A.P. Letter No. 179

July 19, 2002

SPLIT DOLLAR PROPOSED REGULATIONS: THE INITIAL ANALYSIS

It's hard to know where to begin. The proposed regulations present many analytical problems, and it is hard to discuss any one area separately, because the difficulties presented by one topic are infected by other parts of the regulations.

Unfortunately, the 92 pages of regulations and explanation last about 90 pages longer than they need to, and their meticulous methodology does not create the precision they seek, but instead provides confusion, some contradiction, and (depending on the interpretation) unfair taxation. Treasury could have achieved its goal by simply dispensing with their Revenue Rulings and relying on existing transactional and tax principles to govern the financing of life insurance. But they didn't do that, so begin we must.

You may be inclined to react with dismay or discouragement upon reading some of this. Don't. For two reasons. First, this is an analytical piece, not an emotional lament, and somebody – that's us – has to do it, to go beyond mere explanation to a clinical dissection of the regulations. Second, even if these regulations are finalized in identical form, the financing opportunities abound. Paradoxically, creation often begets limitations for the creator. The IRS will be confined within its own self-imposed rigid boundaries. Our creativity is not, and you will see that shortly. In the meantime, the "old rules," with some equity tax risk, still prevail. So will we.

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TABLE OF CONTENTS

I. WHAT IS A SPLIT DOLLAR ARRANGEMENT? 1

II. WHO IS THE OWNER AND NON-OWNER? 1

III. WHAT REGIME APPLIES: ECONOMIC BENEFIT OR LOAN? 2
- A. ECONOMIC BENEFIT REGIME 2
- B. LOAN REGIME 2
- C. EXAMPLES NOT COVERED BY THE REGULATIONS 3

IV. ECONOMIC BENEFIT TAXATION 5
- A. WHEN DOES ECONOMIC BENEFIT REGIME APPLY? 5
- B. HOW IS THE BENEFIT TAXED AS AN ECONOMIC BENEFIT? 5
- C. DEDUCTIONS AND INCOME 8
- D. DISTRIBUTIONS FROM AND TRANSFERS OF POLICIES AND POLICY INTERESTS 9

V. SPLIT DOLLAR LOAN REGIME 10
- A. IN GENERAL 11
- B. SPLIT DOLLAR ARRANGEMENTS SUBJECT TO LOAN REGIME 11
- C. TAX TREATMENT OF INTEREST 12
- D. TYPES OF SPLIT DOLLAR LOANS 12
- E. ADDITIONAL ISSUES UNDER LOAN REGIME 15

VI. SUMMARY 16

I. WHAT IS A SPLIT DOLLAR ARRANGEMENT?

[Most of the citations in this piece will refer to Proposed Regulation Section 1.61-22. For reader friendliness, all sites to regulation subsections will refer to this major section, unless otherwise indicated: For example, "Subs. (b)(1)" refers to Section 1.61-22(b)(1)]

A split dollar life insurance arrangement is one:

- between an owner and a non-owner of a policy
- where one of the parties who is paying all or a portion of the premium is entitled to recover all or a portion of those payments
- where that recovery is to be made from, or is secured by, the proceeds of the policy, and
- where the arrangement is not part of a group-term plan under section 79.

Subs. (b). Right away, we're confused: Who is this owner or non-owner? More about that in a minute. First, this twist. Regardless of whether these parameters are met, a split dollar arrangement always includes an arrangement connected with the performance of services by an employee where the employer pays all or any portion of the premiums and the policy beneficiary is designated by the employee or is an individual reasonably expected to be designated as the beneficiary by the employee. Subs. (b)(2)(ii). The same is true for an arrangement between a corporation and a shareholder. Subs. (b)(2)(iii).

II. WHO IS THE OWNER AND NON-OWNER?

So who is this owner or non-owner? It's different than what you are used to thinking. The owner is the person so named in the contract. Subs. (c)(1)(i). So far, so good. If a policy has two named owners, the regulations treat the contract as two separate contracts with two separate owners, but only if all owners have all the incidents of ownership with respect to an "undivided interest" in the contract. If the two owners do not have an undivided interest, then the "first-named policy owner" is treated as "owner" of the entire contract.

For example, A and B are listed as policy owners. Through appropriate documentation, A owns 2/3 of the policy and B owns 1/3. Because each owns an identical fractional interest in each right and benefit of the policy (A owns 2/3 of everything, B owns 1/3 of everything), each are considered owners of separate contracts.

Another example. A and B are the listed policy owners. A owns 2/3 of the cash value and 1/10 of the death benefit. B owns 1/3 of the cash value and 9/10 of the death benefit. A and B do not own undivided interests because each has different fractional rights in different parts of the policy.

Whenever two owners' interests are not undivided, the *first-named person* is treated as the owner. This rule can create confusion and invite gamesmanship with nominal "split ownership" arrangements. It is easy to imagine the ownership of a policy under a traditional endorsement

arrangement being re-worded so that the endorsee is listed as an owner, and is listed first. Now the endorsee is "owner," although he likely controls much less of the policy than the endorser.

Here comes the unconventional part. Regardless of who is named the owner, the employer (or a donor) is treated as the owner where the only policy interest given, or economic benefit provided, to the employee (or donee) is current yearly death benefit protection. Subs. (c)(1)(ii), through Subs. (d)(2). Example: The employee is the contract owner, but the employee's policy interest is limited to receiving a portion of the death benefit (all cash values are owned or controlled, or payable to, the employer in what is commonly referred to as a non-equity split dollar plan). Because the employee's policy interest is so limited, the owner, for purposes of the regulations, is the employer. The same holds true in an arrangement between, say, a trust grantor and an irrevocable trust, where the trust's policy interest is limited to receiving yearly death benefit protection, in which case the grantor is the owner.

Why is this important? Because it is the contraption by which split dollar is defined, and the key to whether the arrangement is taxed as an economic benefit or as a loan. All arrangements defined above are split dollar plans.

III. WHAT REGIME APPLIES: ECONOMIC BENEFIT OR LOAN?

A. ECONOMIC BENEFIT REGIME

Of these arrangements, which are treated as an economic benefit? Subsection (b)(3)(ii) specifies that arrangements entered into between an employer and employee, or between a donor and a donee, where the employee or donee is not the "owner" of the policy, will be treated and taxed as an economic benefit. Common examples: Employee owns the policy and employee's interest is limited to only a portion of the death benefit; an individual, say the insured's spouse, owns the policy and endorses the death benefit to an irrevocable trust; an irrevocable trust owns the policy but another party, again the insured's spouse, is entitled to repayment of the greater of cash values or premiums paid from or secured by the policy; employer owns the policy and endorses a portion of the death benefit to the employee.

B. LOAN REGIME

What is, and will be treated as, a loan? A split dollar arrangement is a loan where the owner is treated as the borrower and non-owner treated as the lender in the transaction, if: the non-owner pays the premium, or a portion thereof; this payment is a loan under general tax principles; and repayment to the non-owner is to be made from, or secured by, either the policy's death benefit or cash value. Common examples: employee owns the policy and employer's interest and repayment is limited to premiums (i.e., employee owns any accruing equity); an irrevocable trust owns the policy and the funding party's recoverable interest is, again, limited to premium advances, with the trust owning any cash value equity. These transactions will be taxed as loans, and to the extent that the arrangement is not accompanied with a minimum interest rate (the AFR) the foregone interest must be treated as both income and/or a gift.

C. EXAMPLES NOT COVERED BY THE REGULATIONS

1. Grantor's spouse owns a policy on grantor's life and endorses the entire death benefit to an irrevocable trust. This arrangement does not meet the definition of a split dollar life insurance arrangement because it fails the second requirement: that at least one of the parties (presumably, the spouse) is entitled to recover all or a portion of the premium advancements. It also does not meet the definition of a loan, because the spouse's payment is not a loan under general principles of Federal tax law. And yet what the spouse is doing, quite precisely, is giving the trust the economic benefit of one year's insurance protection on the entire death benefit. The regulation's insistence that one of the parties must be repaid all or a portion of its premium is equivalent to saying that a homeowner who rents a house to a tenant must retain use or occupancy of a portion of the house before we can call, and treat, the transaction as a rental. In such a situation, we would conclude that the homeowner is providing the tenant with the economic benefit of one year's occupancy of the entire premises, which will be considered income or a gift to the tenant unless the tenant pays to the homeowner one year's fair rental value. The life insurance financing arrangement described in this paragraph, no matter how you try to pigeonhole it as split dollar or otherwise, provides to the trust only the economic benefit of the death benefit payable on the policy. But because it does not meet the definition of a split dollar arrangement, the measure of that fair "rental" value of the death benefit is not governed under Subsection (d)(2) -- that the cost of the current protection equals that amount multiplied by the life insurance premium factor designated or permitted in guidance published in the Internal Revenue Bulletin. As such, taxpayers are apparently free to determine the fair value of each year's insurance economic benefit independent of the new regulations.

2. A and B, the shareholders of AB Corporation, enter into a buy/sell arrangement. To fund their obligations under the agreement, A buys a policy on A's life and B buys a policy on B's life. Each party endorses the entire death benefit to the other. At the termination of the policy financing arrangement, the endorsement is removed and each of the insureds owns the entire policy on their life. At no time during this arrangement does B have the right to borrow, take dividends or other withdrawals from the policy owned by and insuring A, and vice versa. Like the scenario in paragraph 1. above, this arrangement does not meet the definition of split dollar and it clearly is not a loan. Yet we know what B is getting and how to value it: the equivalent of yearly term insurance on the face amount of the policy at whatever the fair "rental" value of that economic benefit is. The same analysis, and conundrum, may be faced with some so-called reverse split dollar plans which call for an endorsement of the entire death benefit on an employee-owned policy to the employer. Why? Because it may not be connected with performance of services.

3. An irrevocable trust established by A purchases a whole life policy on A's life. The trust enters into a financing arrangement for the payment of policy premiums with a corporation wholly owned by A (or with A personally). The corporation (or A) will advance premiums to the trust and will be repaid the greater of premium advancements or policy cash values at A's death or at the earlier termination of the agreement. This

arrangement can be described as a non-equity split dollar plan. To avoid any incidents of ownership in the policy being attributed to A, the trust will not grant a collateral assignment to the funding party, or, in other words, the funding party's recovery of premium advances is not secured by the proceeds of the life insurance contract. In addition, it is contemplated that the trust may repay the funding party with assets other than policy values. In fact, the agreement specifically states that the trust will repay the premium advancements or cash value from any assets available to the trustee except for the policy. This arrangement is not "regulation-defined split dollar" because Subsection (b)(ii) requires that the funding party's entitlement to recovery is to be made from or secured by the proceeds of the life insurance contract. Neither is the case here. For the same reason, the arrangement does not meet the definition of a split dollar loan. Proposed Reg. Sec. 1.7872-15(a)(2)(C).

So what is it? The regulations state that general tax principles apply to the premium payments. Subs. (b)(5). To ascertain the tax treatment, let's take a step back and determine, fundamentally, what has taken place. The corporation, or A, has advanced money to the trust. In exchange, the employer, or A, has the right to be repaid an amount equal to the greater of the advanced funds or the advanced funds plus the growth thereon.

One interpretation of the arrangement is that it only provides the trust with current life insurance protection, so it should be taxed identically to a secured split-dollar plan or, in other words, under the economic benefit regime.

Another interpretation is that the parties are entering into a life insurance joint venture or partnership where the employer makes a contribution sufficient to allow the partnership to purchase cash value that is allocated to the employer's partnership interest, and the trust contributes sufficient funds to purchase the death benefit which is allocated to the trust's partnership interest. The ultimate tax result would be the same as with a split-dollar plan taxed under the economic benefit regime.

Finally, some may argue the arrangement is a loan with the policy's growth measuring the trust's cost of borrowing (i.e., interest). But because the employer's right to money over and above the funds advanced is contingent, the better line of reasoning is that it is a joint venture or partnership and not a loan under "general tax principles."

4. Take the same facts as the previous example, but assume that the parties' agreement does specify that the trust's repayment to A's corporation "is to be made from the policy." In that case, the arrangement meets the definition of split dollar. The next question is whether the arrangement is taxed under the "economic benefit regime" or the "loan regime." The answer to that question turns on whether the arrangement is properly characterized as non-equity or equity. Unfortunately, the definitions of equity and non-equity are ambiguous.

   To the extent the *arrangement* requires the trust to pay back the greater of premiums or cash value, it looks like it is a non-equity plan. This conclusion causes the premium-paying corporation to be "treated as owner," and would impose the economic benefit

regime. But because the policy is unsecured, the trust still has sole contractual access to the *policy's* cash values. The purported definition of an equity plan is that whenever an arrangement is non-equity, any rights in the contract provided to the non-owner are economic benefits. This may imply that any unsecured arrangement is inherently an equity plan. If so, it seems we would be under the loan regime, where we face the puzzling question of whether the employer's entitlement to cash values constitutes a sufficient rate of interest so as to avoid §7872. In the end, the non-equity definition is more precise, and it seems to focus on rights in the *arrangement* rather than rights in the life insurance *contract*, so the unsecured situation should likely be seen as non-equity, thereby invoking the economic benefit "regime."

IV. ECONOMIC BENEFIT TAXATION

A. WHEN DOES ECONOMIC BENEFIT REGIME APPLY?

An arrangement is taxed as an economic benefit when the plan is designed as either traditional endorsement split-dollar (the employer owns the policy and endorses death benefit to the employee's beneficiary) or non-equity split dollar (the employee owns the policy, but the employer maintains the right to receive the greater of the policy's cash value or premiums advanced). Subs. (d)(1). Likewise, these rules apply to donors and donees in the gift tax context. Subs. (d)(1). For example, a trust owns a policy and the plan gives the donor (who is paying the premiums) the right to the cash value or premiums paid, whichever is greater.

B. HOW IS THE BENEFIT TAXED AS AN ECONOMIC BENEFIT?

1. Non-equity plans. The employee is taxed on the value of the economic benefit received under the arrangement. Subs. (d)(1) and (2). For plans that provide the employee only current life insurance protection, the economic benefit is determined by multiplying the life insurance protection provided (in other words, the death benefit to be paid to the employee's chosen beneficiary) by the "life insurance premium factor." Subs. (d)(2). This life insurance premium factor is not defined in the proposed regulations; the criteria to determine the factor are to be published in the Internal Revenue Bulletin.

   But this is not as straightforward as it seems. For example, we typically say the non-owner receives an economic benefit equal to its share of the death benefit under the parties' agreement. This is common sense short-hand for the language of Subsection (d)(2). Instead of defining the non-owner's interest in terms of the *non-owner's* right to death benefit under the split dollar agreement, it starts the other way:

   > "the amount of the current life insurance protection provided to the non-owner…equals the excess of the average death benefit[?] of the life insurance contract over the total amount payable to the owner under the split dollar agreement. The total amount payable to the owner is increased by the amount of any outstanding policy loan."

Confusing? Absolutely. But also something more. Regulations should not determine for parties what <u>shall</u> increase or decrease an interest. The parties are free to agree that the employer's "amount payable" is the greater (or lesser) of premiums paid or <u>gross</u> cash value, and that any employer withdrawals from the policy will not reduce the employer's share of the death benefit.

2. <u>Equity plans</u>. If the employee receives an economic benefit in addition to current insurance protection, that benefit will also be taxed to the employee. Subs. (d)(3). Any right or benefit in a life insurance contract, including an interest in cash surrender value, provided during the year to an employee is income. A couple of issues arise right away. First, the regulations are silent on how this benefit is valued; that issue is "reserved." Subs. (d)(3)(ii).

Second, the Treasury seems to confuse rights under an arrangement with rights under the life insurance contract. In general, an employee can have the contractual right to a benefit, but until the employer transfers to the employee the right to an actual asset, the employee does not have taxable income. Instead, the employee has a promise to be paid something. While promises have legal significance and moral importance, they do not trigger taxable income.

Specifically, the regulations seem to be in direct conflict with basic tax law principles concerning the timing of taxable income, such as Section 83 and the economic benefit doctrine. In the preamble to the proposed regulations, the Treasury distinguishes between nonqualified deferred compensation and "equity endorsement split-dollar" (equity collateral assignment split-dollar will be taxed as a loan). Preamble §3(a). The Treasury says that the two are different because nonqualified deferred compensation is an "unfunded, unsecured" promise to pay, in contrast to equity split dollar where the employee "obtains an interest in a specific asset of the employer (such as where the employer makes an outright purchase of a life insurance contract for the benefit of the employee)."

This distinction is unrealistic and troubling. Assume an employer wants to give a key employee an incentive to stick around, so the employer agrees to "put away" $10,000 every year into an account for an employee. The employer also agrees to credit that account with growth based on the performance of the Standard and Poor's 500 index. To insure that it will have sufficient funds to meet its binding contractual arrangement, the employer invests $10,000 every year in an S&P 500 mutual fund designed to track its liability. It is clear that the employer has purchased those mutual funds for the eventual benefit of the employee. Yet, the principal and annual increase in the value of the mutual funds is not taxable income to the employee because the mutual funds are owned by the employer and subject to the claims of its creditors. <u>Sproull v. Comm'r</u>, 16 T.C. 244 (1951), *aff'd* 194 F.2d 541 (6th Cir. 1952). It is only when the asset is set aside for the employee in a creditor-proof trust that the asset and its growth is taxable to the employee.

What is different when the employer owns the life insurance policy, but endorses the death benefit to the employee? The policy is still owned by the employer and subject to

its creditors, so any "interest" in the policy (other than the death benefit protection) should not be currently taxed to the employee. The regulations *could* be read to support that position. Subsection (d)(3) states that the employer must provide a right or interest to the employee for that right to be subject to income tax. In a vacuum, that language can be read to mean that a transfer of a right does *not* actually take place until that property is not subject to the corporation's creditors claims. But the Treasury's examples are questionable and troublesome.

First of all, the examples contained in Subsection (h) anticipate and require the same tax treatment for lifetime and at death terminations of an endorsement split dollar plan. In other words, the examples presume that the agreement provides for the same economic split between the employer and employee at death or a prior termination of the agreement. No way. Generally, upon the employee's death, whatever death benefit is endorsed to the employee is paid to the beneficiary; anything not endorsed goes to the employer. If the plan terminates prior to the employee's death, the endorsement is terminated and the employer owns the policy in its entirety; the employee owns and will receive nothing. The employer *can* transfer the policy at that time to the employee, for example, as a bonus or under a separate nonqualified deferred compensation arrangement, but that eventuality is not, and should not be, a part of the split-dollar arrangement itself.

None of the examples deal with how these plans are really structured. Look at Example 4. It describes a plan where the employer and employee modify the plan in the seventh year to provide the employer with 80%, rather than 100%, of the cash values. Or Example 3, where the agreement is amended to give the employer the greater of its premiums or 50% of cash values at termination or death. It is questionable how helpful these examples can be if the Treasury posits scenarios that are not based on business reality.

But more troubling than the regulations' lack of practicality are their disregard for Section 83 and the economic benefit doctrine in Example 2. There, the employer purchases an insurance contract on the employee's life. The corporation then enters into a split-dollar agreement providing that "*upon termination of the agreement or the employee's death*," the employer is entitled to receive an amount equal to the lesser of (1) its premiums paid or (2) the cash surrender value of the contract.

The Example states that *in each year* the agreement is in effect, the employee is accorded *additional* benefits under Subsection (d)(3) which must be included in gross income. Presumably, by using the language "in addition," the drafters intend to tax the employee on something in addition to current life insurance protection. But, in the example, the employer owns the policy. The employer transfers absolutely no right of any kind in cash values to the employee, much less vests the employee in those values. The only economic benefit the employee receives is annual death benefit coverage, irrespective of cash value growth. Yet, it seems that because the employer might not receive the greater amount when the plan terminates, something more than the annual economic benefit in the employee's current gross income. Apart from the fact that anyone can see that the

employee has received nothing more, this is a clear violation of the economic benefit doctrine.

A situation that is common in the real world is to combine an endorsement split-dollar plan with a nonqualified deferred compensation plan. In that plan, the employer owns a policy on the life of the employee. The employer purchases the policy to have an asset to meet its legal obligation to pay the employee a nonqualified deferred compensation benefit. But if the employee dies, the employer has no need for the policy. So the employer endorses the entire death benefit to the employee's chosen beneficiary. The employer's motive is simple: if its legal obligation to pay deferred compensation (at employee's retirement) is triggered, the employer has an asset it can use. If the employee dies, the employer understands it gets nothing, but it has no specific need for any portion of the death benefit. Finally, the employee will either pay employer for the value of the death benefit (a contributory plan) or the employer will provide that benefit as compensation (a noncontributory plan).

So how is this common plan taxed under Example 2? Because the employer is entitled to nothing upon the employee's death, the regulations imply that some portion of the cash values are *immediately* taxed to the employee, even though the employee has no current right to those cash values *and* the policy is subject to the claims of the employer's creditors. Before the employee dies, the employer's creditors can seize the policy or the employer can surrender the policy.

C. DEDUCTIONS AND INCOME

The proposed regulations also state that in a non-contributory plan the value of the current life insurance protection is compensation income to the employee, but that the employer does not get a corresponding compensation deduction. Subs. (f)(3). That treatment is in direct conflict with section 162: an employer *shall* be allowed a deduction for reasonable salary or other compensation. Under that same Subsection (f)(3), if the plan is contributory the employee's premium contribution (or donee in the gift tax context) is *income* to the *employer* (or donor)! Under what theory? There is no specific inclusion section that Congress has added to the tax code, so the Treasury must look to the general inclusion section, section 61.

There, income is circuitously defined as "income from whatever source derived." Realizing that this is not the most workable definition, the Supreme Court helped out by defining income, for purposes of section 61, as an accession to wealth, clearly realized, over which the taxpayer has dominion and control. Comm'r. v. Glenshaw Glass, 348 U.S. 426, 431 (1955). So where is the employer's accession to wealth in a contributory plan? If the employer does not endorse the death benefit, the employer retains purchased wealth. If the employer endorses the death benefit, the employer actually loses wealth. If the employee pays the employer the value of that death benefit under a contributory plan (the value established by the Service and published in the Internal Revenue Bulletin), the employer is in no better position, from a wealth perspective, than if the employer had held on to the death benefit. There is simply no accession to wealth, so the Treasury is incorrect in treating the employee's contribution as the employer's income.

D. DISTRIBUTIONS FROM AND TRANSFERS OF POLICIES AND POLICY INTERESTS

Under the "economic benefit" regime, the regulations treat the owner as transferring economic benefits to the non-owner. This includes current life insurance protection and also any other economic benefits. The general thrust is correct: if an owner transfers something in addition to death protection to a non-owner, it should be accounted for (as wage to employee, or gift, depending on relationship of owner and non-owner).

1. <u>Distributions from a policy</u>. Virtually all "split dollar economic benefit plans" treat the employer (or donor) as owner. Any distribution from a policy, whether it be a surrender, dividend, or loan, that is "provided directly or indirectly to a non-owner," is treated as two transactions: (i) a distribution from the policy to the owner governed by §72, and (ii) a distribution from the owner to the non-owner, treated simply as a distribution of cash (wages or gift, depending on relationship). Subs. (e)(1).

   This is sensible enough, and would be the tax result without these regulations. If a corporation owns a policy and takes a partial surrender but instructs the insurer to pay the money to an employee, it makes sense that any §72 treatment will be enjoyed by the policy-owning corporation (it will receive any 1099 from the insurer as well), and that the entire amount received by the employee will be taxable compensation without any §72 treatment.

   The calculation of the amount to be included in income is…well, look:

   > (i) The amount treated as received by the owner under paragraph (e)(1) of this section; over
   >
   > (ii) The amount of all economic benefits described in paragraph (d)(3) of this section actually taken into account under paragraph (d)(1) of this section by the transferee (and the transferor for gift tax and employment tax purposes) reduced (but not below zero) by any amounts that would have been taken into account under paragraph (d)(1) of this section if paragraph (d)(2) of this section were applicable to the arrangement plus any consideration paid by the non-owner for all economic benefits described in paragraph (d)(3) of this section reduced (but not below zero) by any consideration paid by the non-owner that would have been allocable to amounts described in paragraph (d)(2) of this section if paragraph (d)(2) of this section were applicable to the arrangement. The amount determined under the preceding sentence applies only to the extent that neither this paragraph (e)(3)(ii) nor paragraph (g)(1)(ii) of this section previously has applied to such economic benefits.

   Subs. (e)(3)(ii). What?! Translation: the non-owner gets taxed on what he receives, but he can first subtract what he already paid for or was taxed on. But he can not subtract the current life insurance protection he paid for or was taxed on. Simply put, paying one year

term rates, or being taxed on them, does not give the endorsee non-owner any set-off against amounts received.

2. Transfers of policies.

a. In General. Transfers from an owner to a non-owner of an entire contract or of an "undivided interest" therein are taxed essentially the same as policy distributions which are "provided to" the non-owner. Remember, a transfer of an "undivided interest" occurs if the non-owner receives an identical portion in each right and benefit of the contract (one-third of cash value, one-third of death benefit, etc.) Again, the non-owner transferee is taxed on the value of what is received, but gets credit for anything he paid tax on or paid for, as long as it is in addition to death benefit protection.

b. Timing With Section 83. In discussing transfers of entire policies, or transfers of undivided interests in policies, the regulations say that in an employment situation, no transfer is deemed to occur unless and until it also occurs under section 83. Nothing under the new §83 regulations seem to accelerate the timing of taxation, so it is odd that the drafters anticipate that the proposed regulations under §61 could cause taxation earlier than the existing rules of §83 would by themselves. See Subs. (g)(3) and (4).

c. Valuing the Transfer. The regulations provide potential ammunition against "springing cash value" policies.

The existing regulations under section 83 specify that if the property transferred from an employer to an employee is life insurance, only the cash surrender value is to be treated as property. This has always left the door open for springing cash value.

The new regulations, under section 61 and section 83, state that "the fair market value of a life insurance contract is the cash surrender value *and the value of all other rights under such contract* (including any supplemental agreements thereto and whether or not guaranteed)." In addition, the new regulations require that the fair market value "is determined disregarding any lapse restriction." Subs. (g)(2) & (3) and §1.83-3(e). This may give room to fairly value springing cash value policies.

d. Death Benefit. One last thing. The regulations say that death benefit paid to a beneficiary *other than the owner* is excluded from gross income. Subs. (f)(2). The regulations do not expressly address death benefit paid to the owner. Is this an intentionally ominous omission? If so, we're not daunted – the owner's death benefit must also be tax-free under Section 101.

V. SPLIT DOLLAR LOAN REGIME

[All citations in this Section IV refer to proposed regulations Section 1.7872-15. For reader friendliness, all citations to regulation subsections will refer to this major section, unless otherwise indicated. For example, "Subs. (a)(1)" refers to Section 1.7872-15(a)(1)]

Two Preliminary Notes:

1. Because the world of loans is new, and perhaps intimidating, to many of our split dollar-oriented readers, this portion is a straight summary of the tax treatment for split dollar plans treated as loans under section 7872.

2. The devilish tax and timing rules of section 7872 and the proposed regulations can be by-passed altogether by using a term loan with an interest rate no less than the AFR.

A. IN GENERAL

Certain split dollar arrangements are subject to the loan regime, which differs from the economic benefit regime in the following significant ways:

- No tax on the value of the economic benefit
- No taxable transfer of equity
- Different documentation and accounting
- Adequate interest must be charged, or interest will be imputed

It is important to remember that each premium payment is treated as a separate loan with cumulative effect. For example, in the tenth year of an arrangement involving a policy with a premium of $10,000, there will be cumulative loans outstanding of $100,000.

The regulations allow no de minimus exception, so split dollar arrangements involving even modest premium amounts are not exempt from the loan regime. Subs. (a)(3).

B. SPLIT DOLLAR ARRANGEMENTS SUBJECT TO LOAN REGIME

Split dollar arrangements which must be treated as loans are equity arrangements where the policy owner (employee/donee, also known as “borrower”) has an obligation to repay the non-owner (employer/donor, also known as “lender”) only premiums paid. Non-equity arrangements, where one party has a right to receive back the greater of cash value or premiums paid, and the only economic benefit available to the other party is the value of current life insurance protection, are not subject to the loan regime, but instead will be taxed under the economic benefit regime.

Assume, for example, a split dollar arrangement where an employer pays a $10,000 premium each year on a policy owned by an employee. In year ten of the arrangement, the cumulative premiums paid (and thus aggregate loan) is $100,000, and the cash value is $120,000. If the arrangement requires the employee to pay back only $100,000, it is subject to the loan regime. If the employee is required to pay back $120,000, it is not subject to the loan regime, but will be taxed under the economic benefit regime.

An equity split dollar arrangement is subject to the loan regime if it meets all three of the following criteria:

(i) the payment is made either directly or indirectly by the non-owner to the owner;
(ii) 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; and
(iii) the repayment is to be made from, or is secured by, either the policy's death benefit or cash surrender value.

Subs. (a)(2). The terms "owner" and "non-owner" have the same definition as in Prop. Reg. Sec. 1.61-22 (c), discussed in II, above.

Not all equity split dollar arrangements fit this definition. For example, an arrangement may be unsecured and repayment may be expected from a source unrelated to the policy. Ironically, if this arrangement is not a split dollar loan then the de minimus exception for modest premium loans would be available.

C. TAX TREATMENT OF INTEREST

1. Loans with Adequate Interest**.** Parties in an equity split dollar arrangement may choose to treat each premium payment as a loan evidenced by a promissory note bearing interest at a stated rate. The interest rate is adequate if it is at or above the government's Applicable Federal Rate (AFR), published monthly.

   If a split dollar arrangement is cast as a loan bearing adequate interest, it is governed by general tax rules. Interest paid by the borrower to the lender is treated as taxable income to the lender. The borrower cannot take a deduction for interest paid.

2. Loans without Adequate Interest. If the split dollar arrangement is subject to a loan regime but does not bear interest at an adequate rate, it is a "below market loan" and interest will be imputed at the appropriate AFR under the principles of Section 7872. Generally, the amount by which the AFR exceeds any stated interest is deemed to be transferred from the funding party "lender" to the owner (borrower), and then paid back to the lender as interest income. The timing, amount and nature of these deemed transfers depends upon the relationship of the parties (employer/employee, corporation/shareholder, donor/donee) and whether the loan is a demand loan or term loan.

D. TYPES OF SPLIT DOLLAR LOANS

1. Split Dollar Demand Loans. Split dollar loan arrangements which are payable in full at any time on demand of the lender are "split dollar demand loans." A split dollar demand loan is a below market loan if the stated interest rate, if any, is lower than the blended annual rate (published by the IRS in July of each year) during any year of the arrangement. If it is a below market loan, the amount of foregone interest is treated as transferred by the lender to the borrower and retransferred as interest by the borrower to the lender at the end of each calendar year that the arrangement remains outstanding. The amount of foregone interest for the year is determined by the appropriate AFR less any interest that actually accrues on the loan during the year. Subs. (e)(3).

In an employer/employee situation, the amount of the interest is deemed to be transferred from the employer to the employee as taxable income to employee, then transferred back to the employer. While this results in income to the employer, it may be offset by a deduction available to the employer. The income taxable to the employee is not offset by a deduction. In a donor/donee situation, the imputed transfer of interest from lender to borrower is treated as a gift, and the retransfer from borrower to lender results in income to the lender. Both situations can arise in the same arrangement, in which case it is viewed as two or more successive below market loans.

The proposed regulations offer this example:

> (i) On January 1, 2009, Employer X and Individual A enter into a split-dollar life insurance arrangement under which A is named as the policy owner. A is the child of B, an employee of X. On January 1, 2009, X makes a $30,000 premium payment, repayable upon demand without interest. Repayment of the premium payment is fully recourse to A. The payment is a below-market split-dollar demand loan. . . . Assume that the blended annual rate for 2009 is 5 percent, compounded annually.
>
> (ii) Based on the relationships among the parties, the effect of the below-market split-dollar loan from X to A is to transfer value from X to B and then to transfer value from B to A. . . . The below-market split-dollar loan from X to A is restructured as two deemed below-market split-dollar demand loans: a compensation-related below-market split-dollar loan between X and B and a gift below-market split-dollar loan between B and A. Each of the deemed loans has the same terms and conditions as the original loan.
>
> (iii) Under . . . this section, the amount of forgone interest deemed paid to B by A in 2009 is $1,500 ([$30,000 x 0.05] - 0). Subs. (e)(2)(iv).

The result is that in year one, employee B is taxed on $1,500 of income, and may also be subject to gift tax on the $1,500 deemed transferred to child A. In the second year, assuming AFR remains at 5 percent, the loan outstanding is $60,000, and the amount deemed transferred as income to B and gift to A is $3,000. In year ten, if the AFR remains unchanged, the loan outstanding is $300,000, and the amount deemed transferred as income to B and gift to A is $15,000.

2. Split-Dollar Term Loans. A split-dollar term loan is any loan that is not a split-dollar demand loan. Rather than being subject to repayment on demand, the arrangement calls for repayment after a fixed term. A split-dollar term loan is below market if the present value (using the appropriate AFR as the discount) of all payments due under the loan is less than the loan itself. The appropriate AFR is generally based on the loan's term: short-term (under 3 years), mid-term (3 but not over 9 years), or long-term (over 9 years). The amount of the foregone interest is included in the borrower’s income when the loan is made, and included in the lender’s income as it accrues over the life of the loan.

The regulations provide the following example:

(i) On July 1, 2009, Corporation Z and Shareholder A enter into a split-dollar life insurance arrangement under which A is named as the policy owner. On July 1, 2009, Z makes a $100,000 premium payment, repayable without interest in 15 years. Repayment of the premium payment is fully recourse to A. The premium payment is a split-dollar term loan. Assume the long-term AFR (based on annual compounding) at the time the loan is made is 7 percent.

(ii) Based on a 15-year term and a discount rate of 7 percent, compounded annually (the long-term AFR), the present value of the payments under the loan is $36,244.60 …. This loan is a below-market split-dollar term loan because the imputed loan amount of $36,244.60 (the present value of the amount required to be repaid to Z) is less than the amount loaned ($100,000).

(iii). . . on the date that the loan is made, Z is treated as transferring to A $63,755.40 (the excess of $100,000 (amount loaned) over $36,244.60 (imputed loan amount)). … Z is treated as making a [taxable] distribution to A on July 1, 2009, of $63,755.40. Z must take into account as OID an amount equal to the imputed transfer. Subs. (e)(4)(vi).

Partial results are summarized as follows:

- In year one, shareholder A is taxed on $63,755.40 of dividend income.
- In year two, assuming the AFR remains at 7 percent, a new $100,000 loan is made, with a 14 year term (assuming all premiums must be repaid at the end of the 15th year of the arrangement). The present value is $38,781.72, which means that A is taxed on $61,218.28 in the second year.
- In year ten a new $100,000 loan is made with a five-year term. Assume a 6% mid-term AFR. The present value is $74,725.82, which means that A is taxed on $25,274.18 in the tenth year.
- Z must include these amounts in income as they accrue over the life of each loan under "original issue discount" rules.

3. Demand vs. Term Loans. Demand loans impute higher interest in later years of a split dollar arrangement, while term loans impute higher interest in early years.

For example, assume a split dollar arrangement where employee owns a policy with a $10,000 premium paid by employer, which has a right to recover premiums paid. The following illustrates for select years the difference between an arrangement payable on demand vs. a 15 year term. Assume AFR rates as follows: 5% (short term), 6% (mid term), 7% (long term).

	Employee Income	Computation
Year 1		
Demand Loan	$500	10,000 x 5%
Term Loan (15 yrs)	$6,375.54	10,000-3,624.46 (PV at 7% for 15 years)
Year 7		
Demand Loan	$3,500	70,000 (cumulative premiums) x 5%
Term Loan (8 yrs)	$3,725.88	10,000-6,274.12 (PV at 6% for 8 years)
Year 14		
Demand Loan	$7,000	140,000 (cumulative premiums) x 5%
Term Loan (1 year)	$476.19	10,000-9,523.81 (PV at 5% for 1 year)

E. ADDITIONAL ISSUES UNDER LOAN REGIME

1. Converting from Demand Loan to Term Loan. It is possible to convert from a demand loan to a term loan during a split dollar arrangement. For example, an arrangement may call for premiums to be repayable on demand for an unspecified period. At any time during the arrangement, the parties may amend the arrangement and call for repayment at a defined term. The arrangement thus converts from a demand loan to a term loan arrangement.

   On conversion, the full amount of cumulative premiums will be treated as a term loan, which may result in large taxable income in the year of conversion. For example, assume the parties in the prior example treated the $10,000 premium payments as demand loans for the first 10 years, and then amend the agreement to require premium repayment after 5 additional years. The employee must recognize $25,274 as income in the tenth year ($100,000 cumulative premiums less $74,725.82 (PV at 6% for 5 years)).

2. Split Dollar Loans With Trusts. If an irrevocable life insurance trusts owns a policy subject to a split dollar loan arrangement, the rules set forth above generally apply. If the premiums are paid by an individual, any imputed interest is treated as a gift to the trust, and a retransfer from the trust to the individual as taxable interest income.

   However, if the irrevocable trust is a grantor trust, the trust is essentially disregarded for income tax purposes. All income earned by the trust is taxed to the individual grantor, and transactions between the trust and the individual are generally ignored for income tax purposes. Therefore, the deemed transfer of interest from the individual grantor to the trust is still treated as a gift, but there should be no income tax consequences.

3. Repayment on Death. Split dollar loan arrangements requiring repayment of premiums on the insured's death are generally treated as demand loans for income tax purposes. However, rather than valuing foregone interest by the blended annual rate, the AFR appropriate for the loan term is used, which is generally life expectancy at the time the loan is made. Subs. (e)(5)(ii).

4. Waived, Cancelled, or Forgiven Interest. If accrued and unpaid interest on a split dollar loan is waived, cancelled or forgiven, the interest is deemed to be paid on that date by the borrower to the lender and then transferred back to the borrower.

5. Special Loan Rules. There are additional special rules for certain split dollar loan arrangements, including the following:

   - loans that provide for contingent payments
   - loans that are non-recourse to the borrower (unless the parties make a written representation that a reasonable person would expect that all payments under the loan will be made)
   - loans subject to certain borrower or lender options
   - loans that are conditioned on the future performance of substantial services by an individual

6. Loans and Estate Inclusion Considerations. Suppose that A (or A's 100%-owned corporation, but we'll stick with A) lends money to her irrevocable trust to buy a policy on A's life. Be careful. If the policy is assigned to A as security for repayment, the assignment may give A an incident of ownership which will include the death proceeds in A's estate under section 2042 – an unacceptable planning result. No collateral assignment should accompany this transaction. The arrangement is still governed by the regulations if repayment is to be made from the policy. But even if the agreement specifies that repayment is not to be made from the policy, the general tax principles of a loan transaction should apply.

VI. SUMMARY

We know, or at least we think we do, the purpose and intended result of these regulations: to prevent what Treasury sees as tax-free transfers of wealth from one party to another by means of some arrangement that manipulates life insurance. Perhaps too much thought went into how to construct an ideology to achieve certain results rather than relying on general transactional and tax principles to let the nature of things take its course.

And so we have policy owners called non-owners, and people who do not own policies called owners, and clear loan transactions nonsensically called "split dollar treated as a loan." We have definitions of split dollar that don't cover some common plans. We have examples that bear little relation to planning reality. We have apparent or potential taxation where no transfers have occurred and no accession to wealth has been achieved. And all because we're not looking at split dollar for what it is: a financing technique – supplying capital or using others' – for the

acquisition or use of this asset called life insurance. We don't analyze buying or renting a property as "split house" or "split premises" or, for that matter, "split dollar." We shouldn't here. At least not any more.

The regulations' complexity and somewhat artificial methodology are unnecessary. Let's get rid of the old terms and ideologies and dispense with the new ones. Let's treat life insurance like any other asset. Let's apply general tax principles to the economic and transactional realities inherent in a financing arrangement involving life insurance. We'll come out near the same place, but for the right reasons, and in ways that planners and their clients can rely on.