a partnership in Kansas which was to be converted to LLC and held that although there was a transfer for value, the LLC was treated as a partnership for tax purposes and the exception to the rule was applied.

   b. In Rev. Proc. 99-3, the Service stated that it would not issue advance rulings on the status of the partnerships substantially all of the assets of which consist of life insurance on the lives of the partners, and whether the transfer of the life insurance policies to such partnerships would constitute a transfer for value.

5. Transfer to a corporation in which the insured is a shareholder or officer.

   a. It should be noted that there is no exception under the transfer for value rules for a transfer to the shareholders of a corporation in which the insured is a shareholder or officer. This can cause a problem in a cross-purchase arrangement when it is desirable to transfer the policies among shareholders as discussed later in the outline.

6. If a previously tainted policy (considered transferred for value) is subsequently transferred under one of the exemptions, it can lose its taint.\(^3\)

7. If a policy is transferred for value, the amount includable in taxable income is the death benefit minus (i) actual value of consideration, and (ii) premiums and other amounts subsequently paid by transferee.

V. **SPLIT DOLLAR ARRANGEMENTS**

   A. A split dollar arrangement is a method of sharing the cost of life insurance between two parties, and, for purposes of this outline, between a company and its employees (or trusts) and between a company and its owners (or trusts). At the
termination of the agreement, one party receives back the payments that it made (or an amount set forth in the agreement) and the other party receives the policy or remaining death benefit.

B. The split dollar agreement sets forth how the premiums will be paid, who will be entitled to the proceeds and/or cash surrender value of the policy and when, as well as who will own the policy and who will have rights to the policy. Generally, the amounts to be repaid are paid back when the agreement becomes too expensive to maintain and is terminated, or at the death of the insured, when there is cash available and no more premium payments required.

C. The policy is owned by one of the parties, and rights to the same are held by the other party. There are two types of ownership.

1. The first method is called the collateral assignment method and the person or entity entitled to the death benefit owns the policy. The other party usually is paying a portion or all of the premiums and is protected by an assignment of certain rights in the policy against all or part of the cash value and death benefit for its rights of repayment of the amounts it advanced. Usually the insured or a third party owns the policy and certain rights to the policy are assigned to the company who is paying all or a portion of the premium. The insured may or may not contribute to the premium payments, depending on the economics of the arrangement.

2. The second type of ownership is called the endorsement method, in which the company owns the policy. The insured or third party has irrevocable rights to the death benefit of policy which are set forth in the “endorsement” of the policy. Companies like the endorsement method because, as the owner of the policy itself, they control the policy and its benefit, albeit subject to the agreement. However, as an asset of the company, it is subject to the company’s creditors, notwithstanding the endorsement to the insured/third party, who may be regarded as only another, subordinate, creditor. In addition, for financial statement purposes, the endorsement method is preferred by companies. In a collateral assignment arrangement, an account receivable under the agreement must be reflected on the company books, which under some state laws may be prohibited, especially if the account receivable is non-interest bearing.

D. Split dollar arrangements provide life insurance benefits to an employee or owner at a reduced cost. This can be very important to an owner or employee to whom life insurance may otherwise be unaffordable as a result of health, occupation or interests, such as flying small aircraft. However, even though the cost to the employee or owner is initially reduced or eliminated, it must eventually paid back, either out of the cash surrender value or the death benefit. If there was no obligation to repay the company, the entire amount paid by the company would be compensation to an employee (or a dividend or distribution to an owner, depending on the type of entity).
1. Even with the repayment obligation, there are income consequences to the insured. What is currently under debate is how much and what is taxable.

   a. If the insured is entitled to the death benefit, what is taxable to the insured, at the very least, is the cost of life insurance protection received each year when paid for by the company. If, however, the insured reimburses the company for such cost or the company is entitled to the death benefit, rather than the insured, then such cost is not taxable to the insured. The question then becomes has the insured received any economic benefit when the company paid the premium that would be includable in the insured’s taxable income.

   b. A discussion will follow about the income and gift tax consequences of a third party owner of the policy (or, third party with rights to a portion of the proceeds).

E. The split dollar arrangement can utilize a single life policy on the insured or a second to die policy on the lives of such person and his or her spouse.

F. Treatment of split dollar arrangements prior to Notice 2001-10 and 2002-8.

The Service issued Notice 2001-10 on January 29, 2001, 35 and Notice 2002-8 on January 3, 2002, 36 which revoked 2001-10. To understand the impact of these Notices, the rules prior to the Notices must be addressed and compared to the Notices.

1. There are two types of split dollar arrangements, equity and non-equity.

   a. In a non-equity arrangement, the amount to which the company is entitled to be repaid is equal to the greater of the total premiums paid by the company or cash surrender value of the policy.

   b. In an equity arrangement, the company is only entitled to receive back the total premiums paid by the employer. In an equity split dollar arrangement, if the cash surrender value grew larger than the premiums paid by the company, as a result of cash build-up and investment return on the cash surrender value, the increased value became the insured’s or third party’s property.

2. Theories of income taxation of split dollar.

   a. An income tax consequence arose when each premium payment was made. This is still the case under Notice 2002-8, although the measurement of the amount includable in the taxable income of the insured has changed under the Notice.

   b. When the company paid any portion of the premium, if the insured (or a third party) was entitled to the death benefit, there resulted
an economic benefit equal to the value of the insurance protection to the insured, and the insured must include this benefit in his or her taxable income less any portion of the premium allocable to the value of the insurance protection paid by the insured.

(1) This benefit, prior to the Notices, was measured by what was known as the P.S. 58 cost, which is cost of term insurance on the insured’s life based on US Life Table 38 published in 1946.

(2) In Rev. Rul. 66-110, as amplified by Rev. Rul. 67-154, the Service permitted the determination of the benefit by using the insurance company’s tables for term insurance (so long as it was the insurance company who was issuing the insurance for the split dollar arrangement). However the alternative rate had to be for the published one year initial unrestricted term insurance rates available to all standard risks for a person of the same age as the insured.

(3) There are no court cases or published rulings involving second-to-die policies. There is a letter called the “Greenberg letter” by the industry (in which both the writer, an insurance company representative, and the recipient, a Treasury Department official, had the name Greenberg) which discussed this issue. In practice, the benefit is measured by using a “P.S. 38” rate which is derived from the same US Life Table 38 that sets forth the P.S. 58 table rates. The P.S. 38 rates are calculated by multiplying the P.S. 58 cost of one insured by the P.S. 58 cost of the other insured with further adjustment for interest.

(4) A major problem with split dollar is the year-by-year increase in this benefit as the insured ages, which can make the income tax burden (and possibly the bonus discussed below that the company pays out to cover such tax burden) prohibitive. At this point, the agreement is generally terminated or “rolled out”, the company is repaid what it is due under the Agreement and the insured, or third party, holds the policy with no further obligations to the company.

(5) The company’s portion of the premium is a non-deductible expense under Section 264(a)(i). The portion paid by the insured is non-deductible expense to the insured under the same Code section.

(6) If the company desires a deduction for the amount of the premium payment and the insured is an employee, it can pay a bonus to the employee, who would use it to pay his or her share of the premium. The employee would have taxable income in the year the bonus was paid. The company could also pay an additional bonus to cover the employee’s income taxes.


a. The split dollar agreement sets forth the method of premium payments, and the general method is that the company pays at least the cost of
insurance protection (if not the entire premium), and the insured/third party pays the balance, if any.

b. The cost of the insurance protection paid by the company will be included in the taxable income of the insured, and if a third party is entitled to the death benefit, the insured will be deemed to have made a gift to the third party of the same amount.38

c. If the company is paying only the cost of insurance protection, the company’s share of the premium will increase each year as the insured gets older, since the cost increases as the insured gets older. The gift to a third party will also get higher.

d. Alternatively, the insured can pay the cost of insurance protection, and the company pays the balance of the premium. Then there is no taxable income to the insured, at least initially.

4. If the agreement is terminated while the insured is alive, the company receives what it is entitled to, either from the insured or the third party, who makes the payment by borrowing against the policy or through the payment of other assets. The insured/third party then owns the policy with no restrictions.

5. **Ownership of Policy.**

a. If the insured owns the policy (under the collateral assignment method) or rights to the death benefit (under the endorsement method) the policy proceeds will be includable in the insured’s estate, although that portion of the death benefit payable to the company would be a claim against the estate.

b. If an irrevocable trust is used to hold the insurance policy under the collateral assignment arrangement or the rights to the death benefit are irrevocable assigned to the trust under the endorsement method, the death benefit would escape estate taxation, so long as there is no incidents of ownership under Section 2042 in the insured’s hands.

c. If the insured is the controlling shareholder of the company, then such shareholder is deemed to hold all of the rights in the policy that the company holds. As a result, the rights in the policy that amount to incidents of ownership under Section 2042 cannot be held by the company because such rights will be attributable to the controlling shareholder. Usually, such rights, under the agreement, are waived or held by the trust. This can cause a problem if the company needs such rights in the policy to secure its rights of repayment under the split dollar agreement.
G. Notice 2001-10.

1. In all rulings by the Service, including Notice 2001-10 and Notice 2002-8, it is accepted that the outside of the loan transaction discussed below, the insured receives a benefit from the company when the company pays premiums that are not reimbursed by the insured equal to the value of the life insurance protection.

   a. The Service rejected the measure of the benefit that has been used in the past, namely the P.S. 58 costs and the alternative rates issued by insurance companies in Notice 2001-10.

      (1) Under this Notice, the P.S. 58 rates could only be used for taxable years ending on December 31, 2001. The Service provided a Table 2001 in the Notice to measure the benefit received by the insured whenever the company pays the premium and is not reimbursed by the insured. This table is based on the term table of uniform premiums under Section 79(c), with some adjustments.

      (2) The benefit can also be measured using the term tables of the insurance company issuing the policy, if lower, if it meets all of the requirements set forth in Rev. Rul. 66-110. However, after December 31, 2003, in order to use these tables, they must be made available to any person who applies for term insurance from the insurance company, who must sell term insurance at these rates to people who apply through normal distribution channels. Finally, the insurance company cannot more commonly sell term insurance at higher rates to persons with standard risks.

   b. The Notice also stated that any dividends paid or distributions made to the insured from the policy was also taxable to the insured under Section 61.

   c. The insured will have taxable income equal to the entire premium if

      (1) the company has no beneficial interest in the policy (such as a collateral assignment method between a company and a non-employee shareholder), which would not be the case between an employer and employee under the Notice which states that in a non-loan transaction an employer has a beneficial interest in the policy through its payment of the premiums, regardless of the method used, and

      (2) there is no reasonable expectation of repayment of such amounts.

   d. The Notice then addressed the tax consequences that arise when the cash surrender value of the policy exceeds the amounts payable to the company in an equity split dollar arrangement (the “equity”). Again, outside of the loan transaction, the Service stated that such excess resulted in taxable income to the insured/employee under Section 83. The Service also stated that general tax principals would apply for income and gift tax purposes outside of the compensation context. As a
result, such excess in a policy in which a non-employee owner was the insured, would result in taxable income to the insured under Section 61.

(1) The Service arrived at Section 83, which requires a transfer of property in exchange for services in order to be operative, by finding in the Notice that by making the premium payments that gave rise to the excess cash value, the company acquired a beneficial interest in the policy which it transferred to the insured.

(2) The question that arises with this position is (i) when does the transfer take place, each year or at the termination of the agreement, on which the Service is undecided, and (ii) is there actually a transfer for property, as required under Section 83, when the company makes the transfer of its beneficial interest in the policy in exchange for services, and (iii) if Section 83 does not apply, do the economic consequences change at all, in light of the Service's application of general tax principles to the arrangement?

(3) If the parties decide to treat the characterization as a non-loan transaction (or the facts of the situation do not fit into a characterization as a loan), (i) the company will be treated as having acquired an ownership interest in the policy through its share of premium payments, and (ii) the insured will have taxable income equal to the equity.

(4) The Service did not take a position on the timing of when the equity will be included in the insured's taxable income; as it occurs or when the agreement is terminated. The Service admitted in the Notice that this issue requires further review. In the meantime, the Service states in the Notice that it will not find such additional income until the agreement is terminated, at least until their review is completed. Furthermore, if the Service finds that taxable income arises prior to the termination of the agreement, the Service will grandfather any arrangements that were entered into prior to the Service's findings. How that grandfathering will work, whether it will cover the entire agreement or just the payments that were made up to the date of the Service's findings, is unclear.

e. Notice 2001-10 stated that the parties may characterize the split dollar arrangement as a loan transaction which would avoid the Section 61/83 characterization, and the parties would be governed by Section 7872. However, whether the parties' characterization as a loan transaction would be honored depends upon the facts of the situation. The Service will accept the parties' characterization of the payments if (i) it is not clearly inconsistent with the substance of the arrangement, (ii) it has been consistently followed by the parties from the inception of the arrangement; and (iii) the parties fully account for all economic benefits conferred on the employee in a manner consistent with the characterization. The characterization, once made, is irrevocable.
If the transaction is characterized as a loan, then the treatment of the loan will be determined under Section 7872. Accordingly, if interest is not charged at the applicable federal rate, there is taxable income to the insured equal to the foregone interest. In a term loan, the lender is deemed to have transferred the present value of the foregone interest for the entire term to the borrower at the inception of the loan. This will result in taxable income to the insured at the inception of each loan.

A demand loan will only treat the foregone interest on an annual basis as being transferred to the borrower. This will result in spreading out the taxable income and perhaps eliminating some of the income if the agreement is terminated early. A demand loan is defined as any loan payable in full at the lender’s demand or has an indefinite term. If the split dollar agreement can be terminated (and the loan comes due upon termination) upon termination of employment or can be terminated by either party at will, this would be a demand loan. A term loan is defined as any loan that has an ascertainable term and any loan that is not a demand loan. Ascertainable is set forth in the regulations to include a period that is determined actuarially. If the agreement terminates solely at death or upon retirement, which must occur at a certain age, or after a fixed number of years, the term would be definitely determinable.

The foregone interest is determined under the applicable federal rate in Section 1274(d). A demand loan uses the short-term rates and can fluctuate. A term loan uses the rate for the same term for the entire period, and the period can last long enough that the long-term (higher) rates are applicable. Foregone interest would also be a gift by the insured to a third party owner of the death benefit.

One concern with loan transactions is state law considerations. Some states prohibit corporations from making loans to or for the benefit of officers, directors and shareholders.


1. On January 3, 2002, the Internal Revenue Service (“Service”) issued Notice 2002-8, which is their guidance on the tax consequences, both present and future of split dollar arrangements. It is probably the only guidance on this topic we are going to see for quite some time, at least until the Service issues its intended proposed regulations on the subject.

2. As stated above, there are two methods of ownership of the policy. The endorsement method, where the company owns the policy and the collateral assignment method, where the insured owns the policy.

a. In the past, the ownership of the policy wasn’t really relevant to the tax consequences of a split dollar arrangement. In fact, in Notice 2001-10, the Service stated that “the determination of the employee’s gross income is
unaffected by whether the endorsement method or the collateral assignment method is
used.”

b. The position of the Service in part II of 2002-8, however, is very different. The Service states that Treasury and the Service intend to
issue proposed regulations setting forth two mutually exclusive regimes and the regime
that will be applied to all arrangements entered into after the date of Final Regulations
will depend on who owns the policy, the company or the insured. If endorsement method
is used the transaction will be treated as an economic benefit arrangement. If the
collateral assignment method is used, the transaction will be treated as a loan transaction.

3. In Part III of Notice 2002-8, the Service addressed and
revised its prior position set forth in Notice 2001-10 on the measurement of the taxable
income the insured receives each time a premium is paid. Notwithstanding the repayment
obligation, the insured receives a taxable economic benefit equal to the value of current
life insurance protection.

a. The first and oldest measurement is the PS 58 cost, which was first introduced in Revenue Ruling 55-747. The Service stated in Notice
2001-10 that such measurement no longer bore an appropriate relationship to the fair
market value of the value of current life insurance protection and revoked Revenue
Ruling 55-747. Notice 2002-8 states that Revenue Ruling 55-747 remains revoked,
however, notwithstanding such revocation, the PS 58 costs can still be used, permanently,
for arrangements entered into before January 28, 2002, to value life insurance protection
provided to the employee and one or more additional persons.

b. The second measure of value (if you can’t or don’t
want to use the PS 58 costs) is Table 2001. It was included in Notice 2001-10 and
republished in Notice 2002-8. Table 2001 has much lower rates than PS 58 rates. Under
2002-8 this Table can be used for all arrangements entered into until future guidance is
issued. The Notice also states that appropriate adjustments should be made to the table if
more than one life is insured.

c. The third measure set forth in Notice 2002-8 is the
insurer’s own rates under the standards set forth in Revenue Ruling 66-110 as amplified
by Revenue Ruling 67-154. These rates can be used permanently for arrangements
entered into prior to January 28, 2002. For arrangements entered into after January 28, 2002
more stringent standards are imposed on insurer rates in order to use them for
periods after January 31, 2003. If an insurance company cannot meet these more
stringent standards by January 1, 2004, the company’s rates cannot be used to measure
the value of the life insurance protection and the higher Table 2001 rates will have to be
used.

d. The rates under all three measures of value will
increase as the insured gets older and at a certain point, it may become uneconomical to
continue to maintain the split dollar arrangement in light of the income tax burden to the
insured (or the company if the company is bonusing out the money to the insured to help him or her meet the tax obligation). At that point, especially if the arrangement has sufficient growth in its cash surrender value to support the policy without further company contributions, the arrangement is usually terminated, the amounts due to the company are paid out of the policy values and the policy becomes the insured’s or third party’s with no further obligation. This termination, often called a “roll-out”, can result in additional taxation.

4. The most controversial amount of taxable income is the equity in “equity split dollar arrangements”. Equity split dollar is an arrangement where the company is only entitled to be repaid for the premiums it paid during the arrangement (or sometimes the lesser of such payments and the cash surrender value in the policy). Any growth in the cash surrender value over the amount payable to the company is the insured’s (or third party’s). Cash surrender value can exceed such amount payable to the company at any time during the arrangement, based on market conditions, although it usually takes several years. What the Service first raised in a 1996 TAM was that at such time as the cash surrender value exceeds the amounts payable to the company, the insured has taxable income. Furthermore, the insured has taxable income when an equity split dollar arrangement is terminated and premiums returned to the company allowing the insured (or third party) to keep the excess (which is used to maintain the policy once the company payments have ceased).

   a. Notice 2002-8 states that the Service will not treat the insured as having taxable income when the cash surrender value exceeds the amounts payable to the company, either under the proposed regulations or for any arrangement entered into before the proposed regulations. Essentially, you will not have interim taxation of the equity in the arrangement.

   b. However the taxation of the equity at the termination of the arrangement is a different matter. For arrangements entered into before January 28, 2002, pursuant to paragraph 4 of Part IV of Notice 2002-8, so long as the company is entitled to full repayment of the amounts it advanced, then, if the arrangement is terminated before January 1, 2004, there is no taxation of the equity at termination. If these arrangements are not terminated before January 1, 2004 but for all periods beginning on or after January 1, 2004, if all amounts due to the company (and not repaid to the company) since the inception of the arrangement, are treated as a loan, then the arrangement will not be deemed to be terminated and, as such, there is no taxation of the equity at termination.

   c. All other arrangements that don’t fit into the safe harbors described above, will still not be deemed to be terminated, even if the company is repaid its premium payments, so long as the insured continues to include the economic benefit in his or her taxable income, each year, regardless of the company’s economic interest in the policy under paragraph 2 of Part IV of the Notice. Without termination, there is no taxation of the equity in the arrangement.
5. Split dollar arrangements can be structured as loan transactions or can be converted from an economic benefit transaction to a loan transaction at any time, so long as all amounts payable to the company (and not repaid to the company) since the inception of the agreement are treated as loans entered into at the beginning of the first taxable year of the conversion, under paragraph 3 of Part IV of the Notice. Under 2001-10, this kind conversion was not possible because the loan had to be treated as such from the inception of the arrangement). If there is equity in the arrangement at the time of conversion, however, there may be a deemed termination of the arrangement and taxation of the equity.

   a. In either transaction, if a third party owns the policy, the amount of taxable income to the insured is a deemed transfer to the third party with the resultant gift tax consequences.

   b. In the loan arrangement, there is no economic benefit passing to the insured, whether its in the form of the value of the insurance protection or when the cash surrender value exceeds the amounts payable to the company or at termination of the arrangement. The loans will, however, be subject to the rules of Sections 1271-74 and 7872. Taxable income only arises if interest is not charged at the applicable AFR or the repayment requirement is removed. Notice 2002-8 states in Part II, which admittedly discusses only the proposed regulations the Service intends to issue, that in an employment relationship, the foregone interest will be deemed to be interest income paid by the employee to the employer and compensation income paid by the employer to the employee. To the employer the arrangement would be a wash because the deduction for compensation would offset the interest income. In the non-employment relationship, there would be no such offsetting deduction.

   c. Notice 2002-8 did not give any guidance on whether the loan is a demand loan or term loan, as requested by practitioners in their comments to Notice 2001-10, although it states, again in Part II, that it would be a series of loans, presumably as the premiums are paid.

6. In conclusion, split dollar arrangements that are entered into prior to January 28, 2002, have received very favorable grandfathering in Notice 2002-8. They can continue to use the PS 58 costs, they can be converted to loans and they can remain as economic benefit arrangements, there will be no interim taxable income when the cash surrender value exceeds the amounts payable to the company and no taxation at the termination of the agreement, if the arrangement fits within the safe harbors of the Notice.

7. Split dollar arrangements that are entered into after January 28, 2002 and prior to the date of final regulations can be structured as loans or economic benefit arrangements, there will be no interim taxable income in an equity split dollar arrangement and they too can be converted from benefit arrangements to loans. There are still many unresolved issues in split dollar arrangements, many of which will
undoubtedly be raised in the comments to Notice 2002-8 and perhaps resolved by the Service in their Regulations.

I. **Split Dollar Arrangements: A Beleaguered Technique.**

On July 3rd, 2002, the Service and Treasury issued the anticipated Proposed Regulations setting forth the system of taxation that governs split dollar arrangements entered into after the date of the Final Regulations. These Regulations were much worse than expected and imposed new levels of taxation on the parties to a split dollar arrangement that had not previously existed.

On July 28th, an article appeared in the New York Times discussing a form of split dollar arrangement that permitted the transfer of large amounts of assets to the insured's family at little or no gift tax, utilizing a loophole in the Service's previously issued Revenue Rulings, which was not completely closed by Notice 2002-8. On August 16th, the Service and Treasury issued Notice 2002-59, to prohibit what is referred to in the Release to the Notice as an abusive tax avoidance transaction using split dollar life insurance. In a New York Times article dated August 17th, the reporter stated that Treasury acted after being sent a copy of the July 28th New York Times article by Rep. Lloyd Doggett (Tx-D).

On July 30th, Congress passed the Sarbanes-Oxley Bill, which President Bush subsequently signed into law. This new law prohibits loans and other "extensions of credit" by any publicly traded company to its executives after July 30, 2002. When the Bill was reviewed prior to passage, the possibility of the inclusion of split dollar transactions in the prohibition against extension of credit and loans was raised with Senator Sarbanes, who refused to rule out the possibility (although at the same time admitting that Congress had not considered the implications to split dollar arrangements), which would terminate split dollar arrangements between publicly traded companies and their executives.

So what changed between January and July? Mainly the myriad of stories that have appeared in the news over the past eight months about the many executives who have walked away with generous split dollar arrangements and policies that have large cash surrender values, notwithstanding the failures of their companies. In light of the loss of jobs and loss of value in 401(k) plans holding company stock suffered by the rank and file employees, these split dollar arrangements appeared to favor the executives who were responsible for their company's failures over the general employees. It should be kept in mind when reviewing these events, that these out-of-work employees vote and they now have plenty of time to make it to the polls in November.

The Proposed Regulations apply for purposes of Federal income, employment and gift taxes. There is no mention of estate taxes. They contain an expansive definition of "split dollar arrangements" and they also define who is to be considered the owner and the non-owner in the arrangement. These definitions are very
important since the tax consequences of an arrangement under these Regulations depend on whether the non-owner or the owner is making premium payments.

There are two regimes described in these Proposed Regulations, an economic benefit regime and a loan regime. The Preamble describes them as being mutually exclusive. Generally, endorsement method split dollar arrangements are subject to the economic benefit regime and collateral assignment methods split dollar arrangements are subject to the loan regime, but there are exceptions to these rules. Under the economic benefit regime, the owner is treated as providing economic benefits to the non-owner. The value of the economic benefits, reduced by any consideration paid by the non-owner to the owner, is treated as transferred from the owner to the non-owner. Depending on the relationship of the owner and non-owner, the transfer may be compensation, gift or dividend. Depending on the relationship between or among a non-owner and any one or more other persons, the economic benefit may be treated as provided from the owner to the non-owner and separately from the non-owner to such other person or persons.

In loan regime, the owner and non-owner are treated, respectively, as the borrower and lender. Each premium payment is a separate loan, and the $10,000 de minimus exception rule of Section 7872 does not apply. Furthermore, any amounts received by lender under the contract that is part of a split dollar arrangement is treated as though the amounts had been paid to borrower and then paid by borrower to lender. No amount received by lender with respect to the loan is treated as received by reason of the death of the insured.

Under Notice 2002-59, Treasury and the Service state that the parties to a split dollar arrangement may only use the valuation methods set forth in Notice 2002-8 to value the current life insurance protection (which were the table known as Table 2001 and the insurer’s own rates, but only if these rates met certain requirements) received by the party other than the party paying that portion of the premium. In other words, these methods may be used only to establish the economic benefit that is passing from one party (the payor) to another party. This describes the standard split dollar arrangement. According to this Notice, these valuation methods cannot be used to measure what the payor is paying on its (or his or her) own behalf, which would not be considered transferred to the payee. There have been no intimations of this theory set forth in Notice 2002-59 in any prior Revenue Rulings, Field Service Announcements or Notices.

Where are we now? Until the words “extension of credit”, as they appear in the Sarbanes-Oxley bill, are explained, no publicly traded company should enter into a new split dollar arrangement with any of its executives, whether or not it is an economic benefit arrangement, and certainly not using a loan arrangement. The payment of an economic benefit, in light of the repayment obligation under the terms of the arrangement, could be construed as an extension of credit. Although split dollar arrangements entered into prior to July 30th, and not materially modified thereafter, are grandfathered under the new law, we don’t know if premium payments made after July 30th pursuant to a grandfathered arrangement are likewise grandfathered or are treated as
a new split dollar arrangement. Unless we receive some guidance on the matter, premium payments by a publicly traded company on even a grandfathered arrangement should be delayed until the grandfather provisions are explained.

The policies underlying any grandfathered split dollar arrangement should be left alone as well until we receive further guidance. In the Preamble to the Proposed Regulations, the question was raised whether if the only material modification in the split dollar arrangement was a Section 1035 policy exchange, should the entire arrangement be considered materially modified (and hence, lose its grandfathered status). The Preamble’s question was phrased in a manner that could lead us to believe that the Service and Treasury considered a policy exchange to be a material modification, but as a policy matter (no pun intended), they were considering whether, notwithstanding the material modification, such an exchange should eliminate the benefits of grandfathering. Accordingly, in light of the Service’s and Treasury’s question in the Preamble to the Proposed Regulations, policy exchanges in a split dollar arrangements that are grandfathered under the Sarbanes-Oxley law, should be carefully considered, in light of the possibility that the grandfathering of the entire arrangement under the new law may be lost.

For others who are contemplating split dollar arrangements or have already entered into them, the world has not changed too much since Notice 2002-8, unless the arrangement contemplated the type of transaction described in the New York Times articles. If so, the taxpayer would be wise to consider very carefully whether to enter into such an arrangement, based on their belief of whether Notice 2002-59 is correct or not. However, even if the taxpayer considers Notice 2002-59 to be wrong, consider this analogy. You may have the absolute right to poke a stick in a hornets’ nest on your own property, but do you really want to do it?

For those who already have such arrangements in place, the arrangement should be examined to ensure it meets parameters set forth in the various Revenue Rulings, but it should not necessarily be unwound. It is questionable whether Treasury and the Service have the ability to retroactively eliminate a transaction that takes advantage of a loophole in its own Revenue Rulings.

Finally, split dollar arrangements that are entered into prior to the date of the Final Regulations which are not between publicly traded companies and their executives will not be subject to the Sarbanes-Oxley law; nor will they be subject to the regimes set forth in the Proposed Regulations; therefore such arrangements are something to be considered. However, they should be considered quickly. In light of the speed in which Notice 2002-59 was released in reaction to the New York Times article, Treasury and the Service are probably not going to delay very long after the hearings on the Proposed Regulations, which are scheduled for October, before issuing Final Regulations. Once the Final Regulations are issued, there will be a whole new system of taxation of split dollar arrangements, and if there are any more company failures accompanied by executives with large compensation packages, including grandfathered
split dollar arrangements, the Final Regulations could be even more onerous than the Proposed Regulations.

J. **Reverse Split Dollar.**

In reverse split dollar the company will receive the death benefit, and the insured has a right of repayment of (a) the amounts the insured paid for premiums, or (b) in an equity arrangement, the greater of (i) the amounts he or she paid, or (ii) the cash surrender value. If the insured dies, his estate or the third party receives an amount set forth in the agreement and the company receives the remaining death benefit. Since the company receives the death benefit for which it pays the cost of the insurance protection, this portion of the premium would not be taxable income to the employee/insured.

1. Generally, the employee owns the policy and endorses the death benefit (subject to the employee’s rights) to the company. Upon termination of the arrangement prior to the employee’s death, the employee retains the policy (with its cash value), and the company releases its rights to the death benefit. So long as the company simply paid for the value of the insurance protection each year, when the agreement terminates there is no further tax consequences and no repayment obligations from the employee. If the corporation paid for more than the value of insurance protection, then there is a repayment obligation on the part of the employee, and if not enforced upon termination, there is compensation income to employee.

2. The continued availability of the P.S. 58 (and P.S. 38) rates in reverse split dollar and, indeed, the availability of the transaction itself, has been called into doubt in light of the terms and language used in Notice 2002-8.

3. The parties must be careful when entering into a reverse split dollar arrangement and choosing a method of measuring the value of the insurance protection; if the payments the company makes are too high (more than the cost of the insurance protection), it will result in compensation to the insured. If the amount is too low, a gift may result if a trust or third party holds the rights to the cash value.

4. As the insured grows older, the economic benefit increases dramatically in a non-loan transaction. This results in greater contributions by the employee (or third party owner) to avoid taxable income, greater imputed income and/or increased gift. In a loan transaction, the loans grow over the years and will reduce the cash value or death benefit to a greater extent as time passes. Accordingly, it generally becomes economically desirable to terminate the arrangement after several years, and in a non-loan transaction, usually when the insured reaches his or her late 50s or 60s. However, upon termination, the company must be repaid.

   a. In an endorsement arrangement, the company receives the amount due and then transfers the policy back to the insured/third party who is holding an unrestricted irrevocable right to the death benefit. The transfer for value rules should be considered if the transfer is made to a third party.
b. In a collateral assignment arrangement, it is terminated by repaying the company through withdrawals from the policy, surrender of paid up additional and/or loans from the policy. The insured/third party retains the policy.

c. There is also the issue of the tax consequences of termination the policy in light of an excess of cash value over the amount payable to the company, which may be triggered at termination under Notice 2002-8 in an equity arrangement, if the arrangement does not fit within one of the Notice’s safe harbors.

d. If policy does not have sufficient cash surrender value to repay the company, then if there is an employment relationship, the company can bonus to the insured over one or more years by releasing the amount due back to it. The insured can also pay the employer back over a period of years, which should have less impact on the policy, if the payments are made by borrowing against the policy or by borrowing from a third party. The company can lend the money to the insured with an interest bearing or interest-free loan.

e. If a third party, such as a trust, holds the policy, the insured could gift additional assets to the trust from the inception of the arrangement to ensure that the trust has other assets with which to pay the company upon termination of the agreement. The usual gifting techniques should be considered to maximize the amount of assets that can be transferred into a trust with little or no gift tax, such as GRATs, sales, using entities to achieve discounts in values, and transferring stock options with appreciation potential.

f. In a second to die policy, a first to die rider may be available to fund the amounts necessary to terminate the arrangement.

VI. THE USES OF LIFE INSURANCE IN CLOSELY HELD BUSINESS AND BY CLOSELY HELD BUSINESS OWNERS

Closely-held businesses and business owners use life insurance for a variety of reasons, and pay for the policy (i) out of the assets of the business, (ii) with a cost sharing arrangement, or (iii) with compensation paid to the employee such as a split dollar arrangement. The business and its owners use life insurance primarily because it provides the liquidity that is absent in a closely-held corporation. This liquidity, in the form of a death benefit, will support the owner’s family at the death of the owner when the business may fail or suffer cash flow problems as a result of the owner’s death. Even if the business does not suffer at the death of the owner, the loss of the decedent/owner’s salary (if still working) is a serious blow to his or her dependents. The liquidity represented by the death benefit also provides the means by which the business can pass to the succeeding owners with the least impact as business cash flow.
The tax-free build up of the cash value in a policy also provides a great deal of benefit for a closely-held business and its owners. It is a fund, if the policy is owned by the business, which can be used to meet cash flow needs of the business, if necessary, and its death benefit can be used to hire key replacements. The cash flow can also be used to support a retirement plan for the company’s employees. With respect to the owners, since the closely-held business can result in the owner being subject to creditor claims through personal guarantees of business debt, the creditor protection of life insurance policies are especially valuable, and the death benefit provides a fund for the family when, perhaps everything else is lost. Just the knowledge of its existence and the fact that the family is provided for through the life insurance policy, may allow the owner to take the risks that ultimately make the business successful. In a closely-held business, life insurance provides certainty, which is a valuable commodity when starting up, running and retiring or succeeding from a business that survives on the basis of the efforts of a small number of people.

A. At the Inception of the Business: Buying the Business using a Split Dollar Arrangement.

1. Many times a purchaser retains the previous owner as a consultant in the business in order to take advantage of the previous owner’s expertise and contacts.

2. The prior owner could enter into a split dollar arrangement with the company, as an employee, thereby ensuring that the owner’s family will receive insurance proceeds at the owner’s death. If the policy is held in an insurance trust, an even greater benefit would pass to the owner’s family, since the sale proceeds received by the owner would be includable in his or her estate, whereas the assets in an irrevocable trust may escape estate taxation.

3. If the purchase price of the company is reduced by the amounts to be paid under the split dollar arrangement (in an attempt to defer taxable income by the owner, albeit at ordinary income rates, rather than capital gain rates), the Service may recharacterize the transaction as payments for purchase of stock, which would not receive benefits of the split dollar arrangement.

B. Obtaining Business Credit.

1. When borrowing money from a third-party lender, a closely-held company’s ability to repay the loan, from the lender’s standpoint, is dependent on the owner’s ability to repay the loan. Lenders will oftentimes require the company or the owners to purchase life insurance on their lives, making the lender the beneficiary of the policy during the term of the loan.

2. The payment of the policy premiums by the company will be non-deductible since it is for the benefit of the company, in enabling it to get the loan, under Section 264. However, if the lender takes out the policy on the owner/insured’s
life, so long as certain requirements set forth in Rev. Rul. 75-46 are met, the lender can deduct the premium payments as ordinary business expenses under Section 162.

C. Attracting Employees.

1. Split dollar arrangements are not that advantageous for non-employee company owners because of the phantom income that occurs in the flow through entities and the dividend treatment of a C corporation, although it will allow an owner to leverage his or her gift tax exclusions. It is much more advantageous for employees, both for their retirement and estate planning.

2. Group term life insurance allows employees (and owner-employees) who are otherwise uninsurable due to health or hobbies, or insurance is prohibitively expensive due to age, health or hobbies, to obtain life insurance for their families. In addition, if they irrevocably assign their benefits to an irrevocable trust, then their families will receive the proceeds estate tax free, so long as the employee survives the transfer by three years. One disadvantage of group term life insurance is that the healthy younger employees will discover that they can obtain insurance at a cheaper cost by themselves, rather than paying through the group term life insurance, since the group policy takes into account factors that do not apply to them. Many times this is addressed by requiring such employees to maintain a certain level of group term life insurance to keep the insured pool as high as possible which will keep the premiums lower for the older employees/owners.

3. With the disadvantages of group term policies, split dollar arrangements, with their use of individual policies, which can be tailored to the individual employee’s situation, can be much more attractive.

D. Creditor Protection.

1. When a creditor obtains a judgment against a closely-held business or owner, the creditor can attach the property of the owner to satisfy that judgement. If these creditors are creditors of the company, then they can reach the assets of the company, but if the company is a corporation or limited liability company or a limited partnership with a corporate general partner, the creditors cannot reach the assets of the owner without piercing the entity veil. This is true unless the owner guaranteed the company’s obligation that gave rise to the claim. If this is the case (and oftentimes it is when the business is in its inception), any assets the owner can protect from his or her creditors become very important. Some types of property are specifically exempt from creditor claims under state statutes. If the debtor declares bankruptcy to work out these creditor claims, then the Federal bankruptcy laws must be reviewed to determine which property is exempt.

a. Life insurance cash values and/or death benefit are oftentimes protected under these laws under the theory that life insurance protects the debtor’s family and prevents them from becoming destitute and thereafter a burden on the
public. As a result, the protections oftentimes depend on the identity of the beneficiary of the policy rather than whether or not the debtor owned the policy.

b. Many statutes will protect a limited amount of the cash value in policies or the death benefit of a policy owned by the debtor where someone other than debtor is the beneficiary, regardless of who is the insured.

c. Certain state statutes will only protect the cash value in the policy or the death benefit owned by the debtor if the policy is payable to a specified class of beneficiaries, such as dependents of the debtor.

d. If the policy is owned by the debtor or the death benefit is payable to the debtor's estate, then upon the debtor's death, regardless of the state law protections for the policy, when the policy or the proceeds are paid to the estate, the proceeds will be subject to creditor claims under the probate process in the debtor's state of domicile.

2. The applicable state law that applies to protect the cash value of the policy is generally the state law to which the insurance contract is subject. In which case, if faced with less than favorable protections under the applicable state law, a Section 1035 exchange for a new policy subject to a different state law under the new contract should be considered.

3. Federal bankruptcy exemptions for life insurance contracts owned by the debtor shield a dollar amount of the cash value in a policy in which the debtor is the insured.

4. Other creditor protections for life insurance have been written about extensively and they include irrevocable life insurance trusts for the benefit of the debtor's family, where the non-debtor spouse, as a beneficiary, could be entitled to distributions (which would allow the spouse access to the cash value of the policy). These protections also include holding life insurance policies in spendthrift trusts for the family; and utilizing Alaska and Delaware trusts for the debtor and the family. Life insurance can also be held in offshore trusts or even simpler, held by the non-debtor spouse. Although if the spouse holds such policies, the terms of the spouse's Revocable Trust or Last Will and Testament should provide that such policies pass to a trust for the benefit of the debtor upon the spouse's death and not to the debtor outright. Finally, a limited liability company or limited partnership holding such policies may provide protection from creditors since creditors generally can't reach the assets held in these entities but only obtain charging orders giving them rights to distributions from the entities.
E. Life Insurance as a Retirement Benefit.

1. Qualified Plans.

   a. As a result of the anti-alienation provisions of ERISA, tax-qualified plans are protected from the claims of the owner's, and the company's, creditors. As such, setting up and funding these plans to the greatest extent possible is not only good retirement planning for closely-held business owners, it provides a means by which a fund can be created for the benefit of the owner and his or her family that will still be there in the event the remainder of the owner's assets, including the assets of the company, are lost to creditors, usually, in this context, as a result of the failure of the business and the enforcement of the guarantees provided by the owners to obtain financing to carry the business.

   b. It is possible to hold life insurance in certain tax-qualified plans. The question is whether it is desirable to do so. The most prevalent types of qualified plans which can hold life insurance and the funding limitations are as follows:

      (1) Defined Benefit Plans.

      A defined benefit pension plan is "benefit oriented", containing a fixed obligation to provide definitely determinable benefits at retirement. Annual contributions are made to the plan on an actuarial basis in order to fund the cost of providing the stated benefits upon retirement. Defined benefit pension plans generally also provide for proportionately reduced benefits upon pre-retirement death, disability or other termination of employment.

      (2) Defined Contribution Profit Sharing Plans.

      Profit-sharing plans and money purchase pension plans are "contribution oriented" because benefits, whether in the form of cash or employer stock, are not fixed, but are based upon the amount in an employee's account consisting of (i) contributions by the employer (and sometimes the employee), (ii) forfeitures of accounts of terminated employees which are allocated to the remaining participants, and (iii) income and appreciation (if any) on such contributions and forfeitures.

      (a) Money purchase pension plans typically contain definite, predetermined formulas fixing the amount which an employer must contribute to the plan every year and allocating such contributions among the participating employees.

      (b) Contributions to profit-sharing plans, however, are determined annually in the sole discretion of the employer.
c. Contribution Limitations.

(1) Defined Benefit Plan Limits. Each year of the plan, the amounts contributed to the plan cannot exceed the amounts necessary to fund the participant’s retirement benefit and the maximum annual benefit payable to a single participant in the form of a life annuity commencing at retirement is the lesser of $160,000 for plan years ending after December 31, 2001 (adjusted for cost of living adjustments), or 100% of the average of 3 of the participant’s highest consecutive years of compensation.

(2) Defined Contribution Plan Limits. For plan years beginning after December 31, 2001, the maximum annual amount which may be contributed to a plan on behalf of a single participant is the lesser of $40,000 (adjusted for cost of living adjustments) or 100% of the participant’s annual compensation under the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”).

(3) When the employer makes these contributions, they are deductible by the employer.

d. Holding Life Insurance in a Tax Qualified Plan

(1) Qualified pension and profit sharing plans are permitted to provide death benefits, providing they are “incidental” to the real purpose of the plan, namely, providing retirement benefits.

(a) The incidental benefit rules are applied differently based on whether the plan is a defined benefit plan or a defined contribution plan, and the type of policy used.

(b) Deferred contribution plans.

(i) Whole life insurance: premiums must be less than fifty percent (50%) of cumulative employer contributions and forfeitures allocated to account.

(ii) Whole life/term blend: one-half of premium allocable to whole life portion and entire remaining premium must be less than twenty-five percent (25%) of employer contributions and forfeitures allocated to account.

(iii) All other policies: premiums must be less than twenty-five percent (25%) of employer contribution and forfeitures allocated to the account.

(c) Profit sharing plans are not subject to these rules. Instead, in these plans, life insurance may be purchased with any funds in the plan that have been held in the plan for more than two years, if contributed by the employer, and with any funds contributed by the employee.
(d) Money purchase plan and defined benefit plans.

(i) Premiums are permitted to the extent of life insurance that provides a death benefit of one hundred times the projected monthly pension payable at normal retirement age.\(^48\).

(ii) Alternatively, the plan can use the premium test set forth in Revenue Ruling 74-307\(^49\).

(e) There has been no formal guidance on limitations to which universal policies held in qualified plans would be subject, although the Service, in a private letter ruling, treated universal policies the same as, understandably, non-whole life\(^50\).

(2) In a money purchase plan, the policy must be on the life of the employee, but in a defined benefit plan, the policy may be able to insure the employee and the employee’s spouse, provided that the death benefit is definitely determinable. In a profit sharing plan, the policy can insure the employee and may be able to insure his or her spouse and anyone in which the employee has an insurable interest\(^51\). These same insureds can be maintained if the policy was purchased by amounts held in a rollover account in a qualified plan. IRAs cannot hold life insurance policies.

(3) The benefit of holding life insurance in a qualified plan (aside from the creditor protection, which is the primary reason this should be considered) is that the employer makes the contribution to the tax-qualified plan (and receives a deduction for the contribution) and the premiums paid by the plan are being paid with plan assets, which are “before tax dollars”.

(a) Under Section 72(m)(3)(B), however, since it is anticipated that the employee (or his family) will receive the insurance under this plan, there will be taxable income to an employee to the extent of the cost of the life insurance protection under the policy determined under Notice 2001-10.\(^52\) In a contributory pension plan, the cost of the insurance protection is includable in the employee’s income only to the extent it exceeds the sum (i) of employee contributions made to the plan during the year, and (ii) the excess, if any, of all employee contributions over cumulative cost of insurance protection\(^53\).

(b) When the policy is distributed out of the plan the value of the policy minus the employee’s contribution (basis) in the policy (which is the amount includable in the employee’s income when each premium was paid) is includable in the employee’s income, unless the policy is converted to an annuity within sixty days of the distribution\(^54\). If the employee dies prior to the distribution of the policy, the proceeds minus the cash value, will be paid out of the plan income-tax free under section 101(a)(1). The cash value, minus the decedent’s basis in the account (described above), will be subject to income tax. The proceeds, along with the rest of the plan will be includable in the employee’s estate, for estate tax purposes.
One technique is for the plan to purchase a large amount of insurance (subject to the incidental benefit rules), enough to cover the estate tax burden that will arise if the employee dies while the policy is held in the plan. At retirement age, the policy is distributed to the employee who then contributes it to an irrevocable life insurance trust. (This distribution will result in the loss of the creditor protection.) During the subsequent three year period, if the employee dies, the policy will be includable in the estate, but its high death benefit will provide the liquidity to pay the additional estate tax. Once the three year period ends, the death benefit is reduced to account for the elimination of the estate tax burden.

e. There has been some discussion in prior years of holding life insurance in "subtrusts" under a deferred benefit plan, which, so long as the insured/participant could not amend the beneficiary designations of the plan, may remove the life insurance from the insureds' estates. From a business planning standpoint, this type of transaction is impractical, even if it works, in light of the resultant restrictions on the participant, and holding life insurance in a qualified plan should instead be considered for its creditor protection and deductibility of contributions, notwithstanding the estate tax inclusion.

2. Non-Qualified Plans.

Companies create non-qualified plans, such as deferred compensation plans and supplemental employee retirement plans, because they are private, can benefit particular employees, and are very flexible. So long as the employee is not in constructive receipt or the benefits provided are subject to substantial risk of forfeiture, there will be no taxable income to the employee. However, the company only receives a deduction for the amounts contributed to a non-qualified plan at such time as the amounts are includable in the employee’s income.

a. Generally non-qualified plans are used for key employees who don’t need the income immediately but are concerned about their retirement or premature death. The risk the employee runs, however, is that avoiding taxable income requires that the assets funding the plan remain in the company’s hands. Control of the company can change in the future or the company can suffer a downturn, putting such assets at risk.

b. In a non-qualified deferred compensation plan, an employer makes a promise, in writing, to pay to an employee certain deferred compensation, commencing at some future date, for life or a period of years, in return for some kind of performance by the employee. A deferred compensation plan is a voluntary salary reduction or deferral by the employee. A "Supplemental Executive Retirement Plan ("SERP") is a supplement to a retirement income plan provided by the employer, and the majority of SERPs are defined benefit plans.

c. An employer can establish a reserve for meeting these obligations while preserving the "unfunded and unsecured" nature of his promise to pay, so long as the reserve remains subject to general claims of the employer’s creditors.
The reserve can be funded with life insurance contracts without adverse tax consequences to the employee so long as fund remains the unrestricted asset of the employer and the employee has no right in the fund whatsoever. As insurance, the employer’s contributions can accumulate tax-free inside the policy until retirement. If an universal policy is used, contributions can vary from year to year and, if a variable policy is held, the insured can (within the limits described above) direct the investments of the fund. Upon retirement, the policy may be distributed to the employee or the employer may borrow amounts from the policy to pay the employee or allow the employee to borrow the amounts directly.

d. A Section 162 bonus arrangement is one where the employer can pay a bonus to the employee by paying the premium for life insurance on the employee’s life, the contract is owned by the employee and payable to the employee’s selected beneficiary. As bonus compensation, the company’s payment is deductible by the company under Section 162(a)(1) and taxable to the employee. See discussion of Notice 2001-10 above when utilizing a split dollar arrangement with a Section 162 bonus arrangement.

e. A split dollar arrangement is a “welfare benefit plan” to which Title I of the Employee Retirement Income Security Act of 1974 (“ERISA”) applies, unless the insured is the only participant of the plan or owns 100% of the company. However, as a non-qualified plan, the company can create a split dollar arrangement for any employee it wants, because this type of plan is not subject to the ERISA nondiscrimination rules, and furthermore, there are no vesting, participation, or funding requirements. However, ERISA requires that it must be established and maintained pursuant to a written agreement. A split dollar arrangement may be used to supplement a qualified pension or profit sharing plan where certain employees have maxed out their benefits. The arrangement may provide both a significant pre-retirement death benefit and a semi-tax deferred retirement benefit.

f. SERP-swaps.

(1) One drawback with non-qualified deferred compensation and SERP benefits, as with qualified retirement plans, is that when the beneficiary withdraws the assets from the plan, or (unlike qualified retirement plans) dies, the amounts will be subject to income tax, as well as an estate tax at death. If, before becoming entitled to the payment of the benefit, the individual waives his or her right to receive all or part of his unfunded benefits under a deferred compensation plan or SERP, and in return, the company agrees to pay an amount equal to the present value of the waived deferred compensation or SERP as a premium under a split dollar arrangement with an irrevocable life insurance trust owning the policy (which is either a policy on the individual’s life or the joint lives of the individual and the individual’s spouse), then the employee has converted what will be subject to estate and income tax to something that is subject to neither, other than what is reportable under Notice 2001-10.
(2) The employee’s family is protected in the event of premature death if there is a life insurance policy on the employee’s life. The family is in a better position if they receive the insurance, rather than the remaining deferred compensation or SERP payments since the insurance will be income tax free (and estate tax free if an irrevocable trust is used to hold the policy) to the family. If the family receives deferred compensation or SERP payments, such payments will be includable in the decedent’s estate and will be items of income in respect of a decedent.

(3) This type of transaction, called a “SERP-swap” (or any kind of swap of non-qualified employee benefits) allows executives who do not need the income that is payable to them at some future date under these plans, but are concerned about their estate tax burden, to “swap” SERP benefits (and possibly deferred compensation) for a split dollar life insurance arrangement which, if an irrevocable trust is used, will ensure the proceeds will be paid income and estate tax free to the family.

(a) In a swap, the executive agrees to forfeit all of his or her right to the SERP in exchange for a split dollar insurance policy. The SERP could consist of deferred compensation balances, accrued pension benefit obligations, non-qualified stock options and restricted stock, future salary and bonuses. The company would use its cost savings that result from not having to pay out the SERP to purchase the split dollar policy.

(i) If the SERP benefits are already accrued, and the employee swaps them, the issue is whether the employee received cash in exchange for the SERP and contributed the cash to the employer to pay the premiums on the split dollar policy. This is based on doctrines of constructive receipt, economic benefit or assignment of income.

1. The swap should not fall under constructive receipt doctrine, so long as the employee could not withdraw the SERP and it was otherwise not available to the employee at anytime before the swap, even if the benefits were already earned or the services were already performed.

2. The swap should escape the economic benefit argument so long as the SERP was only an unsecured promise to pay and the employee had a substantial risk of forfeiture of the SERP, which is defined in part as the requirement for future performance of substantial services.

3. If there is an assignment of income to a third party (the insurance trust) there would be taxable income to the employee, but if the SERP is unfunded and never paid to the employee or the trust, should argument should not succeed, since an assignment never took place. The Service has taken the position that this doctrine will apply, however, if the assignor has sufficient control over what type of benefit he or she will receive.
(i) Whether an employee can swap a SERP for an interest-free loan under a split dollar arrangement is an issue.

(ii) One type of swap is when an employee with nonqualified stock options ("NQSO") swaps them for a split dollar insurance policy.

1. The exercise of a NQSO by an employee results in compensation to the employee equal to the difference between the exercise price and the fair market value of the stock on the date the option is exercised. This compensation is subject to FICA, FUTA and Federal income tax withholding, which causes a cash flow problem for the employer.

2. This swap is desirable for both the company, as a result of FICA, FUTA and withholding tax issues faced by the company (and its possible need to issue additional stock to satisfy the option exercise); and for the employee (as a result of the income tax consequences to the employee). The options could be valuable but nearing expiration and the employee may be reluctant to exercise them as a result of the income tax consequences.

3. However, there is an issue of an exchange for the underlying stock subject to the option (if it has value) taking place under Section 1001. The Service recently issued a private letter ruling which approved a plan which allowed employees with stock options to surrender uninvested options having built-in gains in exchange for a deferral account balance in a Rabbi Trust, which vested at same time options would have vested. If these transactions are accepted, then an exchange for a split dollar arrangement should also be acceptable. Furthermore, in Mitchell v. Commissioner, the Tax Court held that the option held by the taxpayer had no readily ascertainable fair market value and that was exchanged for another option, also with no readily ascertainable fair market value and as such, the exchange had no tax consequences.

4. The Service is planning to issue guidance on SERP or deferred compensation swaps in the near future, although the promised guidance on split dollar arrangements will take precedence.

F. Business Succession and Life Insurance.

In a closely-held business, oftentimes the business provides the primary source of economic support for the owner and family and is both the cause and possibly the solution for the death taxes, if any, that arise at the owner’s death, unless the family has an alternative source to meet these needs, such as insurance.

1. If there is no insurance, what are the alternatives?

a. Continue to pay such expenses as they arise, if the business can support it.
b. Borrow the funds. Consider the cost of borrowing, even if a lender would be willing to lend money on the strength of the business when the owner has died.

c. Create an investment fund in the business. However, investments in a C corporation could be subject to accumulated earnings tax. This alternative requires the company to set aside funds on a regular basis that may be needed for the business. It also requires a great deal of discipline and foresight on the part of the owners.

d. Sell the business.

(1) If the estate or family takes back a promissory note, the estate or family becomes a creditor of the business. Furthermore, they may not be able to wait for the note payments to pay the estate taxes or to meet the family needs.

2. Use of Insurance Proceeds.

a. Insurance can provide liquidity to the family and the business, for the cost of replacing employees or the owner and ensuring the continuity of the business by providing working capital, maintaining the credit standing of the business, provide funds to redeem the deceased owner’s stock or business interest, fund non-qualified deferred compensation for new management and provide security for loans. It is also a source of liquidity for taxes and support for the family.

b. Insurance permits the family to continue the company without having to sell to raise cash.

c. Finally, it permits the family to sell the company to purchasers who are holding insurance on the deceased owner’s life, and receive full payment immediately, in order to meet its needs.


a. If the company is a sole proprietorship, a buy-sell agreement would be between the owner/estate and the potential purchaser, who would agree to buy the business upon the death or retirement of the owner. The purchaser usually holds a policy on the owner’s life. If the purchaser is an employee, the company could bonus out funds to assist the purchaser with paying the premiums. The employee could also enter into a split dollar arrangement with the company, whereas the company loans money to the employee who pays the premium. All of the issues of Notice 2001-10 will apply to this transaction. It is not possible to have a redemption agreement (discussed below) in a sole proprietorship, unless the purchaser has the right to purchase at least one share (or some interest) in the company prior to the redemption.
b. If there are more than one owner, then the agreement can either be a redemption agreement or cross-purchase agreement, both of which can be funded with insurance if the sale takes place upon the death of an owner.

c. In a redemption agreement, the company agrees to buy, and the owner agrees (on behalf of his estate and heirs) to sell, the interest at his death. The company would own the insurance policy, pay the premiums and be the beneficiary of the policy (see discussion on corporate owned life insurance above).

(1) With a redemption agreement in place, when the company purchases a deceased owner's interest, the value and proportionate interest of the remaining owners' ownership in the company is increased. However, the basis of the remaining owners' interest remains unchanged.

(a) Another drawback of a redemption is that state law can restrict a company's ability to redeem stock if the company's financial position is not that strong, or state law can require the consent of the other owners to the redemption, which may not be forthcoming if any other owner sees better uses for the insurance proceeds. Finally, any insurance policy held by the company is subject to the company's creditors, which does not provide a great deal of security to the family of the insured owner.

(b) When the last remaining owner is living, the company no longer needs the insurance policy on his or her life. At that point, it would be advantageous for the owner if the company distributed the policy to the owner who thereafter transferred it to an irrevocable trust. The transfer of the policy to the insured is exempt from the transfer for value rules, however, the value of the policy may be includable in the owner's taxable income as a distribution from the company, depending on the nature of the entity. If the company is a flow-through entity, the distribution will not be taxable to the extent the value is less than the owner's basis in the company interest. Since, in a redemption, that basis was not increased by the prior redemptions of stock that occurred as each owner died, the owner's basis may not provide much protection against taxable income, especially if the policies had built up a large amount of cash value through premium payments or investment returns on the cash value. If the company is not a flow-through entity, the distribution will either be compensation or a dividend.

(c) If the policy remains in the company, upon the owner's death, regardless of whether or not the owner is a controlling owner (one who owns 50% or more of the voting rights in the company), the proceeds will not be includable in the owner's estate, so long as the proceeds are payable to or for the benefit of the company. However, the value of the company (and the owner's interest) will be increased by the value of the insurance proceeds.

(2) In a cross-purchase agreement each owner will be contractually obligated to sell his ownership interest in the company upon his death (or at certain other times) to the other owners, and the other owners are obligated
(or have a right) to buy the interests. Each of the other owners usually carries life insurance on each owner’s life in order to be able to meet his or her obligation (or right) to purchase a pro-rata share of the deceased owner’s ownership interest. In the event there are more than two owners, the number of policies required to effect the purchase would be N (number of owners) multiplied by N-1.

(a) A cross-purchase agreement can require a substantial number of policies (with the resultant cost) and the need to purchase policies on each owner’s life may disproportionately cost younger members more since older insureds are more expensive.

(b) When one owner dies, the policies the decedent owned on the other owners, which will be includable in the decedent’s estate, should be transferred to remaining owners to continue the agreement (since each owner now owns a larger interest in the company as a result of the purchase of the deceased owner’s interest, the additional policy received from the deceased owner’s estate will be helpful to meet the increased purchase price obligation when another owner subsequently dies). Alternatively, the policies could be distributed to the company if the parties had entered into a wait and see type of buy-sell, as discussed below.

(i) These policy transfers will be contractual obligations of the decedent, and, as a result, could be treated as claims against the estate, rather than taxable bequests, which will not reduce the decedent’s exemption from estate taxes available to his or her family.

(ii) If the business is a corporation, when planning for the distribution of the decedent’s policies on the other owners’ lives to non-insureds (the owners other than the insureds), the transfer for value rules should be kept in mind, since these transfers are being made pursuant to contractual obligations and are therefore made for consideration. If the decedent’s policies are transferred to each insured, the transfer will fit within the exceptions to the transfer for value rules; however, the death benefit will be includable in the insured’s estate. Even if the insured subsequently transfers the policies, there will still be estate tax inclusion for three years after the subsequent transfer. If the non-insured transferees were also partners in a partnership, the transfers should fall within the transfer for value exception.

(3) A “wait and see” plan utilizes the cross-purchase and redemption plan within one buy-sell agreement. Life insurance policies are owned by and payable to the co-owners who have an option to purchase the decedent’s interest in the company, but if any one of them (or all of them) elect not to so purchase the interest, the company must purchase the decedent’s interest, so it also holds policies on the owner’s lives. Alternatively, the company can hold the initial right to purchase the stock (in a redemption), and the shareholders purchase what the company does not purchase.
(a) Usually, this is not an “all or nothing” plan, and each of the policies don’t cover the entire value of the ownership interests. As such, many times the owner’s purchase some portion of the decedent’s interests, and the company purchases the remainder.

(b) If the company will purchase the decedent’s entire interest, and does not have a large enough insurance policy, the other owners could lend the money to the company out of the proceeds they each receive, from the policies they own.

(4) Family Buyouts.

(a) If one or more family members work in the company but there are other family members who are not employees, there could be problems with the control and direction of the company. Employee owners usually take money out of the company in the form of compensation and benefits leaving the non-employee owners with very little receipts, if anything. As a result, there is pressure on the employee owners to sell the business, which would allow the entire family to benefit from the sale proceeds.

(b) A buyout can take place either at the time the original owner dies and the family is about to inherit the company so that the family employees buy out the estate’s ownership interest, or it can take place anytime after the original owner’s death when frictions arise. A buyout funded with life insurance can enable the employee’s family members to purchase the interests outright.

(c) A buy-out funded with life insurance can also remove a reluctant spouse from the business. In many situations, although it would be more appropriate to bequeath the company to family members who are working in the business and not to the spouse, who is uninvolved, the spouse, or a marital trust for his or her benefit, receives the business because of the decedent’s desire to defer the estate tax with the use of the marital deduction from estate taxes. This type of bequest may become even more prevalent under the estate tax repeal if the company owner dies while an estate tax is in effect, but there is a chance the spouse may survive until the estate tax has been repealed (although under the repeal, the loss of a full stepped-up basis at death may mean income tax if the business is sold).

(i) The spouse may not be the mother of the family members working in the company and/or may not want to rely on those family members to produce enough cash from the business to support him or her (which can cause friction on a personal level). However, as a result of the estate taxes and the fact that the company may be the primary source of support of the spouse, the company ends up in the spouse’s hands.

(ii) A buyout by the family members working in the company, funded with insurance, will remove the spouse from
the business and give him or her an alternative source of assets for his or her support. An alternative form of buyout, using a promissory note, does not remove a spouse from the business. It only converts the spouse from an owner to a creditor of the business and the family.
(5) Vehicles for holding life insurance funding buy-sell agreement.

(a) Trusts.

Under a cross-purchase buy-sell agreement, a trust can be utilized to hold the life insurance policies on all of the owners. The beneficiaries of the trust are the owners, and as each owner dies, the trust uses the proceeds to purchase the decedent’s interest.

(i) A trust and the trust beneficiaries are not listed as one of the exemptions from the transfer for value rules of the policies. As each owner dies, his or her interest (as a trust beneficiary) in the remaining policies is eliminated. If this elimination is considered a transfer and made pursuant to the buy-sell agreement, a transfer for value occurs; unless the other beneficiaries were also partners in a partnership.

(ii) If an irrevocable trust was used to hold the policies and used the proceeds to purchase a deceased insured’s interests, would it keep the policies (and the entity interests) out of the insured’s estate? The remainder interest each insured would have in the trust may result in the policy proceeds or a portion of the trust being included in each insured’s estate. Furthermore, if the trust were deemed to be meeting the beneficiary’s own obligations under the agreement, it may result in the trust being includable in the owner’s estate. Practically speaking, few business owners want to operate the business through a trust and its trustees, even though such trust could provide creditor protection for them.

(b) Partnerships and LLCs.

(i) As the partnership receives the death benefit of each policy, each partner’s basis in the partnership will be increased by the proceeds. An increased basis allows each partner to take a larger distribution of cash and marketable securities from the partnership tax free (with certain exceptions for certain types of assets).

(ii) When a partnership pays the premiums on a life insurance policy owned by the partnership, it is not deductible, so the taxable income used to pay the premium will decrease each partner’s basis. If the partnership pays premiums on a life insurance policy owned by a partner, it is a deemed distribution of cash to the partner, which will be tax-free to the extent of the partner’s basis in the partnership.

(iii) The deceased partner’s estate will be increased by the value of the decedent’s partnership interest. The interest would include a share of the insurance proceeds. So long as the decedent did not hold any incidents of ownership over the insurance (which would not be the case if the decedent was the general partner of the partnership), the entire amount of the insurance proceeds should not be included in his or her estate. As a sole or controlling shareholder in the
corporate general partner, the proceeds should not be includable in the decedent's estate.\(^6\)

(c) Corporations.

(i) The insurance proceeds should not be included in a controlling shareholder's estate as stated above, although the value of the corporation and the owner's interest therein will be increased.

(ii) Proceeds received by an S corporation are not subject to income or AMT tax at entity or owner level, and will increase the owner's basis in the S corporation share. Proceeds received by a C corporation are not taxable income to the corporation, but will be subject to AMT if the corporation does not fit within the exemption.

(iii) Since there is no exception for the transfer for value rules for policies distributed to shareholders or a corporation other than the insured (although there is an exception for transfers to the corporation itself), using a corporation to hold the policies eliminates a lot of flexibility with respect to the policies, unless the shareholders are also partners in a partnership.

G. Contribution of Group Term Life Insurance into Insurance Trust.

1. Insurance proceeds are includable in the insured's gross estate under §2042 if, at the time of death, the insured owned the policy or possessed any "incident of ownership" in the policy.\(^6\) The term "incident of ownership" refers, under §2042(2) of the Code and Reg. §20.2042-1(c), to the right of the insured (or the insured's estate) to the economic benefits of the policy, including the power to (i) change beneficiaries of the policy, (ii) surrender the policy, (iii) assign the policy, (iv) pledge the policy and (v) borrow against the policy. To insulate the insurance proceeds from the imposition of estate tax on the death of the insured, proper planning is required.

2. One option is to have the proceeds payable to the surviving spouse since the proceeds would pass free of estate tax as a result of the unlimited marital deduction under §2056. Of course, what remains of such proceeds would be fully taxable in the spouse's estate.

3. Another option is to have someone else or another entity own the policy (and all attendant rights) on the insured's life so that the insured and the insured's spouse would not possess any incidents of ownership in the policy and, as a result, the life insurance would not be included in either of their estates.\(^6\)

   a. In many cases, the optimum tax result is produced when insurance is owned by an irrevocable trust and the spouse and children are the beneficiaries of the trust. In most cases the incidents of ownership in a group term life insurance policy can be transferred,\(^7\) so long as the master policy gives the insured the right to convert his or her insurance to an individual policy upon the termination of employment.
b. The payment of the premium either by the employer or the employee through payroll deductions or other methods of contributions are deemed gifts to the trust by the employee. These deemed gifts, however, if structured correctly, would be eligible for the $10,000 annual exclusion from gift taxes under §2303(b) for each beneficiary of the trust, by giving each such beneficiary a right to withdraw such amount deemed gifted to the trust for a period of no less than thirty days.\footnote{71}

c. The issue with group term life insurance is that no amounts are actually paid into the trust, which raises the issue of whether the beneficiary has a realistic right of withdrawal sufficient to qualify the deemed gifts for the annual exclusion.

(1) The beneficiaries must be informed of when the premiums are being paid to the insurance company and informed that their right of withdrawal arises at that time and lasts for a subsequent 30 day period.

(2) The trust should be funded, separate and apart from the life insurance policy, with an amount of assets equal in value to at least one premium payment, to ensure that if all of the beneficiaries exercised each of their withdrawal rights, the trustee of the trust could meet each beneficiary's demand by distributing such amounts already held in the trust. Transferring this amount to the trust will be another gift.

d. The employee must weigh whether using the annual exclusion amount to shield the premium payments on group term life insurance, which he or she may not maintain after he or she leaves the company, is the best use of the annual exclusion.
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The accounts, however, must be under the control of the insurer, not the owner, and although the owner can direct allocation policy and degree of market risk, the insurer must have control over individual investment decisions. See Rev. Ruls. 80-274, 81-225, 82-54.

A segregated account is adequately diversified if no more than 55% of the value of the total assets of the account is represented by the type of investments described in Section 851(b)(3). Section 817(h). All references to "Section" shall refer to the Sections of the Internal Revenue Code of 1986, as amended.

An "accredited" investor is one who has $200,000 of annual income in the last two of three years and a net worth of $1,000,000.

A qualified purchaser is a person who owns at least $5,000,000 in investments.

If the trust had situs in Delaware or Alaska, the same creditor protection may be available; however, these products (and the Delaware and Alaska trusts) have not been tested in the bankruptcy context.

Section 4371 imposes a 1% excise tax on premiums paid to foreign life insurance companies on a life insurance policy issued on a U.S. citizen or resident unless insurer elects to be taxed under U.S. law.

The Service upheld private placement variable policies as insurance in PLR 9433030.

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§415(b)(1). See Rev. Rul. 98-1, 1998-2 I.R.B.-5. The $90,000 limit is reduced proportionately for participants who have less than 10 years of participation (not service). §415(b)(5); I.R.S. Notice 87-21, 1987-2 C.B. 458.

P.L. 107-16 (H.R. 1836), signed by President Bush on June 7, 2001. EGTRRA §§611,632. §415(c)(1); these amounts must include not only the amounts the employer contributed, but also any forfeitures in the plan that are allocated to the participant’s account, as well as the participant’s after-tax contributions. §415(c)(2); I.R.S. Notice 87-21, 1987-2 C.B. 458.


The $90,000 limit is reduced proportionately for participants who have less than 10 years of participation (not service). §415(b)(5); I.R.S. Notice 87-21, 1987-2 C.B. 458.


PLR 19996333.

But see DOL Advisory Opinion 98-07A questioning whether a second-to-die policy can be held in a qualified plan. See also, Donald O. Jensen’s article, “Life Insurance Potpourri”, in The Thirty-Fourth Annual Philip E. Heckerling University of Miami 2000 Institute on Estate Planning, in which he states on pages 4-6 that certain IRS officials have informally taken the position that second-to-die policies (and, presumably, any policy on the life of anyone other than participant) cannot be owned by a profit sharing or defined benefit plan, since it would violate the exclusive benefit rule and the definitely determinable benefit requirement of the Code.


PLR 7922109.

Treas. Reg. §1.402(a)-1(a)(2). The Service will not use the cash value as the basis for taxation if it is “artificially low”.

Treas. Reg. §1.451-1(a).


Section 83 and the regulations thereto.

PLR 9513027.

PLR 199901006.

65 T.C. 1099 (1965), aff’d 590 F.2d 312 (9th Cir. 1979).

Treas Reg. §20.2042-1(c)(6).

See PLR 9349002, 9511009, 9309021, wherein under various scenarios the Service found inclusion in the estate (i) under Section 2037 with the decedent having a reversionary interest in the trust with a value greater than five percent of the trust fund, and (ii) because decedent held incidents of ownership over the policy under his or her rights under the buy-sell agreement.

Section 705(a)(1)(B) and Treas. Reg. §1.705-1(a)(2).

Section 264.

Section 705(a)(2)(B).

PLR 200111038.

Treas. Reg. §20.2042-1(c)(6).

§2042(2).

§2042(2).


ANALYSIS OF THE SPLIT DOLLAR PROPOSED REGULATIONS

By

Mary Ann Mancini
Steptoe & Johnson LLP

I. Effective Date Provisions

A. These regulations apply to any split dollar arrangement entered into after the date the Final Regulations are published.

1. Arrangements that are "materially modified" are treated as new arrangements entered into on the date of modification.

2. Preamble requests comments on whether a Section 1035 exchange after the date of the Final Regulations in an arrangement entered into prior to the date of the Final Regulation should be subject to these rules if the Section 1035 exchange is the only material modification to the arrangement. In light of this reference to a Section 1035 exchange as a material modification, albeit the only one, then apparently a change in insurance policies may be construed as a material modification.

B. Taxpayers may use the Proposed Regulations prior to the effective date, provided that all taxpayers who are parties to the arrangement treat the arrangement consistently.

1. Exception: Notwithstanding the general rule, parties to an equity SDA may only rely on these Proposed Regulations if the value of all economic benefits taken into account by the parties exceed the economic benefits that would have been taken into account under these regulations had the arrangement been a non-equity split dollar arrangement (determined using the "life insurance premium factor" designated as guidance published in the IRB).

C. Preamble reminds taxpayers that Notice 2002-8 provides guidance with respect to arrangements entered into prior to date of Final Regulations.

D. The Proposed Regulations did not address the issues raised in Notice 2002-8 other than to state that the provisions of Notice 2002-8 allowing the PS 58 costs to be used by arrangements entered into prior to January 28, 2002 applied only to compensatory arrangements, not to arrangements entered into outside of the compensatory context.

E. The Proposed Regulations apply for purposes of Federal income, employment and gift taxes. There is no mention of estate taxes.
II. Is there a “Split Dollar Arrangement” (“SDA”)?

A. “Split Dollar Arrangement” is defined in §1.61-22(b).

1. General Rule: An SDA is an arrangement between an owner and a non-owner of a life insurance contract (“contract”), other than group term life insurance, in which:

   a. Either party pays, directly or indirectly, all or any portion of the premiums on the contract, including a payment by means of a loan to the other party that is secured by the contract; and

   b. at least one of the parties paying the premiums is entitled to recover (either conditionally or unconditionally) all or any portion of such premiums, and such recovery is to be made from, or is secured by, the proceeds of the contract.

   c. “Contract” means any life insurance contract other than a group-term life insurance plan described in Section 79.

2. Special Rule:

   a. Any arrangement between an owner and a non-owner of a contract is treated as an SDA (whether or not the general rule described above is satisfied) if the arrangement is described below:

      (1) Compensatory Arrangements:

         (a) The arrangement is entered into in connection with the performance of services;

         (b) the employer or service recipient pays, directly or indirectly, all or any portion of the premiums; and

         (c) the beneficiary of all or any portion of the death benefit is designated by the Employee or service provider or is any person whom the Employee or service provider would reasonably be expected to designate.

      (2) Shareholder Arrangements:

         (a) The arrangement is entered into between a corporation and a shareholder of the corporation (in such capacity);

         (b) the corporation pays, directly or indirectly, all or any portion of the premiums; and

         (c) the beneficiary of all or any portion of the death benefit is designated by the shareholder or any person whom the shareholder would reasonably be expected to designate as the beneficiary.
b. This special rule does not refer to (i) a security interest or right of recovery, (ii) private arrangements, or (iii) partnership arrangements.

B. Comments

1. Preamble states that the definition of SDA shall be applied broadly. It provides an example: the non-owner provides funds directly to the owner with which the owner pays premiums, as long as owner is entitled to recover, conditionally or unconditionally, all or a portion of the funds form contract proceeds or has an interest in the contract to secure the right of recovery. In addition, the amount to be recovered by the party paying the premiums (non-owner) need not be determined by reference to the amount of those premiums.

2. In order to have an SDA, recovery must be secured by or made from the “proceeds of the contract” under the General Rule; however, the Special Rule, which preempts the General Rule, does not have this requirement. The Special Rule only applies to Compensatory Arrangements and Shareholder Arrangements.

Query: Definition of “proceeds of the contract”? In light of intention to define the SDA broadly, it may include not only cash surrender value distributions, and death benefits, it may also include loans from the contract (see specified Split Dollar Loans described as a part of the economic benefit regime below, the distribution of which have tax consequences).

3. These rules do not address the central question of what is an “arrangement” raised in Notice 2002-8. Is two parties entering into a split dollar agreement, unsupported by an insurance policy enough? Or is simply buying the policy without an agreement enough?

III. Who is the “owner” of the contract and who is the “non-owner” of the contract? [§1.61-22(c)(1) and (2)]

A. Owner

1. General Rule:

The person named as the policy owner on the contract is generally the “owner”.

a. If two or more persons are named as policy owners and each person has all of the incidents of ownership with respect to an undivided interest in the contract, each person is the “owner” of a separate contract to the extent of the person’s undivided interest. Presumably, each contract would be tested under these rules.

Preamble’s example: An Employer and Employee jointly own a contract and share equally in all “rights and benefits” under the contract, there are two separate contracts. (The Preamble also says “(and, ordinarily neither contract would be treated as part of an SDA).”)
b. If two or more persons are named as policy owners and neither person has all the incidents of ownership with respect to an undivided interest in the contract, the first-named policy owner is the “owner”.

2. **Exceptions** (deemed owner rules):
   a. Non-equity Compensatory SDA
      (1) If, at all times, the SDA is a non-equity SDA, which is defined in §1.61-22(d)(2); and
      (2) the SDA is entered into in connection with the performance of services,
      (3) then, notwithstanding who is named as policy owner of the contract, the Employer or service recipient is treated as the “owner”.
   b. Non-equity Private SDA
      (1) If, at all times, the SDA is a non-equity SDA, which is defined in §1.61-22(d)(2);
      (2) then, notwithstanding the who is named as policy owner of the contract, the donor is treated as the “owner” of any SDA entered into between a donor and a donee (for example a life insurance trust).
   c. Preamble reserves on the issue of the consequences of a modification to these arrangements (for example, converting a non-equity SDA to an equity SDA and requests comments).
   d. If neither owner has all the incidents of ownership, is it possible to pick the regime by who is named first on the policy?

3. The only way to determine who is donor and donee is to extrapolate from the parenthetical “donee (for example a life insurance trust)”. Otherwise, if both parties are making contributions, who is the donor?
   a. If the donee is the life insurance trust, then the donor presumably would be the party making transfers to the insurance trust.
   b. Analogous to an insurance trust would be the child or spouse of the insured.

B. **Non-owner:**

1. Any person (other than the “owner”) that has a direct or indirect interest in such contract (excluding the life insurance company acting as issuer of the policy).
2. Preamble's example: an Employee whose spouse is designated by the Employer as the beneficiary of a contract owned by Employer would have an indirect interest in the contract and would therefore be a “non-owner”.

C. Transfer of the Entire Contract or undivided interest therein: Change of Owner [§1.61-22(c)(3)]

1. A transfer of the ownership of the policy (or an undivided interest in the policy) that is part of an SDA, occurs on the date that the non-owner becomes the “owner” of the policy (or undivided interest therein).

   a. An undivided interest consists of an identical fractional or percentage interest in each right and benefit under the contract.

   b. Upon the transfer of the entire contract, the previous non-owner is treated as the owner of such contract for all purposes.

   c. Upon the transfer of an undivided interest in the contract, the previous non-owner is treated as the owner of a separate contract and continues to be treated as a non-owner of the remaining interest in the contract (presumably a separate contract) that was not transferred.

   d. Exception

      To the extent the ownership of the contract (or undivided interest) is transferred in connection with the performance of services, the previous non-owner is not treated as the owner until the contract is taxable under Section 83.

   e. A modification of an SDA, without a formal change of ownership of the policy, is not a transfer.

2. a. Preamble confirms that a transfer does not occur merely because the cash surrender value of the contract exceeds the premiums paid by the owner or the amount ultimately repayable to the owner on termination of the arrangement or on the death of the insured. In addition, the Preamble continues, there is no transfer if the owner merely endorses a percentage of the cash surrender value of the contract (or similar rights in the contract) to the non-owner.

   b. The Preamble states that unless or until ownership is formally changed, the owner continues to be treated as the owner for all Federal income, employment and gift tax purposes.

IV. Two Regimes

There are two regimes described in these Proposed Regulations, an economic benefit regime and a loan regime. The Preamble describes them as being mutually exclusive. Generally, endorsement method SDAs are subject to the economic benefit regime (Section 61) and collateral assignment methods SDAs are subject to the loan regime (Section 7872) but there
are exceptions to these rules. In order to determine which regime applies, the following analysis must be made.

A. Do you have a Split Dollar Loan?

Section 1.61-22(a)(3) states that the rules of §1.61-22 (economic benefit regime) do not apply to any Split Dollar Loan as defined in §1.7872-15(b)(1). First question is then, when do you have a Split Dollar Loan?

1. General Rule: A payment made pursuant to an SDA is treated as a Split Dollar Loan if:

   a. The payment is made, directly or indirectly, by the non-owner to the owner (including a premium payment made by the non-owner directly to the insurance company with respect to the policy held by the owner);

   b. 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 (whether with or without interest); and

   c. the repayment is made from, or is secured by, either the policy’s death benefit or cash surrender value.

   d. Partial Repayment Obligation

      If the non-owner is entitled to repayment of some but not all of the payment, the payment is treated as two payments, one that is repayable and one that is not and both are tested under these rules.

      See Examples 2 and 3 of §1.782-15(a)(2)(iv). Employee is owner under SDA and Employer makes premium payments and is entitled to be repaid 80% of each payment. 80% of Employer’s payment is Split Dollar Loan. 20% is governed under §1.61-22(b)(5). “Non-owner payments that are not Split Dollar Loans”, which actually states if payments are neither Split Dollar Loans nor consideration for economic benefits, then this provision and §1.61-2(d)(2)(ii)(A) apply. So, if not a Split Dollar Loan, test under economic benefit regime and if it fails as an economic benefit transaction, §1.61-22(b)(5) applies.

2. Exceptions to General Rule:

   a. Compensatory SDA

      (1) If the SDA is entered into in connection with services; and

      (2) the Employee or service provider is not the owner;

      (3) then the SDA is not treated as a Split Dollar Loan, even if the requirements for a Split Dollar Loan are otherwise met.
b. Private SDA

(1) If the SDA is entered into by a donor and a donee (for example an insurance trust); and

(2) the donee is not the owner;

(3) then the SDA is not treated as a Split Dollar Loan, even if the requirements for a Split Dollar Loan are otherwise met.

c. Non-owner payments that are not Split Dollar Loans or economic benefit transfers are subject to §1.61-22(b)(5).

V. Tax Consequences under each Regime

A. Economic Benefit Regime [§1.61-22(d)]

1. Under §1.61-22(d)(1), the owner is treated as providing economic benefits to the non-owner.

a. The value of the economic benefits, reduced by any consideration paid by the non-owner to the owner, is treated as transferred from the owner to the non-owner.

(1) Depending on the relationship of the owner and non-owner, the transfer may be compensation, gift or dividend (partnership distributions?).

(2) Depending on the relationship between or among a non-owner and any one or more other persons, the economic benefit may be treated as provided from the owner to the non-owner and separately from the non-owner to such other person or persons.

(a) See below for tax consequences of any payment by the non-owner to the owner in an economic benefit regime.

(b) Example in Regulations refers to the economic benefits being treated as compensation from Employer/owner to Employee/non-owner and then as a gift from Employee/non-owner to Employee’s children.

b. Determination of economic benefits in a non-equity SDA (defined in these Regulations as an arrangement where the only economic benefit provided to the non-owner is current life insurance protection (including paid up additions)). [§1.61-22(d)(2)]

(1) The economic benefit equals the excess of the average death benefit under the contract over the total amount payable to the owner under the SDA.

(a) The total amount payable to the owner is increased by the amount of any outstanding policy loan.
(2) The cost of the current life insurance protection provided to the non-owner equals the amount of the current life insurance protection multiplied by the life insurance premium factor designated or permitted in guidance published in the IRB.

(a) What will the guidance contain? What about insurer's own rates, P.S. 38 rates, as well as the table published under Notice 2001-10 and republished in Notice 2002-8.

(3) Example in Preamble

Employer/owner of $1,000,000 policy under SDA pays all of the $10,000 annual premium and is entitled to receive the greater of its premiums or cash surrender value of the contract upon termination or death.

In 10 years, Employer/owner has paid $100,000 of premiums and in year 10, the cost of the term insurance protection for Employee/non-owner is $1 for $1,000 of insurance and the cash surrender value is $200,000. In year 10, Employee/non-owner has $800 of taxable income ($1,000,000 - $200,000 = $800,000 times .001 (Employee’s premium rate factor). If however, Employee/non-owner had paid $300 of the premium, Employee/non-owner would only have $500 of taxable income.

(4) The Preamble requests comments on whether there is a need for more specific guidance in computing cost of that death benefit that varies during year.

c. Determination of economic benefits in an equity SDA (defined as any arrangement subject to §1.61-22(d)-(g) other than arrangement described in §1.61-22(d)(2). [§1.61-22(d)(3)]

(1) Any right in, or benefit of, a contract (including, but not limited to, an interest in the cash surrender value) provided during the taxable year to a non-owner under an SDA is a economic benefit provided to the non-owner.

Notice 2002-8 specifically said in Part II that it would not tax the equity in an SDA under the prospective Proposed Regulations under Section 83 until termination. It was stated in the context of a compensatory SDA, but this portion of the Notice also contained the overriding language that the same principles are expected to govern other types of SDAs. The Preamble refers to Revenue Ruling 66-110 and states that a non-owner who has an interest in the cash surrender value of a contract is in a better economic position than a non-owner in a non-equity SDA. The Preamble distinguishes a mere unfunded promise to pay money in the future, which does not result in current income, from an SDA, by stating that a non-owner’s interest in the contract in an equity SDA is more like that of an Employee who obtains an interest in a specific asset of the Employer such as where an Employer makes an outright purchase of a contract for the benefit of an Employee. The Employer’s right to a return of its premium only affects valuation of the Employee’s interest.
Method of Valuation is reserved.

(a) Preamble suggests one potential approach, which is to subtract from current premium payments made by the owner the net present value of the amount to be repaid to the owner in the future.

d. Amounts received under contract (in an equity or non-equity SDA) other than the death benefit. [§1.61-22(e)]

(1) Other than the death benefit, any amount received under a contract that is part of an SDA, including, but not limited to, a policy owner dividend, proceeds of a **specified policy loan** or proceeds of a withdrawal from or partial surrender of the contract, is treated, to the extent provided directly or indirectly to the non-owner as though such amount had been paid to the owner and then paid by the owner to the non-owner who is a party to the SDA.

(a) Amount received is taxable to the owner in accordance with the rules of Section 72. Under Section 72(e)(5)(c), amounts received under a life insurance contract will only be included in gross income to the extent it exceeds the investment in the contract.

(b) The non-owner must take the amount into account as a payment of compensation, a dividend or a gift or other transfer, depending on the relationship between the owner and the non-owner.

(2) “Specified Policy Loan” [§1.61-22(e)(2)]

(a) Any policy loan to the extent that

(i) the proceeds of the loan are distributed directly from the insurance company to the non-owner; and

(ii) a reasonable person would not expect that the loan will be repaid by the non-owner; or

(iii) the non-owner’s obligation to repay the loan to the owner is satisfied or is capable of being satisfied upon repayment by either party to the insurance company.

(3) Amount required to be taken into account is calculated as follows:

(a) The amount received under the contract;

(b) §1.61-22(e)(3) subtracts from any amount received under contract, the economic benefits received by non-owner under an equity SDA reduced, but not below zero, by (i) the economic benefits of a non-equity split dollar arrangement (value of insurance protection) plus (ii) any consideration paid by non-owner for the economic benefit in
the equity SDA reduced, but not below zero, by consideration paid by non-owner allocated to the non-equity amounts (value of insurance protection). If such amounts were previously taxed, they are not subject to tax as an amount received under the contract.

Example: $1,000,000 contract, premium is $10,000 per year. Employer gets back premiums paid. In Year 10, total premiums paid $100,000, cash surrender value is $150,000. Employee premium rate factor is $1 per $1,000. Value of term insurance protection is $900 in Year 10. Value of equity (under Preamble suggestion) of net present value of $10,000 premium payment is $6,700 (based on 20 year life expectancy and 5.6% interest rate), $10,000 - $6,700 = $3,300 value of equity. Employee pays nothing.

If a $50,000 distribution is made, non-owner’s taxable income is presumably calculated as follows: $50,000/[$4,200 - $900 + 0 = $3,300] = $46,700. (The uncertainty of this calculation is how the equity portion of the premium payment is calculated). Since the owner is taxed under Section 72, Section 72(e)(5) allows the owner to recover his or her basis first, so this distribution should be non-taxable to owner. If the distribution was a “specified policy loan” that is paid to the non-owner, it is treated as a loan to the owner (and therefore not taxable to the owner, regardless of his or her basis) and a distribution from the owner to the non-owner that is taxed based on the relationship between the two parties. See Example 8(ii) of §1.61-22(h).

2. Other Tax Consequences [§1.61-22(f)]

a. Non-owner (prior to transfer of contract, if any).

(1) Receives no basis in the contract under Section 72(e)(6).

(2) Any amount of death benefit paid to non-owner is excluded from gross income under Section 101(a) to the extent that such amount is allocable to current life insurance protection provided to the non-owner pursuant to the SDA, the cost of which was paid by the non-owner or the value of which the non-owner actually took into account.

b. Owner

(1) Any premium paid by an owner under an SDA creates basis in the contract under Section 72(e)(6).

(2) No premium or payment of economic benefit (which is deemed distributed to the owner and from the owner to the non-owner), is deductible by the owner (except as provided in Section 1.83-6(a)(5).

(a) Section 1.83-6(a)(5) provides that in the case of a transfer of a contract in connection with the performance of services, a deduction is allowable.

(b) The deduction provided under §1.83-6(a)(5) would be taken at the time the service provider or Employee includes the amount taken into account in income and would be equal to the such amount included as compensation to the service provider.
(c) The owner in an equity SDA may take this deduction under §1.83-6(a)(5) only if the economic benefits under the equity SDA exceed the amount of economic benefit taken into account under a non-equity SDA.

(3) Any amount paid by a non-owner, directly or indirectly, to the owner for current life insurance protection or for any other economic benefit is included in the owner’s gross income and creates basis in the contract for the owner for purposes of Section 72(e)(6).

c. Distribution of economic benefits by a corporation owner to a shareholder non-owner in an SDA is treated as a distribution of property.

(1) Even if not a part of an SDA, if a non-owner corporation makes a premium payment on behalf of a owner shareholder or transfers a contract or undivided interest therein (not a Split Dollar Loan if no repayment obligation), will be treated as a distribution of property.

(2) The parties may take advantage of this provision in an equity SDA only if the economic benefits under the equity SDA exceed the amount of economic benefit taken into account under a non-equity SDA.

d. Tax Consequences of the Transfer of the Contract (or undivided interest thereto) [§1.61-22(g)]

(1) In General

(a) Upon a transfer of a contract, the transferee takes into account the excess of the fair market value of the contract (or undivided interest therein being transferred) over the sum of (i) the amount of consideration paid by the transferee for the contract and (ii) the amount of all economic benefits taken into account by the transferee in an equity SDA reduced (but not below zero) by the amounts of current life insurance protection taken into account, plus any consideration paid by the non-owner for all economic benefits in an equity SDA reduced (but not below zero) by any consideration paid by the non-owner that would have been allocable to the value of insurance protection portion of the economic benefits in an equity SDA.

(b) But only to the extent such economic benefits had not previously been taken into account.

(c) Fair Market Value of the contract:

The cash surrender value and the value of all other rights under the contract (including any supplemental agreements thereto and whether or not guaranteed) other than the value of current life insurance protection.

(d) A transfer from a corporation owner to a shareholder non-owner is treated as a distribution of property.
(2) Exception

(a) Transfers in connection with the performance of services.

(i) The general rule does not apply until such contract (or undivided interest in such contract) is taxable under Section 83.

(ii) Fair market value is determined disregarding any lapse restrictions and is determined at the time the transfer of such contract is taxable under Section 83.

(3) Basis in Contract after Transfer

(a) The new owner's basis in the contract equals the greater of the fair market value of the contract or the sum of (i) the amount of consideration paid by the transferee for the contract and (ii) the amount of all economic benefits taken into account by the transferee in an equity SDA reduced (but not below zero) by the amounts of current life insurance protection taken into account, plus any consideration paid by the non-owner for all economic benefits in an equity SDA reduced (but not below zero) by any consideration paid by the non-owner that would have been allocable to the value of insurance protection portion of the economic benefits in an equity SDA, but only to extent not previously taken into account.

(b) Transfers of the contract between a donor and a donee.

(i) In the case of a transfer of a contract between a donor and a donee, the amount treated as consideration paid by the transferee to acquire the contract under Section 72(g)(1) to determine the transferee's basis in the contract after the transfer equals (i) the amount of consideration paid by the transferee for the contract and (ii) the amount of all economic benefits taken into account by the transferee in an equity SDA reduced (but not below zero) by the amounts of current life insurance protection taken into account, plus any consideration paid by the non-owner for all economic benefits in an equity SDA reduced (but not below zero) by any consideration paid by the non-owner that would have been allocable to the value of insurance protection portion of the economic benefits in an equity SDA, with two exceptions:

aa. The consideration shall include the aggregate of premiums or other consideration paid or deemed to have been paid by the transferor; and

bb. The amount of all such economic benefits shall not include such benefits to the extent such benefits were excludable from the transferee’s gross income at the time of receipt.
(c) Transfers of an undivided interest in a contract.

(i) The basis is determined multiplying the amount determined under the general rule (as modified by these special rules, if applicable) by a fraction, the numerator of which is the FMV of the portion transferred and the denominator of which is the FMV of the entire contract.

e. Example in Regulation for donor and donee

Donor is owner of a contract under an SDA with donee. (Donor is owner and makes payment with expectation of repayment; this is taxed under the economic benefit regime). In Year 5 of SDA, donor gifts the contract to donee by changing the ownership of the policy to donee. At the time of the transfer, FMV of contract is $200,000 and donor had paid $50,000 of premiums. The donee had previously received gifts of $80,000 of economic benefit in the contract (which were excludable from donee’s income as gift).

Upon transfer, donee’s basis is $50,000 (donor’s premium payment). The $80,000 of gifted economic benefit is not included in basis because the amount was excluded from donee’s income.

B. Loan Regime [§1.7872-15]

1. General Rule

a. The owner and non-owner are treated, respectively, as the borrower and lender.

b. Each premium payment is a separate loan.

c. The de minimus exception rule of Section 7872 does not apply.

d. Any amounts received by lender under the contract that is part of an SDA is treated as though amount had been paid to borrower and then paid by borrower to lender.

e. No amount received by lender with respect to a Split Dollar Loan is treated as received by reason of the death of the insured. [§1.7872-15(m)]

2. Types of Split Dollar Loans [§1.7872-15(b)]

a. Split dollar demand loan: Any Split Dollar Loan that is payable in full at any time upon demand of the lender.

b. Split dollar term loan: Any Split Dollar Loan other than a split dollar demand loan.

c. Exceptions. When split dollar term loans are treated as demand loans [§1.782-15(c)(5)]:

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1. Certain split dollar term loans payable on the death of an individual;

2. Certain split dollar term loans conditioned on the future performance of substantial services by an individual; and


3. **Interest deductions** [§1.7872-15(c)]

   a. The borrower may not deduct any qualified stated interest, OID or imputed interest on a Split Dollar Loan.

   b. In certain circumstances an indirect participant may be allowed to deduct qualified stated interest, OID or imputed interest, based on the relationship of the indirect participant to the borrower.

4. **Treatment of Split Dollar Loans providing for non-recourse payments** [§1.7872-15(d)]

   a. **General Rule**

      If a payment is non-recourse to the borrower, the payment is a **contingent payment**.

   b. **Exception:** When non-recourse Split Dollar Loans are not treated as contingent payments.

      (1) If the Split Dollar Loan provides for interest payable at a stated rate that is either a fixed rate or a variable rate; and

      (2) The parties represent, in writing, that a reasonable person would expect that all payments under the loan will be made.

         (a) Both the borrower and lender must sign a representation not later than 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 SDA.

         (b) The representation must include names, addresses, and EIN numbers of the borrower, lender and any indirect participant.

         (c) Unless stated otherwise therein, the representation applies to all subsequent Split Dollar Loans made pursuant to the SDA.
(d) Representation must be attached to the Federal income tax return for any taxable year in which the lender makes a loan to which the representation applies.
5. **Below market Split Dollar Loans** [§1.7872-15(e)]
   
a. The $10,000 de minimus amounts of Section 7872 do not apply.

b. **Indirect Split Dollar Loans** [§1.7872-15(e)(2)]
   
   (1) If, based on the facts and circumstances, including the relationship between the borrower or lender and some third person (indirect participant), the effect of a below market Split Dollar Loan is to transfer value from the lender to the indirect participant and from the indirect participant to the borrower, then the below market Split Dollar Loan is restructured as two or more successive below market loans (the deemed loans).

   (a) A deemed below market Split Dollar Loan made by the lender to the indirect participant.

   (b) A deemed below market Split Dollar Loan made by the indirect participant to the borrower.

   (2) Each deemed loan is treated as having the same provisions as the original loan between the lender and borrower, and Section 7872 is applied to each deemed loan.

   (a) Example: Employer/lender makes an interest-free Split Dollar Loan to an Employee's child/borrower. The loan is generally restructured as a deemed compensation-related below market Split Dollar Loan to the Employee/indirect participant and a second deemed gift below market Split Dollar Loan from the Employee to the child.

   (3) **Limitations on investment interest for purposes of Section 163(d)**

   (a) The imputed interest from the indirect participant to the lender that is taken into account by the indirect participant is not investment interest to the extent of the excess, if any, of:

   (i) the imputed interest from the indirect participant to the lender that is taken into account by the indirect participant; over

   (ii) the imputed interest to the indirect participant from the borrower that is recognized by the indirect participant.

   (b) The limitations of Section 7872(d)(1) on gift loans (amount treated as retransferred by the borrower to the lender as of the close of any year shall not exceed the borrower's net investment income for such year) shall apply.
6. **Split dollar demand loans** [§1.7872-15(e)(3)]

a. Testing for sufficient interest

   (1) Each calendar year that a split dollar demand loan is outstanding, the loan is tested to determine if the loan provides for sufficient interest.

   (2) A split dollar demand loan provides for sufficient interest if the rate (based on annual compounding) at which interest accrues on the loan's adjusted issue price during the year is no lower than the blended annual rate for the year published in the July IRB.

   (3) If the loan does not provide for sufficient interest, the loan is a below market Split Dollar Loan for that year.

b. Treatment and Amount of foregone interest

   (1) For each calendar year, the amount of foregone interest on a split dollar demand loan is treated as transferred by the lender to the borrower and as retransferred as interest by the borrower to the lender.

   (2) Amount of foregone interest in a split dollar demand loan equals the excess of

      (a) the amount of interest that would have been payable on the loan for the calendar year if interest accrued on the loan's adjusted issue price at the appropriate AFR and were payable annually on the last day of the calendar year; and

      (b) any interest that accrues on the loan during the year.

c. Timing of transfers of foregone interest

   (1) General Rule

       The foregone interest that is attributable to a calendar year is treated as transferred and retransferred on the last day of the calendar year.

   (2) Exceptions

       (a) Death: In the taxable year in which the borrower dies (if a natural person) or is liquidated or otherwise terminated (all others) any foregone interest is treated, for both lender and borrower, as transferred and retransferred on the last day of the borrower's final taxable year.

       (b) Repayment: Any foregone interest is treated as transferred and retransferred on the day the Split Dollar Loan is repaid in full.
7. **Split dollar term loans** [§1.7872-15(e)(4)]

   a. If a split dollar term loan is a below market loan, then the rules of Section 7872 apply. In general, the loan is recharacterized as consisting of two portions; an imputed loan amount and an imputed transfer from the lender to the borrower.

      (1) The imputed transfer occurs at the time the loan is made and is equal to the excess of the imputed loan amount (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) over the amount loaned.

      (2) Generally, a below market Split Dollar Loan will be treated as having OID equal to amount of imputed transfer, in addition to any other OID on the loan (such as interest that is charged but not payable until end of term).

   b. Testing split dollar term loans for sufficient interest

      (1) A split dollar term loan is tested on the day the loan is made.

      (2) A split dollar term loan provides for sufficient interest if the imputed loan amount equals or exceeds the amount loaned.

         (a) 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 appropriate AFR for the loan term in effect on that date.

         (b) Loan term: The term of a Split Dollar Loan is based on the period from the date the loan is made until the loan’s stated maturity date. See below for special rules for loan terms.

         (i) Payment options:

            aa. If a split dollar term loan is subject to unconditional options (such as to pay off the loan at an earlier date) that are exercisable at one or more times during the term, and, if exercised, would require full payment of the loan on a date other than the stated maturity date, then

               --the borrower is projected to exercise or not exercise an option(s) in a manner that minimizes the loan’s overall yield;

               --the lender is projected to exercise or not exercise an option(s) in a manner that minimizes the loan’s overall yield.

               --If different projected patterns of exercise or non-exercise produce the same minimum yield, the parties are projected to exercise or not exercise an option(s) in a manner that produces the longest term.
bb. If a borrower or lender does or does not exercise the option, then the Split Dollar Loan is treated as retired and reissued on the date the option is or is not exercised.

--The amount for which the loan is deemed to be retired and reissued is the loan’s adjusted issue price on that date.

--the reissued loan must be retested using the appropriate AFR in effect on the date of reissuance to determine if it is a below-market loan.

c. Special Rules for certain split dollar term loans

(1) Split Dollar Loans that are (i) conditioned on future performance of substantial services by an individual, (ii) payable on the death of an individual, or (iii) gift term loans, are split dollar term loans for purposes of testing for sufficient interest. However, foregone interest (and the imputed transfer) is determined annually, similar to a demand loan, but using an AFR that is appropriate for the loan’s term and that is determined when the loan is issued.

(2) Split dollar term loans payable on death

(a) For each year the loan is outstanding, the AFR used in the determination of foregone interest is not the blended annual rate but rather is the AFR (based on annual compounding) appropriate for the loan’s term for the month in which the loan is made.

(b) Loan term rules for split dollar term loans payable no later than death

(i) Term of the loan is the life expectancy of the individual.

(ii) If the loan is payable on the earlier of the individual’s death or another term, the shorter term applies.

(iii) If the actual term exceeds this term, the Split Dollar Loan is treated as retired and reissued as a split dollar demand loan at that time, for the loan’s adjusted issue price on that date.

aa. However, the loan is not retested at that time to determine whether the loan provides for sufficient interest.

bb. For purposes of determining foregone interest, the appropriate AFR for the reissued loan is the same as the original AFR.

(3) Split dollar term loan conditioned on the future performance of substantial services by an individual.
(a) For each year the loan is outstanding, the AFR used in the determination of foregone interest is not the blended annual rate but rather is the AFR (based on annual compounding) appropriate for the loan’s term for the month in which the loan is made.

(b) This rule applies only if the benefits of such loan are not transferable and the conditions of substantial services are within the meaning of Section 83.

(c) Loan term rules for Split Dollar Loans payable on the date on which the condition to perform substantial future services by an individual ends.

   (i) Term of the loan is based on the period from the date the loan is made until the loan’s stated maturity date (or, the term certain, if any, if earlier than date condition to perform ends).

   (ii) If no stated maturity or term certain, term based on seven years.

   (iii) If loan remains outstanding longer than the term because of continued performance of substantial services, the loan is retired and reissued as a split dollar demand loan at the end of the stated maturity date for the loan’s adjusted issue price on that date.

   (iv) The loan is retested at that time to determine if it provides sufficient interest at the then current AFR.

(4) Gift Loans

   (a) Term is determined based on stated maturity date.

   (b) For each year the loan is outstanding, the AFR is not the blended annual rate but is the AFR (based on annual compounding) appropriate for the loan’s term for the month in which the loan is made.

   (c) The term of the loan is its stated maturity date.

   (d) These rules only apply for purposes of the Federal income tax rate. For purposes of the gift tax, gift tax below market split dollar term loans are treated as term loans under Section 7872(b).

(5) Split dollar term loans payable on the later of a term certain and other date.

   (a) The “other date” includes (i) death of an individual, or (ii) date on which the condition to perform substantial services by an individual ends.

   (b) These loans are split dollar term loans.
(c) The term of the loan is the term certain.

(d) The appropriate AFR is based on the term of the longer of the term certain or the loan’s expected return.

(e) Retirement and reissuance:

(i) If a split dollar term loan remains outstanding longer than the term certain, it is treated as retired and reissued at the end of the term certain for the loan’s adjusted issue price on that date.

(ii) The loan is not retested at that time for sufficient interest.

(iii) The appropriate AFR for the reissued loan is the AFR determined on the date the loan was originally made.

8. Split Dollar Loans that provide for contingent payments [§1.7872-15(j)]

These loans are treated under the contingent split dollar method, which, in general, are treated the same as the non-contingent bond method described in §1.1275-4(b) with certain exceptions.

a. Interest must be taken into account whether or not the amount of any payment is fixed or determinable in the taxable year.

b. Amount of interest taken into account for each accrual period is determined by constructing a projected payment schedule and applying rules similar to those for accruing OID. If the actual amount of a contingent payment is not equal to projected amount, appropriate adjustments are made.

c. Description of Method

(1) Determine projected payment schedule.

(a) Includes all non-contingent payments and a projected payment for each contingent payment.

(i) The projected payment for a contingent payment is the lowest possible value of the payment.

(b) The projected payment schedule must produce a yield of not less than zero. If there is a negative yield, the schedule must be reasonably adjusted.

(c) If the split dollar term loan is payable on the death of an individual, the projected payment schedule is determined based on the later of life expectancy or term certain (if there is one).
(d) If the split dollar term loan is payable on the condition of future performance of services, the projected payment schedule is determined based on the later of the date condition terminates or term certain (if there is one).

(e) If a split dollar demand loan provides for contingent payments, the projected payment schedule is based on a reasonable assumption as to when lender will demand repayment.

(f) The lender (rather than borrower) determines the projected payment schedule and is to be used by all parties.

(2) Determine daily portions of interest.

(a) The daily portion of interest is determined by allocating to each day in accrual period the ratable portion of the interest that accrues and includable in income.

(b) If the “issuer” (borrower) of the Split Dollar Loan is not allowed to deduct interest, then issuer is not required to include in income any negative adjustments on loan except to the extent at maturity the total payments made over the life of the loan are less than the issue price of the loan.

(c) The yield based on the projected payment schedule is used to determine whether the loan is a below market Split Dollar Loan under §1.7872-15(e).

(d) To the extent interest has accrued under Section 7872 (foregone interest) on a Split Dollar Loan and interest would not have accrued under this method, the lender is not required to recognize income for a positive adjustment and the borrower is not treated as having interest expense for a positive adjustment.

(3) Examples 1 and 2:

On January 1, 2010, Employer and Employee enter into an SDA in which Employee is named the owner. On January 1, 2010, Employer makes a $100,000 premium payment. SDA provides on December 31, 2013 that Employer will be repaid an amount equal to premium payment plus an amount based on an increase, if any, if the price of a specified commodity for the period the loan is outstanding. The premium payment is a Split Dollar Loan. Repayment of both the premium payment and the interest due is recourse to Employee. Assume appropriate AFR for loan is 7%.

(a) This is a Split Dollar Loan with a contingent payment, subject to contingent split dollar method.

(b) Projected payment schedule provides for a non-contingent payment of $100,000 and a projected payment of $0 for contingent payment (lowest possible value) on December 31, 2013.
(c) Present value of payments is $76,289.52 (7% AFR compounded annually).

(d) Since imputed loan amount ($76,289.52) is less than amount loaned ($100,000), the loan is a below market Split Dollar Loan and is recharacterized as two portions, an imputed loan amount of $76,289.52 and an imputed transfer of $23,710.48.

(e) On date loan is made, Employer is treated as having transferred to Employee $23,710.48 as compensation.

(f) On date loan is made, Employer must take this amount into account as OID [§1.1272-1].

(g) On December 31, 2013, Employer receives $115,000.

(i) There is a $15,000 positive adjustment (actual payment minus projected payment).

(ii) Because Employer accrued imputed interest under Section 7872 and this interest would not have accrued in the absence of Section 7872, Employer does not have to include positive adjustment in income, and Employee does not have an interest expense.

(iii) However, since Employer took a deduction for $23,710.48 as compensation, Employer must take into income the $15,000 to offset compensation deduction and Employee can deduct the same amount to reverse their respective prior tax consequences. This is an “above the line” deduction for Employee.

(h) What if Employer receives $127,000 (more than the $123,710.48 it accounted for)?

(i) Again, the accrual is the result of Section 7872 requirements; Employer does not have to include $23,710.48 in income, and Employee does not have an interest expense for same amount.

(ii) Employee and Employer must reverse prior tax consequences.

(iii) Employer must include in income $3,289.52.
9. **Split Dollar Loans that have a variable rate of interest** [§1.7872-15(g)]

   a. These rules apply to a Split Dollar Loan that is a variable rate debt instrument (within the meaning of §1.1275-5) and that provides for stated interest at a qualified floating rate (or rates).

   b. A Split Dollar Loan that has a variable rate of interest that does not qualify under these rules will be subject to the contingent payment rules.

      (1) These rules will not apply to a Split Dollar Loan if, as a result of interest rate restrictions (such as an interest rate cap), the expected yield of the loan, taking the restrictions into account, is significantly less than the expected yield of the loan without regard to the restrictions.

      (2) If reasonably symmetric interest rate caps and floors or reasonably symmetric governors are fixed throughout the term of the loan, these rules will apply.

   c. Testing for sufficient interest

      (1) Term of split dollar term loans providing for variable rates of interest.

         (a) The rules of §1.1274(c)(2) will determine the term of the loan.

         (b) §1.1274(c)(2) states that if the loan provides for interest at a floating rate that adjusts at varying intervals, the loan term is determined by reference to the longest interval between interest adjustment rates.

      (2) Demand loan

         (a) A split dollar demand loan is treated as if it provided for a fixed rate of interest for each accrual period to which a qualified floating rate applies.

         (b) The projected fixed rate for each accrual period is the value of the qualified floating rate as of the beginning of the calendar year that contains the last day of the accrual period.

      (3) Term loan

         (a) A split dollar term loan is treated as if it provided for a fixed rate of interest for each accrual period to which a qualified floating rate applies.

         (b) The projected fixed rate for each accrual period is the value of the qualified floating rate on the date the split dollar term loan is made.
The projected fixed rate or rates are used for purposes of the accrual of interest each period and the amount of any imputed transfers.

Example

SDA between Employer and Employee in which a third party is the policy owner. Employer makes a $100,000 premium payment that is repayable in 15 years, which is a Split Dollar Loan. Interest is payable on the loan each year at a rate equal to the value of a 1-year LIBOR at payment date. The short-term AFR (based on annual compounding) at the time of the loan is 7%. (Since the interest rate is reset each year, this is appropriate AFR.) The value of a 1-year LIBOR at payment date is 8%, compounded annually. The loan is a variable rate debt.

To test for sufficient interest, the loan is treated as if it provided for a fixed rate of interest equal to 8% compounded daily. Based on a discount rate of 7% compounded annually, the present value of the $100,000 payment is $109,107.91. Since the loan's imputed loan amount exceeds the amount of loan, Section 7872 does not apply.

10. Adjustments for interest paid at less than stated rate [§1.7872-15(h)]

a. If accrued but unpaid interest on a Split Dollar Loan is subsequently waived, cancelled or forgiven by lender, the waiver, cancellation or forgiveness is treated as if, on that date, the interest had in fact been paid to lender and then retransferred by lender to borrower.

b. Characterization of transferred amounts based on relationship of parties and deemed loan rules.

c. See §1.61-22(b)(6) for treatment of amounts other than interest on a Split Dollar Loan that are waived, cancelled or forgiven by lender. §1.61-22(b)(6) states that if a repayment obligation under a Split Dollar Loan is waived, cancelled or forgiven at any time, the parties must take the amount waived, cancelled or forgiven into account in accordance with the relationship of the parties.

d. Split dollar term loans

The amount of interest deemed transferred and retransferred is determined as follows:

(1) Below market split dollar term loan: the amount of such interest is the excess of the amount of interest payable at stated rate over interest actually paid.

(2) Other split dollar term loans: the amount of such interest is the excess, if any, of the amount of interest payable at AFR over interest actually paid.
e. Split dollar demand loans

The amount of interest deemed transferred and retransferred is determined as follows:

1. Each year it is a below market split dollar demand loan: the excess of the amount of interest payable at the stated rate over interest actually paid and allocable to that year.

2. Each year the loan was not a below market split dollar demand loan: the excess, if any, of the amount of the interest payable at the appropriate AFR used for purposes of imputation for that year over the interest actually paid allocable to that year.

f. Examples

Employer and Employee enter into an SDA in which Employee is the owner. Employer makes a $100,000 premium payment, repayable one day less than 3 years with interest of 5% compounded annually. The short-term AFR at the time of the payment is 5%. When Split Dollar Loan comes due, Employee repays the $100,000, but Employer waives the remainder due ($15,762.50).

1. When loan was made, it was not subject to Section 7872. But under the OID rules, Employer was required to accrue compound interest of 5% each year. Employee is not entitled to a deduction for this interest under §1.7872-15(c).

2. Under §1.7872-15(h)(7), the waived amount is treated as if, on the repayment date, $15,762.50 was paid to Employer as interest income, and then Employer paid the same amount to Employee as compensation.

11. Payment Ordering Rules [§1.7872-15(k)]

A payment made by a borrower under an SDA is applied to all direct and indirect Split Dollar Loans in the following order:

a. Payment of interest to extent of accrued but unpaid interest (including OID) on all outstanding loans in order interest accrued.

b. Payment of principal in order loans were made.

c. Payment of amounts previously paid by non-owner pursuant to SDA that were not reasonably expected to be repaid.

d. Any other payments under an SDA.

12. Repayments received by lender under SDA [§1.7872-15(m)]

a. Treated as though amount had been paid to borrower and then paid by borrower to lender.
b. Taxable to borrower (or not) based on applicable rules (§72 or §101(a) for example).

c. Lender must take amount into account under payment ordering rules.

d. No amount received by lender with respect to a Split Dollar Loan is treated as amount received by reason of death of insured.