A.P. Letter No. 180

January 22, 2004

SPLIT DOLLAR FINAL REGULATIONS: THE INITIAL ANALYSIS

ADVANCED PLANNING DIVISION

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The Northwestern Mutual Life Insurance Company ▪ Milwaukee, Wisconsin

SPLIT DOLLAR FINAL REGULATIONS: THE INITIAL ANALYSIS

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I. BACKGROUND

Before 1964, interest-free loans from employers to employees had no income tax consequences. In fact, interest-free loans would not trigger federal income tax for many more years until a U.S. Supreme Court case[1] spurred the creation of §7872 in 1984. Presumably hoping to increase tax revenue, in 1964 the Treasury departed from these general tax principles to create a new system for taxing certain life insurance financing arrangements known then and now as "split dollar." The system created by Revenue Ruling 64-328 stayed in place for nearly 40 years, providing certainty on some issues, but uncertainty on others.

Now apparently dissatisfied with what its creation has wrought, Treasury portends a return to general tax principles. But instead of merely revoking Revenue Ruling 64-328 and its progeny, Treasury has issued voluminous and complex regulations that mandate a new system. Like its predecessor, this new split dollar tax system departs at times from general tax principles, and provides certainty on some issues, but uncertainty on others.

II. DEFINITIONS

A. WHAT IS A SPLIT DOLLAR ARRANGEMENT?

The final regulations provide both a general and special definition of a split dollar arrangement.

1. General Definition. A split dollar arrangement is any arrangement between parties where:

    - either party pays all or any portion of premiums, and
    - at least one party paying premiums is entitled to recover all or any portion of these premiums, and
    - this recovery is to be made from, or is secured by, the proceeds of the life insurance contract, and
    - it is not a group term plan, unless the group plan provides permanent benefits.[2]

2. Special Definition. Regardless of whether the general definition is met, a special definition of split dollar applies to two situations: compensatory arrangements (employer with employee or independent contractor); and shareholder arrangements (corporation with a shareholder). Life insurance financing arrangements between these parties are also treated as a split dollar plan if:

    - the employer (or corporation) pays all or a part of the premium, and either:

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1 *Dickman v. Comm'r,* 465 U.S. 330 (1984)

2 Treas. Reg. §1.61-22(b)(1).

- the employee (or shareholder) has any interest in cash value; or
- the beneficiary of all or any part of death benefit is:
  - designated by employee (or shareholder), or
  - any person whom the employee (or shareholder) would reasonably name.[3]

3. Our Comments.

a. In the general definition, the third element is ambiguous. Although the words "is secured by" means that collaterally assigned policies are covered, there remains the issue of what it means for premium recovery "to be made from" the policy's proceeds.

(1) In particular, there is the question of whether the phrase "to be made from" covers unsecured arrangements which have a structure that mimics the collateral assignment method. Unsecured arrangements should not be covered, because this method anticipates repayment from *any* asset the policyowner holds. As a result, parties may draft out of the general definition with an unsecured agreement, or with one that secures the loan with other assets, or one that explicitly states, "repayment of premiums is not to be made from the policy."

(2) The phrase "to be made from" more likely refers to endorsement arrangements, where the premium payer is a policyowner who will recover premiums from a policy it owns outright, rather than from a policy in which it holds a security interest.

b. The special definition appears to cover employee or shareholder arrangements where, for example, an employer owns a policy and endorses *all* death benefit to an employee. These situations are not split dollar plans under the general definition, which requires the payer to recover premiums from the policy's "proceeds." The word *proceeds* in the general definition must refer only to death benefit, because a premium-paying employer fails to recover premiums from the policy's proceeds – and therefore fails to meet the general definition – only if the employer endorses all the death benefit and the insured dies while the plan is in place. The word *proceeds* could not refer to cash value, because even an employer endorsing all death benefit retains sole control of the cash value if the plan terminates during the insured's life. Furthermore, when the regulations are concerned with premium recovery from cash value – as with the loan definition – they state it specifically and separately from death proceeds: "[repayment from] the policy's death benefit proceeds, the policy's cash surrender value, or both."[4]

c. Because the special definition, amended from the proposed regulations, is now triggered whenever the employee has any interest in cash value, even if he has no

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[3] Treas. Reg. §1.61-22(b)(2).

[4] Treas. Reg. §1.7872-15(a)(2)(C).

interest in death benefit, it reaches those "reverse split dollar" arrangements where the employee owns the policy and endorses the entire death benefit to the employer.

d. The special definition is so broad that it covers traditional bonus arrangements. This has no real effect, in that the regulations retain general tax principles for this situation,[5] essentially taxing the employee on the value of the bonus.

e. Both the special and general definitions exclude two relatively common arrangements:

(1) Where an individual policyowner endorses the entire death benefit to a trust or a family member; and

(2) Where an individual policyowner endorses the entire death benefit to a co-business owner, perhaps to fund a cross-purchase buy-sell.

These plans are not covered by the special definition because neither is between employer-employee or corporation-shareholder. For reasons stated above, they are also not governed by the general definition, because in neither arrangement does the owner recover premiums from the policy's death proceeds. This means that general tax principles apply to these plans. The most logical conclusion is to treat these plans as one party transferring the death benefit to another on an annual basis or for a term of years. The result is similar to the "economic benefit" approach under the regulations (described in IV, below), but these plans are not governed by the regulations.

B. WHO IS THE OWNER AND NON-OWNER?

1. <u>General Rule.</u> The "owner" is normally the party named as the owner on the insurance policy.[6]

When a policy lists two or more owners, and each party holds all incidents of ownership with respect to an undivided interest in the contract, the regulations treat the owners as holding separate contracts.[7] This occurs if the first person owns, say, one-third of cash value and one-third of death benefit, and the second person owns the remaining two-thirds of cash value and two-thirds of death benefit.

If the two or more listed policyowners do not have undivided interests, then the person listed first is normally the owner of the policy. This occurs if the first person owns, say, two-thirds of the cash value and one-tenth of the death benefit, and the second person owns one-third of the cash value, but nine-tenths of the death benefit.

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[5] Treas. Reg. §1.61-22(b)(5).
[6] Treas. Reg. §1.61-22(c)(1)(i).
[7] Treas. Reg. §1.61-22(c)(1)(i).

2. Special Rule. A special ownership rule trumps the general rule. Whenever an arrangement provides only death benefit protection (i.e., a non-equity arrangement) and it involves the "performance of services" or "is entered into between a donor and donee," the employer or donor is always treated as the owner of the policy.[8]

3. Our Comments.

   a. The general rule that the owner is the person listed first allows the parties to choose an "owner" in some situations. For example, in an endorsement plan between two business owners, the parties can list the death benefit endorsee as an owner and list him first, even though the other party controls all policy rights (e.g., cash value) during the insured's life.

   b. A typical example of the special ownership rule's application is what is traditionally called collateral assignment non-equity split dollar:

      (1) The employer pays the premium for a policy actually owned by the employee, and the employer is entitled to an amount equal to the entire cash value. The regulations treat the employer as the owner.

      (2) The donor pays the premium for a policy actually owned by the donee, and the donor is entitled to an amount equal to the entire cash value. The regulations treat the donor as the owner.

   c. The special ownership rule always treats the donor as the owner in a non-equity gift arrangement, but what if the purported "donor" is not making a gift because it is a contributory plan? For example, if a trust actually owns a policy and must repay all of the cash value to the insured, no gift is made under the split dollar arrangement if the trust pays the one-year term rate. If there's no gift, it seems that the arrangement is not "entered into between a donor and donee," and the special ownership rule should not apply.

   d. Because the special ownership rule applies only to employment or gift situations, it does not apply where a *shareholder* or *partner* actually owns a policy, and must pay to the premium-paying business an amount equal to the entire cash value.

   e. The preamble states that the regulations' ownership rules have nothing to do with life insurance estate tax inclusion, which is still governed by §2042.[9]

C. EQUITY AND NON-EQUITY TERMINOLOGY

The final regulations' text eliminates any specific definition of "equity" and "non-equity" arrangements. But the underlying concepts remain, so the notion of providing only life insurance protection has stayed even though the corresponding term "non-equity" is

[8] Treas. Reg. §1.61-22(c)(1)(ii).

[9] This issue is discussed further, *infra* at IV.D. "Treatment of Death Benefit Proceeds."

technically gone. Unfortunately, the preamble of the final regulations perpetuates the proposed regulations' new terminology of "endorsement equity split dollar plans." So, to readjust your thinking cap, here is what the equity and non-equity terminology refers to under the regulations:

1. Non-Equity. A non-equity plan is where the only economic benefit provided is the death benefit. This occurs in a typical endorsement plan. It also occurs where the policyowner receives premium advancements from another party, and that party has a right to recover all cash value in the policy – i.e., the policyowner owns no cash value exceeding premiums advanced, or, no equity.

2. Equity. An equity plan now occurs only in atypical endorsement plans: where the policyowner not only endorses the death benefit (or some portion of it) to another, but also grants to the endorsee some interest in the policy's cash value – e.g., the endorsee has a right to some or all of the equity cash value. The term "equity" no longer has any place in collateral assignment plans where the policyowner owes back only premium advancements to another party; this instead is now called a loan.

III. WHICH TAX TREATMENT APPLIES: ECONOMIC BENEFIT OR LOAN?

A. Any arrangement which falls within the definition of split dollar is generally taxed in one of two mutually exclusive ways: as an economic benefit or as a loan.[10] If the arrangement meets the regulations' definition of split dollar, but does not fit in either the economic benefit or the loan category, then general tax principles apply.[11]

1. Economic Benefit. Any split dollar arrangement that is not a loan is taxed as an economic benefit.[12] While the arrangement is in place, the economic benefits provided by the owner to another party are divided into three categories:

   - cost of life insurance protection – this is the familiar one-year term rate; and
   - cash value to which the non-owner has current access – this occurs only in the newly-named situation of endorsement equity split dollar, which rarely exists; and
   - any other benefits – essentially a catch-all category, perhaps including waiver of premium owned by the employee or supplemental benefits like an accidental death benefit rider.[13]

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[10] Treas. Reg. §1.61-22(a) and (b)(3).

[11] Treas. Reg. §1.61-22(b)(5). This occurs when the non-owner makes premium payments that are neither split dollar loans nor consideration for economic benefits. General tax principles assuredly also apply to life insurance financing arrangements that fall outside the regulations' definition of split dollar.

[12] Treas. Reg. §1.61-22(b)(3)(i) and §1.7872-15(a)(2)(iii).

[13] Treas. Reg. §1.61-22(d)(2).

This economic benefit taxation is very similar to the traditional split dollar taxation we have had for years.

2. Loan. An insurance financing arrangement is treated as a loan if:

- payment is made directly or indirectly by the non-owner to the owner, and
- the payment is a loan under general tax principles or it is reasonable to expect it to be paid back, and
- repayment is to be made from, or is secured by, the policy's death benefit proceeds or its cash surrender value, or both.[14]

The new regulations under §7872 apply to these loans only if sufficient interest (at least equal to the applicable federal rate) is not charged for the loans.

3. Our Comments. Many arrangements will retain essentially the same treatment they always had under old split dollar rules, and some will be forced into loan taxation. But the treatment of other arrangements is uncertain because they do not fit neatly into either tax treatment.

    a. *Collateral Assignment Equity – Loan Treatment.* The most well-known feature of the new regulations is that plans formerly called collateral assignment equity arrangements are now treated as loans. A common example involves an employer paying premiums on an employee-owned policy, where the employee owes just the premiums back to the employer. Income tax consequences in this situation are now determined by interest rates rather than by one-year term rates. And as with any loan, the employee clearly has no tax on equity – the cash value exceeding premiums.

    b. *Endorsement – Stays the Same.* The tax treatment remains largely as it was for traditional endorsement plans. The common example is where the employer owns the policy and endorses death benefit to the employee. The employee either pays the one-year term rate, or pays tax on it.

    c. *Collateral Assignment Non-Equity – Stays the Same.* For example, the employer advances premiums to the policy-owning employee and employer has a right to the entire cash value, so employee controls only the death benefit. Because the arrangement provides only death benefit protection, the employer is treated as the owner and economic benefit treatment applies just as with a traditional endorsement plan: the employee is taxed on a one-year term rate or pays it.

    d. *Special Ownership Rule Uncertainty When "Donor" Not Making Gift.* The special ownership rule operates in gift situations to always treat the donor as the owner whenever only death benefit is provided. A typical example involves a trust-owned policy where the trust owes the entire cash value to the insured, who

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[14] Treas. Reg. §1.7872-15(a)(2)(i).

pays the premium. But where the trust pays the insured a one-year term rate that is full consideration for the death benefit, no gift of the one-year term cost is being made under the terms of the split dollar arrangement. If there's no gift, it seems that the arrangement is not "entered into between a donor and donee," and the special ownership rule should not apply to trigger economic benefit taxation.[15] Then which tax treatment applies?

(1) The economic benefit approach has the appeal of consistency, but it doesn't fit within the regulations' precisely crafted language.

(2) Loan treatment shouldn't apply, because the transaction doesn't meet the regulations' loan requirements.[16]

(3) Because the insured is not even promised to get his principal back (the cash value may be lower than the premiums when the plan is terminated), it may be treated under general tax principles as some type of equity investment by the insured. If so, the doctrines of constructive receipt and economic benefit should prevent the insured from being taxed on the policy's internal cash value growth.[17]

Given the regulations' silence as to this type of plan, the taxation appears to be the parties' reasoned choice.

e. *Collateral Assignment Non-Equity Outside Employment or Gift.* If the parties to a collateral assignment non-equity arrangement are, say, co-shareholders, then the special ownership rules do not apply to force application of the economic benefit approach. We again have the choice between an economic benefit parallel, a loan, and some type of investment approach.

f. *Unsecured Arrangements.* An unsecured arrangement begs the question of whether the general definition of split dollar applies at all, because it is not necessary that the repayment "is to be made from" the policy. Consider a plan where a trust owns the policy, and owes to the insured the premiums the insured paid, but there's no collateral assignment and the agreement specifies that repayment is not to be made from the policy. Even though this drafting negates the regulations' "split dollar loan" rules, it seems that general tax principles should apply to nonetheless characterize this as a loan.

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[15] If the special ownership rule does not apply, then the insured is not "treated as the owner," and therefore cannot be an owner providing economic benefits to a non-owner (the trust). And with the trust being the owner, it is improbable that in these facts it can be seen as an owner providing economic benefits to a non-owner (the insured). So the insured's premium payments are not consideration for economic benefits provided to him by the owner.

[16] Treas. Reg. §1.7872-15(a)(2)(i) requires that the non-owner's payments be a loan under general tax principles, or that it be reasonable to expect repayment "in full."

[17] General tax principles apply whenever the non-owner (here, the insured) makes premium payments that are neither split dollar loans nor consideration for economic benefits. Treas. Reg. §1.61-22(b)(5).

IV. ECONOMIC BENEFIT TAXATION

A. BENEFITS PROVIDED BY POLICYOWNER TO NON-OWNER

Two principles permeate the economic benefit approach: a contract under a split dollar plan is always treated as having one owner; and only the owner is granted any basis in the contract while the plan is in place.[18] As stated above, the regulations divide into three categories the benefits that an owner can transfer to a non-owner:

- cost of life insurance protection;
- cash value to which the non-owner has current access;
- any other economic benefits.[19]

1. <u>Cost Of Life Insurance Protection.</u> For the most part, this benefit is measured by the familiar method of a one-year term rate multiplied by the amount of death benefit controlled by the non-owner (or simply payable to a beneficiary that an employee or shareholder would name).

   a. *What Rate To Use?* The new regulations state that taxpayers should use the "life insurance premium factor designated or permitted in guidance published in the Internal Revenue Bulletin."[20] As of this writing there is no new table, but the revenue ruling which accompanies the regulations and obsoletes previous split dollar revenue rulings tells us to still rely on Notice 2002-08 and Notice 2002-59.[21] So Table 2001 is acceptable, as are the insurance company's lower rates that are made known to customers and are regularly sold through normal distribution channels.

   b. *When To Measure Death Benefit.* The death benefit is measured at the end of the non-owner's taxable year (usually December 31), unless the parties agree to use the policy anniversary date.[22] In the year the arrangement is terminated, however, the valuation date is the day the arrangement ends.[23]

   c. *Reduction For Taxed Amounts.* The term rate is not always multiplied by simply the amount of death benefit the non-owner controls. Instead, that death benefit amount is first reduced by any amount the non-owner is or has been taxed on, which can happen if the non-owner has or had "current access" to cash value. In traditional endorsement plans that provide only death benefit coverage, this reduction will never occur because cash values are never taxable in the first place.

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18 See Treas. Reg. §1.61-22(f)(2).
19 Treas. Reg. §1.61-22(d)(2).
20 Treas. Reg. §1.61-22(d)(3).
21 Revenue Ruling 2003-105. Treasury has stated it is working on a new table, but there is no way to know when or if this new table will become effective.
22 Treas. Reg. §1.61-22(d)(5).
23 Treas. Reg. §1.61-22(d)(5)(i).

2. <u>Cash Value To Which Non-Owner Has Current Access.</u> The non-owner is taxed on any cash value to which he has "current access," which is defined as:

   - any cash value to which the non-owner has a current or future right *under the split dollar arrangement*, and
   - that is currently:
     - directly or indirectly accessible by the non-owner, or
     - inaccessible to the owner, or
     - inaccessible to the owner's general creditors.[24]

   This position generally comports with general tax principles: if an employee has unilateral immediate access to an employer-owned asset, the employee should be taxed.

   a. *Don't Worry, You'll Probably Never See It.* This "current access" transfer occurs only in the newly coined "endorsement equity split dollar" plans, which are so rare that most practitioners never have and never will see them.

      (1) This category never applies to a plan where the employer (or donor) owns the policy subject to a traditional endorsement plan, because these plans do not provide to the non-owner any current or future right to cash value. The only benefit provided is death benefit – and this is true even if the policy's *entire* death benefit is endorsed.

      (2) This category never applies to policies actually owned by an employee (or donee) who owes the entire cash value to the premium-paying employer (or donor), because in these arrangements the employee (or donee) by definition never has any current or future right to cash value. This is true even if the plan is unsecured, because even though the employee has unilateral power over the cash value with respect to the policy, the employee does not have rights to cash value *under the split dollar arrangement*.[25]

      (3) This category never applies to policies actually owned by an employee (or donee) who owes only premiums back to the premium-paying employer (or donor), because these arrangements are characterized as loans to begin with and are not subject to economic benefit treatment.

   b. *When To Measure Cash Value.* The amount of cash value the employee is taxed on is measured at the same time as the death benefit – at the end of the non-owner's taxable year (usually December 31) or, if the parties agree, on the policy

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[24] Treas. Reg. §1.61-22(d)(4)(ii).

[25] See Treas. Reg. §1.61-22(d)(4)(ii)(A). Keep in mind, however, that the special ownership rule treats the employer as the policyowner is this situation, so if the employee actually takes a withdrawal from the policy, it will be taxed as if the employer withdrew the money from the policy, and then separately transferred it to the employee. See *infra*, IV.B. "Distributions From Contract During Insured's Life."

anniversary date. As with the death benefit, in the year the arrangement is terminated the valuation date is the day the arrangement ends.[26]

c. *How to Measure Cash Value.* The policy cash values to which the non-owner has current access are measured without regard to surrender charges or other similar charges or reductions.[27] Cash value also includes any cash value attributable to paid-up additions. The absolute prohibition against reductions for surrender charges may rightfully hinder springing cash value schemes, but is unwarranted for many policies with honest surrender charges that legitimately reduce the value being transferred.

d. *Reduction For Taxed Amounts.* As with the cost of life insurance described earlier, the portion of cash value taxed each year is not simply the amount to which the non-owner has a right and current access. It is first reduced by any amount of cash value or other benefits the non-owner is or has been taxed on, which happens if the non-owner has or had "current access" to cash value.

e. Here are two examples of how to calculate income on the cost of current life insurance protection in conjunction with current access to cash values:

Example 1. Employer pays all premiums and owns a policy with a constant $1,500,000 death benefit. Employer and employee enter into an arrangement where employer controls the death benefit equal to the lesser of cash value or premiums, and employee controls the rest. The arrangement also provides that during the insured's life, as soon as cash value exceeds premiums, the employee can borrow or withdraw from it. This is an endorsement equity plan, which few have ever seen. The yearly premium and cash value amounts are:

	Year 1	Year 2
Cash value	$ 55,000	140,000
Cumulative premiums	$ 60,000	120,000

In year 1, the employee is taxed on:

- cash value in excess of premiums = $0;
  and
- cost of life insurance, which equals the term rate multiplied by $1,445,000. This death benefit amount is found by starting with the entire death benefit ($1,500,000), then subtracting the amount payable to the employer ($1,500,000 minus $55,000 = $1,445,000), then further subtracting the cash value taxed to the employee ($1,445,000 minus $0 = $1,445,000).[28]

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[26] Treas. Reg. §1.61-22(d)(5)(i).

[27] Treas. Reg. §1.61-22(g)(2).

[28] Treas. Reg. §1.61-22(d)(6), Example 1.

In year 2, the employee is taxed on:

- cash value in excess of premiums = $20,000 ($140,000 minus $120,000);
  and
- cost of life insurance, which equals the term rate multiplied by $1,360,000. This death benefit amount is found by starting with the entire death benefit ($1,500,000), then subtracting the amount payable to the employer ($1,500,000 minus $120,000 = $1,380,000), then further subtracting the cash value taxed to the employee ($1,380,000 minus $20,000 = $1,360,000).[29]

Example 2. Use the same facts as above, but assume that while the plan is in place the employee cannot withdraw, borrow, or otherwise access the cash value in excess of basis. But assume that the employee is still entitled to cash value in excess of basis if the agreement terminates during life. Lastly, assume that – solely due to state law – the employer's creditors cannot get at the policy.

In year 1, the employee is taxed on the same amounts as in the first example.

In year 2, the employee is still taxed on the same amounts as in the first example. This is because the employee is deemed to have "current access" to the cash value whenever he has a current or *future* right to cash value (i.e., at plan termination), and the employer's creditor's cannot access the policy.[30] This is one place where these current access rules are objectionable. They impose a tax on an employee who has no true right to currently enjoy any cash, and tax is imposed solely due to the peculiarity of applicable state law, not due to anything in the split dollar agreement itself.[31]

f. This calculation method can produce incorrect results because it does not take into account that part of the cash value growth as a result of cash values already included in the employee's income. In Example 1, employee is taxed on about 14% of the total cash value after year two. In year three, any increase in cash value is due in part to the employee's 14% of cash values already taxed, so the employee should be able to offset future income on a proportionate amount of future growth. Because the regulations do not take this into account they overstate – to some extent, double-tax – the employee's income.

3. <u>Any Other Economic Benefits.</u> This third and final category of taxable benefits is essentially a catch-all category. It likely includes things such as waiver of premium

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[29] Treas. Reg. §1.61-22(d)(6), Example 1.

[30] Treas. Reg. §1.61-22(d)(6), Example 2.

[31] This could be a trap for the unwary, given that identical agreements can cause different tax results for employees in different states. But even before these regulations, careful attorneys drafted split dollar agreements so that the employee clearly has no current or future right to cash value in an employer-owned policy.

and supplemental benefits like an accidental death benefit rider. It may also be intended to prevent shenanigans such as springing cash value (mentioned above), or sponge policies (which similarly declare an artificially low cash value relative to the large premium demanded and long duration of guaranteed death benefit), or schemes not yet seen by Treasury. For plans that provide only death benefit or cash value, and for policies honestly valued, this category should rarely be in play. In fact, the regulations contain no examples of its operation.

B. DISTRIBUTIONS FROM CONTRACT DURING INSURED'S LIFE

As stated earlier, the regulations treat a life insurance policy under a split dollar plan as having only one owner. Whether it is the actual owner or the party "treated as the owner," only the owner receives the §72 treatment given to life insurance policies.[32]

1. As a result, 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: distribution from the life insurance contract to the policyowner governed by §72; and distribution from the policyowner to the non-owner, treated simply as a distribution of cash (e.g., wages or gift, depending on the parties' relationship).

2. This is sensible enough, and often would be the tax result even without these regulations. Consider a corporation owning a policy in a typical endorsement plan with an employee. If the corporation takes a partial surrender but instructs the insurer to pay the money to the employee, it makes sense that the corporation receives §72 treatment (it will receive any Form 1099 from the insurer as well), and that the entire amount received by the employee is taxable compensation without any §72 treatment.

3. Continuing the above example, the employee is taxed on what he receives, but he can first subtract from that taxable amount any cash value he already was taxed on and can also subtract what he paid. But the employee cannot subtract the portion he paid tax on (or paid for) to the extent it related only to life insurance protection.[33] Stated another way, the non-owner (e.g., endorsee) does not take any basis when paying one-year term rates or paying tax on them.

C. DEDUCTION AND INCOME WHILE ARRANGEMENT IS IN PLACE

1. <u>Deduction.</u> While the split dollar plan is in place, the "owner" has no deduction for providing the other person with economic benefits (e.g., life insurance protection and access to cash value).[34] So even if an employer provides life insurance protection to an employee as compensation, and the employee correspondingly recognizes the cost of that life insurance protection as compensation income, the employer does not get a deduction.

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[32] Treas. Reg. §1.61-22(g)(2).

[33] Treas. Reg. §1.61-22(e)(3).

[34] Treas. Reg. §1.61-22(f)(2)(ii).

2. Income. One of the more controversial portions of the final regulations provides that the owner must report income whenever the one-year term cost is paid by the non-owner.[35] The most common example: the employer owns a policy, endorses death benefit to the employee, and the employee pays to the employer or insurer a one-year term rate for that death benefit. For plans covered by these regulations, these new rules conclude that this payment is income.

3. Our Comments.

   a. *Deduction Denial Causes Double-Tax.* The denial of an employer deduction for providing economic benefits departs from the plain language of §162, which states that an employer "shall be allowed" a deduction for "expenses paid or incurred . . . for salaries and other compensation." The statute does not limit an employer's deduction to transfers of property taxed under §83, so the fact that these regulations tax the employee under §61 should not hinder deductibility. In addition, the transfer of life insurance protection to an employee where the employer pays the entire premium is an expense *paid or incurred*. Granted, §264 generally disallows any deduction for payment of *premium*, but here the deduction is based on the payment of *compensation*. The regulation double-taxes the one-year term cost by requiring income to employee while denying employer a deduction for the expense.

   b. *Income Tax In Contributory Plans Should Not Apply Outside Regulations*. The preamble's explanation for taxing the employer in a contributory plan is that the employer is "renting" (the preamble's quotation marks) the death benefit to the employee, and like a landlord, must include rental payments in income. The regulations take the preamble's self-admitted metaphor too far.

      (1) "Rent" is simply a metaphor that practitioners and teachers have employed as a useful tool to explain endorsement plans to those unfamiliar with split dollar. But that is as far as the metaphor goes, and it reflects neither the true legal relationship nor the uniqueness of life insurance or the financing arrangement. The real estate owner gets the property back at the end of the rental. In endorsement plans the employer does not receive the endorsed death benefit if the insured dies while the plan is in place, essentially losing the asset. A landlord does not lose the real estate if the tenant dies.

      (2) The Supreme Court has ruled that taxpayers (presumably including employers in contributory endorsement plans) recognize income only when they have an accession to wealth, clearly realized, over which they have dominion and control.[36] All these elements must be present to trigger income tax.

         i. For example, consider a person who buys an asset that appreciates in value over time. The person later sells it for cash equal to its fair market value.

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[35] Treas. Reg. §1.61-22(f)(2)(ii).

[36] *Comm'r v. Glenshaw Glass*, 348 U.S. 426, 431 (1955).

At the time of sale, the seller is appropriately taxed even though at first blush it seems he had no "accession to wealth" – he merely receives cash equal in value to what he transferred. But he did have an accession to wealth; it occurred while the asset was appreciating in value. So why then no income recognition until the sale? Because it is not until that time that the income is "realized."

ii. If the asset in the above example never appreciates, then its sale does not trigger income recognition, because the amount realized does not exceed what the owner paid (i.e., the basis). The owner has no accession to wealth, and no income recognition.

(3) That policyowners are granted a basis in the entire premium paid is key to understanding why they should not recognize income when receiving payment for endorsing the death benefit. The employer has no increase in wealth because the one-year term rate amount it receives is equal to the basis in the death benefit it simultaneously transfers.

i. The better metaphor of contributory economic-benefit split dollar plans is that the employer is "selling" a term policy to the employee. Term policies steadily lose value after purchase because life insurance protection is "used up" as time passes. A term policy's fair market value at issue is generally accepted to be the premium paid (i.e., one-year term rate), and during the year the value generally equals the unearned portion of that premium.[37]

ii. The owner of a term policy has a basis at least equal to the unearned premium paid in a given year. Nothing in the §72 "investment in the contract" rules states or implies otherwise. If the owner of a term policy sells it for the unearned premium, he does not recognize income because there is a set-off for his basis in the policy – the premium paid – and he therefore has no accession to wealth.

(4) Why is all of this analysis of income and policy basis important? Because if the plan is *not* covered by the regulations, the payment of the one year term cost should not be income under general tax principles.

For example, O and B are co-shareholders. O owns a cash value policy and pays the entire premium. O's basis, under general tax principles and consistent with the new regulations, is the entire premium. O sells (i.e., endorses) the entire death benefit portion of the policy to B. B pays to O an amount equal to O's basis in the term portion of the policy. O should be entitled to subtract from B's payment O's basis in the "term portion" of the policy. Result: no income to O.

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[37] See Rev. Rul. 76-490, 1976-2 CB 300 (for gift tax purposes, value of group term policy equals value of unearned premium).

D. TREATMENT OF DEATH BENEFIT PROCEEDS

1. For Owner. Death benefit controlled by the owner is received income tax free to the owner or its beneficiary to the same extent it is normally under §101(a).[38]

2. For Non-Owner. Death benefit provided to the non-owner likewise is received income tax free to the same extent it is normally under §101(a), as long as the non-owner accounts for the cost of life insurance for that portion of the death benefit (e.g., includes the one-year term rate in income, or pays it).[39]

   If the non-owner does not properly account for the cost of insurance, the death benefit is treated as transferred to the beneficiary in a separate transaction (typically triggering income or gift tax, depending on the relationship).[40]

3. Our Comments.

   a. The result that death benefit improperly accounted for (or mistakenly overlooked) in any given year subjects proceeds to taxation in that year is questionable under §101. Assuming a bona fide plan, failing to account for the one year term cost should be a reporting deficiency for that given year, limited to the amount of the term cost. Failing to account properly should not transform the death benefit into taxable income under §101 any more than a premium bonused to the employee, but omitted from the employee's income, makes the death benefit taxable. As with an ill-accounted bonus, the deficiency should be under-reported income for the one-year economic benefit.

   b. The regulations' treatment of death benefit makes it safer for parties to create plans that split the death benefit in a way that has absolutely nothing to do with how they split the cash value during life, if at all.

      (1) This has long been possible with traditional employer owned endorsement plans, where the employer often would control the entire cash value, but nonetheless endorse all the death benefit to the employee rather than just the portion exceeding cash value.

      (2) The ability to make the lifetime split unrelated to the at-death split was less clear when the employee (or his trust) actually owned the policy under a collateral assignment plan – or under one which mimicked its mechanics without the collateral assignment. To avoid the possibility that any portion of the death benefit would be treated as a taxable bonus (or gift), the employee (or trust) actually owning the policy normally promised to pay death benefit to the employer at least equal to the premiums the employer had advanced.

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38 Treas. Reg. §1.61-22(f)(3)(ii).
39 Treas. Reg. §1.61-22(f)(3)(i).
40 Treas. Reg. §1.61-22(f)(3)(iii).

(3) The final regulations now make clear that the taxability of death benefit is determined solely by the cost of life insurance for which the parties account. This is particularly helpful in the estate planning context.

i. An irrevocable trust can actually own a policy and enter into a non-equity split dollar agreement where all cash value is owed to the premium paying employer. To avoid estate inclusion under §2042, the arrangement would be unsecured (i.e., the trust does not collaterally assign the policy).

ii. Although it is an unsecured arrangement, the special ownership rule still treats the employer as the owner, so that economic benefit treatment applies during life. The annual amount to account for is therefore the one-year term rate, rather than an interest rate, which often is much higher. And even though the trust must pay all cash value to the employer if the plan terminates during life, at death the trust can nonetheless receive the entire death benefit tax free by simply accounting for it, without fear of an income or gift taxable event.

c. The regulations seem to resolve one tax issue – but magnify another – involving death benefit taxation of corporate owned life insurance policies.

(1) Before these rules, if parties wanted to ensure that an employee's beneficiary received the death proceeds of a corporate-owned policy income tax free, they endorsed the death benefit to the employee. The endorsement amounts to a transfer-for-value – employee's consideration being performance of services – but since the endorsement goes to the insured employee, an exception is met. The trade-off for income tax free death benefit is accounting for the yearly cost of insurance. The regulations still allow this.

(2) On the other hand, if the parties wanted to ensure that the employee had no yearly income, they did not endorse the death benefit, but simply designated the corporation as the beneficiary. The corporation received the death benefit tax free, and could pay some or all of it to employee's beneficiary through a separate "death benefit only" agreement. The trade-off for no yearly cost of insurance was income taxable death benefit to the beneficiary. The regulations also still allow this.

(3) Uncertainty arose when the corporation simply named as beneficiary someone who the employee would reasonably name, such as employee's spouse. Since the designation was revocable, there was no yearly transfer of life insurance protection, and no yearly cost of insurance. But the designation's irrevocability after death meant that a transfer occurred upon payment of death proceeds.

i. The transfer is a transfer-for-value, but it has always been unclear to whom the transfer is made. If it is deemed to go to or through the

employee, then the "to the insured" exception is available. But if the transfer is deemed simply to go to the surviving spouse, then the death benefit is taxed (unless the spouse first became a partner of the insured).

ii. Even without the transfer-for-value problem, the proceeds could be income taxed for another reason. The revocability of the designation means the proceeds effectively went first to the corporation and then to the spouse, so the money went through the corporation just as with a taxable "death benefit only" plan.[41] To confuse matters, however, there is some taxpayer-friendly authority treating this situation as providing tax free life insurance death benefit.[42]

(4) Regardless of the prior interpretations, the regulations seem to provide certainty on this issue. The treatment of death proceeds, along with the special definition of split dollar, now encompasses the corporation's revocable beneficiary designation to the employee's spouse.[43] This seems to impose the same treatment as an employer-owned policy endorsed to the employee: annual term rate costs, but tax free death benefit.

(5) But this compulsory endorsement treatment also magnifies a transfer-for-value issue – which frankly already exists for any endorsement. There may be a second transfer-for-value *to the corporation* when the corporation changes the beneficiary designation to itself after the employee quits. There is no problem if the insured is at that time an officer or shareholder, so the parties may want to change the beneficiary before the insured leaves his officer position or transfers his shares.

E. TRANSFERS OF POLICIES OR UNDIVIDED INTERESTS

Transfers of entire contracts between owners and non-owners are taxed much like policy distributions provided to the non-owner, but there are differences. Transfers of an undivided interest in a contract are treated the same as transfers of an entire contract – this occurs if the non-owner receives an identical portion in each right and benefit of the contract (e.g., one-third of cash value, one-third of death benefit).

1. Deduction. An employer transferring a policy (or undivided interest in a policy) is allowed a deduction for the amount the employee includes in income.[44] The regulations provide the deduction solely in the employment context under §83.

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[41] See *Golden v. Comm'r*, 113 F.2d 590 (3rd Cir. 1940); Rev. Rul. 59-184, 1959-1 CB 65; and Rev. Rul. 61-134, 1961-2 CB 250

[42] See *Ducros v. Comm'r*, 272 F.2d 49 (6th Cir. 1959).

[43] The special definition is triggered whenever the beneficiary is merely a person the employee or shareholder would reasonably name. Treas. Reg. §1.61-22(b)(2).

[44] Treas. Reg. §1.83-3(e) and §1.83-6(a)(5).

2. Income. When a life insurance contract that is part of a split dollar arrangement is transferred to the non-owner, the non-owner (e.g., employee) is taxed on:

   - the fair market value of the policy,
   - reduced by any cash value amount the employee paid tax on or paid for earlier due to having "current access,"
   - further reduced by any "other benefits" (catch-all) the employee paid tax on or paid for earlier, but
   - there is no reduction for the cost of any life insurance protection the employee paid tax on or paid for earlier.[45] Again, paying term costs does not earn the employee (non-owner) any basis.

3. Measuring Fair Market Value. The policy's fair market value is its "cash value and the value of all other rights under such contract (including any supplemental agreements and whether or not guaranteed), other than the value of current life insurance protection."[46]

   a. *Surrender Charges*. In the proposed regulations, this portion had stated that value was measured by the "cash *surrender* value." The deletion of the word "surrender" is important, and squarely attacks springing cash value manipulations to understate true policy value. As stated elsewhere, however, it may unfairly penalize transferees of policies subject to legitimate surrender charges.

   b. *Not Just Cash Value*. Perhaps to guard against other methods of understating a policy's true value, the fair market value provision also includes the value of *all other contract rights*.

      (1) Among other issues, this provokes the question of how to measure the value of "sponge policies" or "secondary no-lapse guarantee policies." Some commentators feel these contracts have artificially low stated cash values given the large up-front premium often required and the duration and amount of guaranteed death benefit they provide. Because they normally do not have a cash value that "springs up" at a later date, their promoters claim they avoid typical springing cash value concerns, and can safely use the stated cash value to measure fair market value.

      (2) At first glance, these policies may seem to be helped by the fact that the valuation formula specifically excludes the "value of *current* life insurance protection." But with these policies the innately valuable feature may be the *future* guaranteed life insurance protection, which might not be exempt from the valuation formula. This emerging issue will be interesting to watch in the split dollar context and elsewhere.

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[45] Treas. Reg. §1.61-22(g)(1).

[46] Treas. Reg. §1.61-22(g)(2).

c. *No Uniform Valuation Formula.* These regulations not only highlight the perpetual difficulty of finding a policy valuation formula that is accurate, but also highlight the fact that Treasury has yet to provide taxpayers with a policy valuation formula that applies uniformly. This is somewhat odd, given that "fair market value" and "willing buyer-willing seller" are the overriding standards for any tax purpose. This can frustrate honest taxpayers and embolden unscrupulous ones, because the same policy may be valued several different ways. For example:

(1) If a policy was part of a split dollar plan and then is transferred to an employee, the new regulations use "cash value."[47]

(2) If the same policy was never part of a split dollar plan but was simply a corporate owned key person policy, and then is transferred to an employee, pre-existing and still applicable regulations under §83 use "cash *surrender* value."[48]

(3) If the same policy is given by an individual to a trust, pre-existing and still applicable gift tax regulations use "interpolated terminal reserve."[49]

4. Transferee's Basis After Transfer. After receiving the entire policy (or undivided interest) the transferee's basis in the contract for §72 purposes is whichever is greater:

a. The fair market value of the contract, or

b. What the transferee paid for the contract, plus all the amounts the transferee had earlier paid for the contract's cash value or "other" (catch-all) benefits; but there's no basis credit for cost of life insurance previously taken into account.[50]

But if the transfer is a gift, normal carry-over basis rules apply.[51]

5. Special §83 Rule. Due to a special timing provision, the regulations governing the transfer of a policy (or an undivided interest) do not apply in the employment context until the policy would be taxable under §83.[52]

a. The provision also states that "fair market value is determined disregarding any lapse restrictions and at the time the transfer of such contract (or undivided interest in such contract) is taxable under section 83."

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[47] Treas. Reg. §1.61-22(g)(2), and new additional language in Treas. Reg. §1.83-3(e).
[48] Treas. Reg. §1.83-3(e).
[49] Treas. Reg. §1.61-22(g)(2), and Treas. Reg. §25.2512-6(a).
[50] Treas. Reg. §1.61-22(g)(4)(ii)(A).
[51] Treas. Reg. §1.61-22(g)(4)(ii)(B).
[52] Treas. Reg. §1.61-22(g)(3).

b. This preserves the timing of tax under existing §83 rules, because whenever a property transfer is deemed to occur under §83, it is at that point in time when the contract's value is measured.

c. Seemingly, the ability to enter into restricted bonus plans – and make §83(b) elections – involving life insurance policies is unchanged.

6. <u>When A Transfer Is Not A Transfer (And A Non-Transfer Is A Transfer).</u> The regulations clarify the tax treatment when a non-equity collateral assignment plan is terminated by transferring the policy to the premium payer (e.g., employer).[53] Now, it is clear that this transfer does not trigger income to the employee or the employer.

   a. *Above Water*. Before these regulations, if the policy transferred by the employee to employer had cash values exceeding premiums advanced, many practitioners thought the employer recognized income, given that it receives an amount greater that what it advanced. For example, if the employer advanced $70,000 of premiums for an employee-owned policy that has $80,000 cash value, the transfer of this policy might trigger $10,000 of income for the employer. The counter argument is that the employer ends up in the same place it would have if the employer had owned or paid for the policy from its inception.

   b. *Under Water*. As for policies with no gain, before these regulations many practitioners thought that if the employee can terminate the plan by transferring to the employer a policy with cash value of only $50,000 after the employer had advanced $70,000, the employee would have $20,000 of discharged indebtedness income. The contrary argument was the same as above.

   c. The new regulations treat the employer as the owner from the non-equity arrangement's inception. So, when the employee (the actual policyowner) transfers ownership to the employer to terminate the plan, no income results to either party.

   d. This ownership treatment has these effects upon termination of a collateral assignment non-equity plan (where employee has been *actual* owner):

      (1) If employee transfers to employer a policy with cash value *less than* premiums paid by employer, it is a non-taxable event for both employer and employee.

      (2) If employee transfers to employer a policy with cash value *greater than* premiums paid by employer, it is a non-taxable event for both employer and employee.

      (3) Here it gets odd: If the employer releases all rights under the split dollar arrangement, so that that employee remains the actual owner of the policy, at a time when cash value is *less than* premiums paid by employer, the employee

[53] See Treas. Reg. §1.61-22(c)(1)(ii)(B).

generally is taxed on cash value, and his basis equals that *lower* cash value amount. The employer should get a deduction for the cash value amount if it is reasonable compensation.

(4) Here it gets "odder:" If the employer releases all rights under the split dollar arrangement, so that that employee remains the actual owner of the policy, at a time when cash value is *greater than* premiums paid by employer, the employee generally is taxed on cash value, and his basis equals that *higher* cash value amount. Furthermore, because an appreciated asset is treated as being transferred from the employer, the employer should recognize the gain in the policy. The sting of this should be alleviated by the employer getting a deduction for the cash value amount if it is reasonable compensation, resulting in a net deduction equal to the premiums paid.

e. The special ownership rules apply analogously to donor-donee collateral assignment non-equity situations to treat the donor as the owner. And even though the preamble states that gift tax rules remain as they were before these regulations, the amount transferred is determined the same way as it is in the employment situation. That is, if the donor forgives the trust the cash value it owes back to the donor, he has made a gift of that cash value amount to the trust regardless of whether that amount is more or less than the premiums.

V. LOAN TAXATION

A. IN GENERAL

The regulations also allow life insurance to be financed using loans. With a loan:

- there is no "economic benefit" to value annually;
- there is no potential taxation of policy cash values when the loan is repaid;
- different documentation and accounting are required; and
- sufficient interest (the Applicable Federal Rate) must be charged, or foregone interest will be imputed as taxable income.

Each premium payment is treated as a separate loan. For example, in the tenth year of an arrangement involving a policy with an annual premium of $10,000, there will be 10 outstanding loans with a cumulative balance of $100,000. If premiums are not paid annually but rather on a monthly, quarterly or semi-annual basis, then there is generally a separate loan each month, quarter, or half year. Therefore, for administrative purposes, it is better to pay premiums annually to avoid an excessive number of separate loans.

B. LIFE INSURANCE FINANCING ARRANGEMENTS SUBJECT TO LOAN TREATMENT

A life insurance financing arrangement is generally treated as a loan if it meets all three of the following criteria:

- the payment is made either directly or indirectly by the non-owner to the owner;
- the payment is a loan under general tax principles, or if not a loan under those general principles (e.g., nonrecourse loan), a reasonable person would nevertheless expect the payments to be repaid in full (with or without interest); and
- the repayment is to be made from, or is secured by, either the policy's death benefit, cash surrender value, or both.[54]

In short-hand, the lender will always be the non-owner; the borrower will always be the owner.[55]

Not all loans to pay premiums meet the regulation's loan definition. For example, if the loan is unsecured, and repayment is expected to be made from a source unrelated to the policy, the arrangement is still a loan under general tax principles, but not subject to the loan rules contained in these regulations. This distinction can have a big impact: under general tax principles, loans below certain *de minimis* amounts are ignored by §7872 even if they are interest-free, and there is no penalty-type "deferral charge" if accrued interest is later waived. Although seemingly contrary to §7872 itself, the final regulations' loan rules eliminate the *de minimis* exception and essentially invent a "deferral charge" for waived interest.[56]

C. TAX TREATMENT OF INTEREST

1. Loans With Sufficient Interest. In contrast to a below-market loan, a loan that charges "sufficient" interest is not subject to §7872 or these regulations. The interest rate is considered sufficient if, at all times during the arrangement, it is at or above the appropriate Applicable Federal Rate (AFR).[57] The appropriate AFR depends on whether the plan is a demand loan, term loan or "term loan treated as a demand loan."

   For example, for a demand loan, the interest rate generally must equal or exceed the blended annual rate published by the IRS.[58] The blended annual rate is equal to the product of one half of the January semiannual short term AFR times one half of the

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[54] Treas. Reg. §1.7872-15(a)(2).

[55] Because loans do not involve the transfer of only death benefit, the special ownership rule will never be triggered. See Treas. Reg. §1.61-22(c).

[56] See Treas. Reg. §1.7872-15(a)(3) and (h).

[57] IRC §7872(c)(1) and (e)(1); and Treas. Reg. §1.7872-15(e)(1).

[58] Treas. Reg. §1.7872-15(e)(3).

July semiannual short term AFR.[59] The blended rate is published by the IRS in the Internal Revenue Bulletin in July of each year.

For a term loan, the interest rate generally must equal or exceed the short-term (not over 3 years), mid-term (more than 3, but not over 9 years) or long-term (over 9 years) AFR depending on the stated term of the loan.[60]

Interest paid by the borrower to the lender is taxable income to the lender. The borrower generally cannot take a deduction for interest paid.

2. Loans Without Sufficient Interest. If the loan does not have a sufficient rate of interest, it is a below market loan and interest will be imputed under §7872. The Code treats the foregone interest from the below market loan as follows:

   - A deemed transfer of that amount from the lender to the borrower. The character of that payment depends on the relationship of the parties. For example, if the lender is the employer, the foregone interest is compensation – deductible to the employer, income to the employee.

   - Then the foregone interest is treated as going from the borrower back to the lender to pay the interest. That payment is interest income to the lender and generally a nondeductible personal interest expense to the borrower.

   - The timing of the income and deduction depend on the type of loan as discussed in more detail below.

D. TYPES OF LOANS

1. Demand Loans. Arrangements in which the loans are payable in full at any time on demand of the lender (or within a reasonable time after the lender's demand) are demand loans.[61]

   If the demand loan is a below market loan, the amount of foregone interest is treated as having been paid by the lender to the borrower and retransferred by the borrower to the lender on the last day of the calendar year (or if the loan is repaid during the year, then on the day of repayment).[62] The amount of foregone interest is equal to the loan balance multiplied by the blended rate, minus interest actually paid by the borrower. Here and in the following examples, we assume that all loans (premium payments) are made on January 1 and are outstanding for the entire calendar year.

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[59] Rev. Rul. 86-17, 1986-1 C.B. 377.

[60] Treas. Reg. §1.7872-15(e)(4)(ii), citing IRC §1274(d)(1).

[61] §7872(f)(5) and Treas. Reg. §1.7872-15(b)(2).

[62] §7872(a).

a. *Example 1*: Below Market Demand Loan from Employer to Employee.

Employer lends Employee, the policyowner, $30,000 every year to pay the annual premium. The loans charge no interest and are repayable upon demand. Repayment of the premium payments is fully recourse to Employee.[63] The blended annual rate is 2.5% for the first year.

- In year one, Employee has compensation income of $750 ($30,000 loan x .025 interest rate).
- In year two, the blended annual rate is 5% and the loan balance is $60,000. Employee has compensation income of $3,000 ($60,000 x .05).
- In year ten, the loan balance is $300,000 and the blended annual rate is 4.3%. Employee has compensation income of $12,900 ($300,000 x .043).
- Each year, Employer has taxable interest income, but an offsetting compensation deduction of the same amount.
- If Employee's tax bracket is 30%, Employee's after tax cost is $225 in year one, $900 in year five, and $3,870 in year ten.

b. *Example 2*: Below Market "Demand Loan" from Employer to Employee's Irrevocable Trust.

Employer lends $30,000 to Employee's irrevocable trust to pay the annual premium. The loan charges no interest and is repayable upon demand. The blended annual rate in year one is 2.5% and the trust is a grantor trust.

Although the loan is between Employer and the trust, the arrangement is treated as two loans: (1) a loan between Employer and Employee, and (2) a loan between Employee and the trust.[64] Accordingly, foregone interest constructively transferred from Employer to Employee on the first loan is compensation to Employee. The foregone interest constructively transferred from Employee to the trust on the second loan is a gift from Employee to the trust. The foregone interest constructively re-transferred from the trust to Employee on the second loan is not interest income to Employee, because the trust is a grantor trust and

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[63] The final regulations do not define the terms "recourse" and "nonrecourse." In general, recourse means that the borrower is personally liable for repayment of all amounts loaned, whereas nonrecourse means the lender can only seek repayment from the collateral, if any. It is assumed that these definitions apply to split dollar loans. Assume in all examples that repayment is fully recourse.

[64] Treas. Reg. §1.7872-15(e)(2). Compensation income can be avoided by using an interest bearing loan and having the trust pay sufficient interest to the Employer.

therefore the transfer is disregarded.[65] If the trust were not a grantor trust, Employee would have interest income but may be entitled to an investment interest deduction for constructive repayment to Employer to the extent Employee has net investment income.[66]

- In year one, Employee has compensation income of $750 ($30,000 x .025). In addition, Employee makes a $750 gift to the trust.

- In year two, the blended annual rate is 5% and the loan balance is $60,000. Employee's income, and corresponding gift, are $3,000 ($60,000 x .05).

Avoiding Inclusion Of Policy Proceeds In Insured's Estate. If Employee is a majority shareholder, to avoid estate inclusion the trust-owned policy should not be collaterally assigned to the lending corporation.[67] If the loan is not secured by the policy, the arrangement might not satisfy the technical definition of a "split dollar loan"[68] but it would still be a loan under general tax principles.[69]

2. Term Loans. A pure term loan must be repaid at a stated time rather than at the discretion of the lender. While the Code provides convoluted treatment for a below market term loan,[70] essentially the loan will not be below market if it charges the appropriate AFR for its term: the short-term rate for loans equal to or less than 3 years, the mid-term rate for loans over 3 and up to 9 years, and the long-term rate for loans over 9 years.[71]

   If a pure term loan charges less than the AFR, then at the time of the loan the borrower includes in income the excess of the amount loaned over the present value of all repayments due under the loan. This results in a large one-time up-front income tax hit to the employee when the loan is made. This also results in a large one-time up-front corresponding deduction for Employer, but Employer's interest income will be spread out over the life of the loan. The calculation of imputed interest income to Employee for any pure term loan in later years also causes a one-time up-front tax hit. Presuming all separate term loans end at the same time, the imputed interest amount to Employee for each separate loan decreases in each successive year.

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65 Rev. Rul. 85-13, 1985-1 C.B. 184.

66 See IRC §163(d) and Treas. Reg. §1.7872-15(e)(2)(iii) and (iv), Example 2.

67 Treas. Reg. §20.2042-1(c)(6).

68 Treas. Reg. §1.61-22(b)(1) and §1.7872-15(a)(2)(i)(C).

69 Treas. Reg. §1.61-22(b)(5).

70 Treas. Reg. §1.7872-15(e)(4). A term loan is tested on the day the loan is made to determine if the loan provides sufficient interest. If, after the term loan is tested, the loan is considered a below market loan, the excess of the amount loaned over the present value of all payments due under the loan is included in the borrower's income the day the loan is made, but is included in the lender's income as it accrues over the life of the loan.

71 Treas. Reg. §1.7872-15(e)(4)(ii), referencing IRC §1274(d)(1).

a. *Example 3*: Below Market Pure Term Loan From Employer to Employee.

On January 1, 2005, Employee purchases a life insurance policy. Employer agrees to lend Employee premiums for 15 years with loans to be repaid on December 31, 2019. In year one, Employer lends $30,000 without interest. The long-term AFR at the time the loan is made is 7%.

Tax Consequences To Employee:

- In year one, the present value of the $30,000 repayment due 15 years later is $10,873. On the date the loan (i.e., premium payment) is made, Employee has compensation income of $19,127 ($30,000 minus $10,873).

- In year two, when the long-term AFR is 5%, another $30,000 interest-free loan is made with a 14-year term. The present value of the $30,000 repayment due 14 years later is $15,152. Employee has compensation income of $14,848 ($30,000 minus $15,152).

- In year 10, Employer lends $30,000 interest-free for five years. The mid-term AFR is 3.5%. The present value of the $30,000 repayment due 5 years later is $25,259. Employee has compensation income of $4,741 ($30,000 minus $25,259).

Tax Consequences To Employer:

- Each year, employer is entitled to a compensation deduction equal to the amount Employee includes in income.

- Employer must include the imputed interest amounts in income as they accrue over the life of each loan under the original issue discount (OID) rules. Employer takes the OID amount into income each year for 15 years for the year one loan; the OID amount each year for 14 years for the year two loan; and so on. Accordingly, in the 15th year, Employer accrues OID amounts attributable to all 15 loans.[72]

b. *Pure Term Loans Often Impractical With Life Insurance.* With a pure term loan, the repayment occurs at the end of a stated term. Pure term loans to finance life insurance can produce unusual results:

- if insured dies before the end of the term, the employer still has to wait until the term's end to be repaid (the employer has a claim against the insured-employee's estate).

[72] Treas. Reg. §1.7872-15(e)(4)(iii)(B)(3).

- if the employee is terminated prior to the end of the stated term, the loans may nonetheless remain outstanding between the employer and former employee.

In most situations, pure term loans are not practical because Employer will want to be repaid if the insured dies or is terminated. It may be better to instead design a loan arrangement as a "term loan treated as a demand loan."

3. Term Loans Treated As Demand Loans. If the borrower wants to avoid the uncertain repayment date of a demand loan, but the lender wants to avoid the potential impracticality of a pure term loan, a "term loan treated as demand loan" may work.[73] A loan is characterized as a term loan treated as a demand loan in the following situations:

- The loan is conditioned upon the future performance of substantial services and is not transferable.[74] In this case, the term is the stated term of the loan or, if there is no stated term, it is presumed to be seven years.[75]

- The loan is payable upon an individual's death.[76] In this case, the term is the individual's life expectancy (as determined under the appropriate table in Treas. Reg. §1.72-9).[77]

- The loan is payable at the earlier of a stated term or an individual's death. In this case, the term is the shorter of the stated term or the individual's life expectancy.[78]

- The loan is payable upon the later of a stated term or either (1) the death of an individual or (2) the date on which the condition to perform substantial future services by an individual ends.[79] In this case, the term is generally the longer of the stated term or the individual's life expectancy.[80]

If a term loan treated as a demand loan does not have sufficient interest (i.e., below the AFR for the appropriate term), interest is imputed using rules for demand loans, rather than the more cumbersome term loan rules. This is significant because: (1) the

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[73] The phrase "term loan treated as a demand loan" does not appear in the new split dollar regulations, which instead discuss these loans under the label, "special rules for certain split-dollar term loans." See Treas. Reg. §1.7872-15(e)(5).

[74] Treas. Reg. §1.7872-15(e)(5)(iii)(A)(1).

[75] Treas. Reg. §1.7872-15(e)(5)(iii)(C).

[76] Treas. Reg. §1.7872-15(e)(5)(ii)(A).

[77] Treas. Reg. §1.7872-15(e)(5)(ii)(C).

[78] Treas. Reg. §1.7872-15(e)(5)(ii)(C).

[79] Treas. Reg. §1.7872-15(e)(5)(v)(A).

[80] Treas. Reg. §1.7872-15(e)(5)(v)(B)(2) and (3).

initial AFR remains "locked-in" for the entire duration of the loan; and (2) there is no present value calculation causing a large up-front income tax hit.[81]

Because the present value calculation used with pure term loans does not apply, Employee's income and Employer's corresponding compensation deduction for the foregone interest is spread out over the life of the loan, rather than occurring as a one-time lump sum in the loan's first year.

a. *Example 4*: Below Market Term Loan Treated as a Demand Loan from Employer to Employee.

Employee purchases a policy on January 1, 2005. Employer agrees to lend premiums and the loans must be repaid at the earlier of Employee's death or December 31, 2019. Assume this 15-year term is shorter than Employee's life expectancy, so the relevant term is 15 years.[82] The long-term AFR is 7%. In year one, Employer lends $30,000 interest-free to pay the premium.

- In year one, the amount of foregone interest is $2,100 ($30,000 x 0.07). Employee has $2,100 of compensation income and Employer has a $2,100 corresponding compensation deduction. Employer's net deduction is zero, however, because its deduction is offset by $2,100 of interest income.

- In year two, the long-term AFR is 5%. Employer lends another $30,000 interest-free. There are now two loans of $30,000 each and the amount of foregone interest is $3,600 [($30,000 x .07 = $2,100 for the year one loan) plus ($30,000 x .05 = $1,500 for the year two loan)].

- For each separate loan, the interest rate used to calculate the foregone interest in the loan's first year is the AFR for the loan's term, and that remains the interest rate for the life of that loan.

- Later loans that have a shorter term will use mid-term and short-term rates as appropriate.[83]

- All foregone interest is considered transferred on December 31st unless Employee dies during the year.[84]

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[81] If a term loan treated as a demand loan is between a donor and donee, however, the imputed gift from the donor is calculated using normal rules for pure term loans, but the imputed income from the donee back to the donor is calculated using rules for term loans treated as demand loans. See *infra, Example 5*.

[82] See Treas. Reg. §1.7872-15(e)(5)(ii)(C).

[83] IRC §1274(d)(1)(A).

[84] Treas. Reg. §1.7872-15(e)(3)(iii)(B).

b. *Example 5*: Below Market Term Loan Treated as Demand Loan From Employer to Employee's Irrevocable Trust.

Employee's irrevocable life insurance trust purchases a policy on January 1, 2005. The trust is a grantor trust, so it is treated as identical to the Employee for income tax purposes. Employer lends premiums for 15 years to be repaid at the earlier of Employee's death or December 31, 2019. Assume this 15-year term is shorter than Employee's life expectancy, so the relevant term is 15 years.[85] In year one, Employer lends $30,000 without interest. The long-term AFR is 7%.

The loan is treated as two separate loans: a loan from Employer to Employee and a loan from Employee to the trust. The loan from Employer to Employee is a term loan treated as a demand loan, and its tax effects are the same as described in Example 4, above.

But because the loan from Employee to the trust involves both a term loan treated as a demand loan and a gift, this second loan has special dual treatment. When calculating the interest constructively transferred to the trust for gift tax purposes, it is treated as a pure term loan; but when calculating the interest constructively re-transferred to Employee for income tax purposes, it is treated as a "term loan treated as a demand loan."[86] This means each loan causes a large one-time up-front gift from Employee to the trust due to the required present value calculation; but the interest income back to Employee will be spread out over the life of the loan. But since the trust is a grantor trust, there is no income to Employee.[87]

- In year one, when the AFR is 7%, for the deemed loan between Employer and Employee, the amount of foregone interest is $2,100 ($30,000 x 0.07), and Employee reports that as compensation income. Employer takes the same amount into income as interest from Employee, but has an offsetting compensation deduction.

  For the deemed loan between Employee and the trust, Employee makes a gift of $19,127 to the trust. The gift is calculated under the term loan rules ($30,000 minus $10,873, which is the present value of the $30,000 repayment). If the trust were not a grantor trust, Employee would have $2,100 of income constructively re-transferred from the trust.

- In year two, assume the AFR is 5%. Employer lends another $30,000 without interest.

[85] See Treas. Reg. §1.7872-15(e)(5)(ii)(C).
[86] IRC §7872(d)(2); and Treas. Reg. §1.7872-15(e)(5)(iv)(D).
[87] Rev. Rul. 85-13, 1985-1 C.B. 184.

In year two, there are now two $30,000 loans from Employer to Employee. Employee has compensation income of $3,600 [($30,000 x .07 for the first loan) plus ($30,000 x .05 for the second loan)]. Employer has $3,600 of interest income, but an offsetting compensation deduction.

In year two, Employee is treated as making a gift to the trust of $14,848 ($30,000 loan minus $15,152 present value of the loan principal repayment amount). Because the loans from Employee to the trust are term loans for gift tax purposes, the gift of all the foregone interest for the first year's loan took place in year one. For that loan, no additional gift takes place thereafter.

4. Loans From Individuals to Irrevocable Trusts ("Private" Loans). If an individual makes a below-market loan to an irrevocable life insurance trust, the foregone interest on each loan is treated as a gift to the trust. The amount and timing of the gift is determined by the type of loan.

- If the loan is a demand loan, the amount of the gift is the annual foregone interest on the loan based upon the blended annual rate.
- If the loan is either a term loan or a term loan treated as a demand loan, the amount of the gift is the actual loan, minus the present value of the loan principal repayment.[88]

In addition, for income tax purposes, a re-transfer occurs from the trust to the individual/grantor as taxable interest income. The amount of income to the grantor is either (1) the foregone interest on the demand loan, with a transfer of income generally occurring on December 31; or (2) the annual imputed income using the OID rules for term loans, with transfers of income presumably occurring on the anniversary of the loan date; or (3) the foregone interest on the term loan treated as a demand loan, with transfers of income generally occurring on December 31. However, if the irrevocable trust is a grantor trust, there are no income tax consequences to the grantor for interest re-transferred from the trust to the individual because the trust is essentially disregarded for income tax purposes.[89]

E. ADDITIONAL ISSUES UNDER LOAN TREATMENT

1. Section 7872 *De Minimis* Rules And Loans to Employees, Shareholders, and Donees.

a. *The Internal Revenue Code*. Section 7872, the statute upon which pertinent portions of the new regulations are based, does not apply to certain below-market interest loans:

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[88] See IRC §7872(d)(2); and Treas. Reg. §1.7872-15(e)(5)(iv)(D).

[89] Rev. Rul 85-13, 1985-1 C.B. 184.

- Loans to an employee or shareholder from an employer or corporation where the loan balance does not exceed $10,000; or
- Loans to an individual donee from an individual donor where the loan balance does not exceed $10,000.[90]

In other words, under these circumstances money can be advanced interest-free, up to the exempted amount, and no interest will be imputed. Yet, the new regulations do not apply this portion of the statute to loans meeting the definition of split dollar.

b. *The New Regulations*. Regarding loans to employees, shareholders, and donees, the new regulations state:

> . . . section 7872 is applied to a split-dollar loan without regard to the *de minimis* exceptions in section 7872(c)(2) and (3).[91]

c. *Our Discomfort With This Provision.* This disallowance of the *de minimis* exception is troubling for a couple reasons:

(1) Loans to purchase life insurance have been singled out for this preclusion, with no stated or perceptible reason as to why.

(2) This preclusion, ironically, flies in the face of Treasury's preamble. Responding to one commentator's challenge that there is no authority under §7872 to treat split dollar arrangements as loans, Treasury rebuked:

> The IRS and Treasury believe there is sufficient authority to require the application of section 7872 to split-dollar life insurance arrangements. There is no legislative history indicating that Congress did not intend section 7872 to apply to payments made pursuant to these arrangements.

We don't disagree. But if certain life insurance financing arrangements are loans, then §7872 should apply in totality. Unfortunately, Treasury has broad latitude to issue regulations under the statute, see §7872(h)(1), and most taxpayers may find contesting them too daunting of an undertaking.[92]

d. *This Provision Does Not Apply If Loans Are Not "Split Dollar Loans."* If loans involving employees, shareholders, or donees are not secured by the policy and repayment is expected from sources other than the policy, these below-market

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[90] IRC §7872(c)(2) and (3).

[91] Treas. Reg. §1.7872-15(a)(3).

[92] *See Chevron U.S.A., Inc. v. Natural Resources Defender Council, Inc.*, 467 U.S. 837, 843-844 (1984) ("[A] legislative regulation is to be upheld unless 'arbitrary, capricious, or manifestly contrary to the statute.'")

interest loans are not treated as "split dollar loans" under the new regulations, and therefore the normal statutory *de minimis* rules apply.

2. Certain Interest Payments Disregarded. The final regulations introduce a new and controversial wrinkle to using loans. If the loan agreement provides for the payment of interest, *and* all or a portion of the interest is to be paid directly or indirectly by the lender, then the requirement to pay the interest (found in the original loan agreement) is disregarded.[93] If the parties agree that the interest is to be paid by the lender, the loan is treated as a loan that does not provide for interest, and presumably this deemed "foregone interest" will be taxed. The regulations provide two examples to illustrate the new rule.

   Example 1. Employer lends Employee money to be repaid with interest in 5 years. At the exact same time, they enter into a nonqualified deferred compensation agreement, in which Employee is fully vested, that will pay Employee an amount equal to the unpaid interest. Because of the deferred compensation agreement, the loan is treated as though it does not provide for interest. The Employee reports as income each year an amount equal to the supposedly foregone interest under §7872. In addition, Employee will report as income the amount received under the separate deferred compensation agreement (that is, Employee is taxed on an amount equal to the interest a second time).

   Example 2. The same parties enter into a nonqualified deferred compensation agreement, in which Employee is fully vested, that will pay him an amount based on his last three years' salaries. Five years later, the parties enter into the loan arrangement as described above. The regulations treat the deferred compensation plan as unrelated to Employee's requirement to pay interest on the split dollar loan. This means two things: first, Employee's requirement to pay interest is not disregarded and the loan is treated as a loan that provides for stated interest; and second, there is no imputed annual income to Employee as the loan interest accrues.

   a. *Paradox?* We note at the outset that this new provision has an illogical application. It applies only when the loan actually charges interest, but if that interest rate is at least equal to the AFR, this provision should not apply at all. This is because IRC §7872 itself, and consequently any regulations thereunder, apply only to below-market loans.[94] On the other hand, if the loan charges no interest whatsoever and therefore is clearly below-market, it entirely escapes this rule's costly trap, described below.

   b. *Double-Tax.* It is an unfair imposition of double-taxation for Treasury to treat an interest-bearing loan as if it were not charging interest at all, simply because the parties have a separate deferred compensation agreement that promises to pay an amount equal to that interest. When Employee genuinely owes and effectively pays interest to Employer, without these new rules he would be income-taxed on

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93 Treas. Reg. §1.7872-15(a)(4).

94 IRC §7872(c)(1) and (e)(1).

an amount equal to that interest when Employer pays deferred compensation to Employee. So whatever Employee receives, he is taxed on. With these new rules, however, Employee receives the same amount, but is taxed twice: once on the deferred compensation actually paid, and again on the interest he truly owes and pays to Employer.

(1) It is unfortunate that Treasury does not see that both factually and legally, the loan agreement and the deferred compensation agreement are separate from each other and operate independently. For example, a real possiblity is that Employer can go belly-up, and therefore never be able to fulfill its promise to pay the deferred compensation (this danger is in fact the salient characteristic of the "unfunded and unsecured" nature of nonqualified plans). Simultaneously, however, Employer's creditors could step into Employer's shoes as collateral assignee of the Employee-owned life insurance policy, and require Employee to relinquish the contract to pay off the accrued interest.[95] Employee would receive neither the interest nor the deferred compensation, but these new rules nonetheless tax Employee as if he is guaranteed to receive the interest amount.

(2) Despite the regulations' overreaching, their examples may provide a roadmap on how to avoid a challenge. Any deferred compensation agreement should be made at a different time than the loan agreement, and pay an amount that does not match the interest amount. Likewise, Employer can decide to pay the Employee a discretionary bonus that does not match the interest owed by Employee. Also, a simple pay raise may avoid application of the rule.

(3) What about a private loan arrangement (e.g., between Dad and an irrevocable trust), where Dad charges sufficient interest on the loan and gives cash to the trust to allow it to pay that interest? Although this fact situation seems to fall under the new rules, it should not. This is because in order to avoid any incidents of ownership being attributed to Dad, the trust will not grant a collateral assignment to him. Since repayment of Dad's premium advances is not secured by or to be repaid from the policy, this loan is not a "split dollar loan arrangement" under the regulations. The result is that this rule should not apply. Nevertheless, some bootstrapping can't hurt. Dad can make gifts to the trust in amounts not equal to the interest and at a time other than when interest is payable.

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[95] This scenario is essentially identical to that in *Miller v. Heller,* 915 F. Supp. 651 (S.D.N.Y. 1996), where the court honored the distinct functioning of a deferred compensation agreement and a split dollar agreement. The court ruled that the deferred compensation plan was not "funded" for ERISA purposes – and in dicta stated that it was not income taxable to the employees – even though the parties entered into a collateral assignment split dollar plan: (1) at the same time they entered into the deferred compensation plan; and (2) which was intended to permit the employer to recoup its costs under the deferred compensation plan. The employees had argued that the plan was "funded," presumably to avoid having to transfer ownership of their policies to the bankrupt employer in fulfillment of the split dollar agreement, while the employer was simultaneously failing to fulfill its nonqualified deferred compensation obligation.

3. Waived, Cancelled, Or Forgiven Interest And The Deferral Charge. The final regulations also create a concept called a "deferral charge." If accrued but unpaid interest is "waived, cancelled, or forgiven" by the lender, then the interest amount is treated as having first been paid to the lender, and then retransferred – and income taxed – to the borrower. That amount is also subject to an additional deferral charge – essentially an additional income tax – except in the case of certain nonrecourse loans.

   What is a waiver, cancellation, or forgiveness? The regulations merely state that a payment by the lender (or person related to the lender) to the borrower is a waiver, cancellation, or forgiveness if it is, "in substance," a waiver, cancellation or forgiveness of accrued but unpaid interest. The regulations do not define "in substance" nor do they give examples.

   The regulations do not say so, but this appears to be a facts and circumstances test. For example, the IRS could argue that a bonus is intended to relieve an employee of his interest obligation and is tantamount to forgiveness. But if a bonus is not equal to the interest and is not paid at the same time the interest is due, this assertion is groundless.

   If accrued but unpaid interest is waived, cancelled, or forgiven, the next step is to calculate the deferral charge. The regulations provide the formula for this calculation, which effectively charges an additional cost to the borrower based upon a hypothetical understatement of federal income taxes.[96]

   For *nonrecourse loans*, the regulations provide a way out of the deferral charge: if the parties make a written representation that a reasonable person would expect that all payments under the loan will be made,[97] then the deferral charge does not apply to the waived, cancelled or forgiven interest.[98]

VI. EFFECTIVE DATE

The final regulations apply to any split dollar life insurance arrangement entered into – or materially modified – after September 17, 2003.[99]

1. Entered Into. The regulations provide that an arrangement is "entered into" on the latest of the following dates:

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[96] Treas. Reg. §1.7872-15(h).

[97] Treas. Reg. §1.7872-15(d)(2).

[98] Treas. Reg. §1.7872-15(h)(1)(iv). Both the borrower and the lender must sign this written representation, and it must be filed no later than the last day for filing the federal income tax return of the borrower or the lender, whichever is earlier, for the taxable year in which the first loan is made. The representation applies to all future loans and a copy must be attached to each party's federal income tax return for any year in which a loan is made and to which the representation applies.

[99] Treas. Reg. §1.61-22(j).

a. The date on which the life insurance contract under the arrangement is issued.

b. The effective date of the life insurance contract under the arrangement.

c. The date on which the first premium on the life insurance contract under the arrangement is paid.

d. The date on which the parties to the arrangement enter into an agreement with regard to the policy.

e. The date on which the arrangement satisfies the definition of a split dollar life insurance arrangement.[100]

2. Materially Modified. The regulations do not define or describe which events constitute "material modifications," thereby triggering application of the new regulations. Instead, the regulations give the following *non-exclusive* list of items that are *not* material modifications:

a. A change solely in the mode of premium payment (for example, from monthly to quarterly).

b. A change solely in policy beneficiary, unless the beneficiary is a party to the arrangement.

c. A change solely in the interest rate payable under the life insurance contract on a policy loan.

d. A change solely necessary to preserve the status of the life insurance contract under §7702.

e. A change solely to the ministerial provisions of the life insurance contract (for example, a change in the address to send payment).

f. A "non-discretionary" change made solely under the terms of any agreement (other than the life insurance contract), that is a part of the split dollar arrangement, provided the obligation to make the change existed before September 18, 2003.

g. A change solely in policy ownership as a result of a transaction to which §381(a) applies (i.e., where a corporation acquires assets of another corporation), and in which substantially all of the former owner's assets are transferred to the new owner of the policy.

h. A change to the policy solely if the change is required by a court or state insurance commissioner because of the issuing carrier's insolvency.

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[100] Treas. Reg. §1.61-22(j)(1)(2).

i. A change solely in the insurance carrier because of a reinsurance transaction.

3. Our Comments.

a. *Section 1035 Exchanges?* Noticeably absent from the list of non-material modifications are tax-free exchanges under §1035. Given Treasury's silence, we simply do not know if a §1035 exchange is material.

b. *Oral Agreements?* The regulations state that there is no split dollar arrangement until (among other things) the parties "enter into an agreement with regard to the policy." But nothing in this requirement or the definition of split dollar demands that the agreement be in writing. So, those who have *orally* entered into split dollar agreements years ago presumably should remain unaffected by these regulations, particularly if they have been reporting their taxes in a manner consistent with the arrangement.

VII. CONCLUSION

Is split dollar dead? Well, to the extent split dollar is nothing more than a marketing buzzword, let's hope so. But in its true meaning – the financing of the purchase of life insurance – split dollar is alive and well. Sure, the new regulations change some of the rules, and in some areas this means that things are not as good as they used to be. Other changes, however, offer welcome certainty and create new opportunities. Now, as always, successful planners will be those who study and apply the law in order to help their clients solve problems and meet objectives.