Legal Alert:

IRS Issues Proposed Regulations
On Split-Dollar Life Insurance Arrangements

On July 3, 2002, the Treasury and the Internal Revenue Service, following up on notices issued in 2001 and 2002, issued proposed regulations that provide the most far-reaching guidance ever issued on split-dollar life insurance arrangements. The proposed regulations generally retain the approach of Notice 2002-8, issued in January (click here for a summary of Notice 2002-8), but expand the scope of and elaborate on the guidance provided in that Notice. The proposed regulations are detailed and, in parts, complex. Highlights include the following:

**Definition of Split-Dollar Life Insurance Arrangements**

The proposed regulations are intended to apply broadly to any arrangement between an owner of a life insurance contract and a non-owner:

- where (i) either party pays all or part of the premiums, (ii) the premium-paying party is entitled (conditionally or unconditionally) to recover all or part of those premiums, and (iii) such recovery is to be made from or is secured by the contract proceeds; or

- where (i) an employer/service recipient/corporation pays, directly or indirectly, any or all of the premiums, and (ii) the beneficiary of any or all of the death benefit is designated by, or is any person who would reasonably be expected to be designated as beneficiary by, an employee/service provider/shareholder.

For example, the proposed regulations would generally apply to split-dollar arrangements between businesses and officers, employees, directors, independent contractors, or shareholders (including charitable split-dollar), and arrangements between donors and donees (including so-called “private split-dollar” arrangements). The only exceptions are: (1) for arrangements between a contract owner and the insurance company acting only in its capacity as issuer; (2) for a group-term life insurance plan governed by section 79; and (3) through the detailed rules provided for determining the owner and non-owner of a contract, for arrangements where two or more persons share an undivided interest in all contract rights and benefits and hence which do not involve any split ownership.

**Income Taxation of Split-Dollar Life Insurance**

As under Notice 2002-8, the proposed regulations provide two mutually exclusive regimes for taxing split-dollar arrangements, which purposefully provide substantially different
tax consequences. (Conforming changes are made in the FICA/SECA rules, and these rules also apply with respect to shareholder distributions under section 301.) Both the owner and the non-owner are required to fully and consistently account for all amounts under the arrangement in accordance with the applicable regime.

_Economic Benefit Regime._ This regime is intended to govern endorsement arrangements generally (where the owner is the employer/service recipient/business/donor), and specifically (i) any arrangement entered into in connection with the performance of services where the employee/service provider is not the contract owner, and (ii) any arrangement between a donor and a donee where the donee (such as an irrevocable life insurance trust) is not the contract owner. This regime would treat the contract owner as transferring economic benefits to the non-owner, the value of which (less any consideration paid by the non-owner) would be treated as a payment of compensation, a section 301 distribution to a shareholder, a gift, or other transfer depending on the relationship between the owner and non-owner.

- In the case of non-equity split-dollar, where the only economic benefit conferred is the value of current life insurance protection (including paid-up additions), the benefit transferred would be valued annually as the average death benefit, less the total amount payable to the owner under the arrangement (increased by the amount of any outstanding policy loan), multiplied by a “life insurance premium factor” designated from time to time in IRS guidance. The proposed regulations provide no detail on such a premium factor.

- For equity split-dollar, any other right in or benefit of the insurance contract provided to the employee must also be currently accounted for. The preamble indicates that, in a compensatory context, the employee (non-owner) would be taxed on the value of any interest in the cash surrender value provided to the employee. The preamble also implies that the owner’s current premium payments less the net present value of amounts repayable to the owner in the future might in some cases be taxable. The most important issue for equity split-dollar -- specific guidance on the valuation of current economic benefits -- is reserved pending comments on the proposed regulations.

Neither premium payments nor economic benefits taxed to the non-owner would be deductible by the owner (except upon a section 83 transfer of the contract to the non-owner); the owner, however, would be currently taxed on any consideration paid by the non-owner. The non-owner would be treated as not having “investment in the contract” (basis); the owner would have investment in the contract generally in the amount of premiums, less consideration paid by the non-owner.
Death proceeds allocable to current insurance protection paid for or taxed to the non-owner would generally be excluded from the beneficiary’s taxable income. Other amounts received under the contract by the non-owner, such as dividends, withdrawals or partial surrenders, would be treated as first paid to the owner under the insurance contract and then transferred by the owner to the non-owner, with the amount taken into account by the non-owner reduced by economic benefits previously taxed to or consideration paid by the non-owner (other than for current insurance protection). Similarly, certain “specified” policy loans – essentially, where the loan proceeds accrue to the non-owner – would be treated as a loan to the owner followed by a transfer of cash from the owner to the non-owner. In either case, the taxation of the deemed payment to the non-owner is dependent on the relationship between the owner and the non-owner. Detailed rules are also provided for the transfer of the contract to the non-owner, which is limited for all federal tax purposes to cases where contract ownership is formally changed.

**Loan Regime.** This regime is intended to govern collateral assignment arrangements, where the owner is the employee/service provider/donee. It would treat certain payments made pursuant to a split-dollar arrangement as a “split-dollar loan” and characterize the owner and non-owner as borrower and lender, respectively. Under the proposed regulations, split-dollar loans arise where the premium payment is made directly or indirectly by the non-owner to the owner, or the payment is a loan under general tax principles, or a reasonable person would expect the payment to be repaid in full to the non-owner (whether with or without interest), or the repayment is to be made from or secured by the contract values or proceeds. If an employer pays premiums on a contract owned by an employee that are not treated as split-dollar loans, the employee would be currently taxed on those premiums to the extent the employee’s rights to the contract are substantially vested.

If the split-dollar loan does not provide for “sufficient interest” relative to the appropriate Applicable Federal Rate (AFR), it is treated as a below-market loan, with an imputed transfer by the non-owner to the owner under section 7872. The proposed regulations describe the characteristics and consequences of split-dollar “demand” and “term” loans.

- A split-dollar “demand” loan is payable in full at any time on the demand of the non-owner (or within a reasonable time after such demand). If the rate at which interest accrues on the loan’s adjusted issue price (based on annual compounding, for simplicity) is less than the blended annual AFR for the year, it would not provide “sufficient interest.” The “foregone interest” would be treated as transferred from the non-owner to the owner and then retransferred as interest by the owner to the non-owner at the end of each year, and taxed accordingly based on the relationship of the parties.
All other split-dollar loans would be split-dollar “term” loans. A split-dollar term loan does not provide for “sufficient interest” if the amount loaned exceeds the “imputed loan amount,” which is the present value of all payments due under the loan determined as of the date the loan is made using as a discount rate the AFR appropriate to the term of the loan (generally, the term stated in the split-dollar arrangement). The amount of imputed interest transferred from the non-owner to the owner would be the excess of the amount loaned over the imputed loan amount, which would also be treated as OID (in addition to any other OID on the loan).

Where policies are owned by a third party, such as an irrevocable life insurance trust, the proposed regulations will recharacterize the premium payments as two back-to-back loans. For example, in the case of an employment-related split-dollar arrangement, the first loan will be from the employer to the employee, as a compensation split-dollar loan, and the second loan will be from the employee to the trust, in a split-dollar gift loan.

If the split-dollar loan provides for sufficient interest, then it generally would be subject to the general rules for debt instruments, including the OID rules.

If the “loan” is nonrecourse to the owner, it would be generally treated as a loan providing for contingent payments unless the parties represent in writing (meeting specified requirements) that it is reasonably expected that all payments under the “loan” will be paid. The proposed regulations prescribe a “contingent split-dollar method” for accounting for such payments under a hypothetical payment schedule used to determine the yield of the split-dollar loan, which, in turn, is used to determine the OID on the loan and whether the loan is a below-market loan. Special rules are also provided for numerous alternative structures, including: variable interest rates; contingent interest payments; owner or non-owner options; waiver, cancellation or forgiveness of stated interest by the non-owner; below-market split-dollar loans with indirect participants; split-dollar term loans payable upon death of an individual or conditioned on the performance of substantial future services; and gift split-dollar term loans.

**Estate and Gift Taxation of Split-Dollar Life Insurance**

The gift tax consequences of the transfer of an interest in a life insurance contract to a third party, and the inclusion of contract proceeds in a decedent’s gross estate for estate tax purposes, would generally be determined under applicable law without regard to the proposed regulations. The new rules would apply, however, for gift tax purposes in situations involving ownership of the policy by third parties, such as those involving irrevocable life insurance trusts.
and private split-dollar arrangements. For example, if a reasonable person would expect that the donor or donor’s estate would recover an amount equal to the donor’s premium payments from the contract proceeds and an irrevocable insurance trust is either the contract owner or is entitled to a portion of the contract proceeds, then loan regime or the economic benefit regime, as the case may be, would apply to determine the timing and amount of any gift made by the insured.

Effective Date

The guidance in these regulations would apply to split-dollar arrangements entered into or materially modified after the date of publication of final regulations. Prior rulings – specifically, Rev. Ruls. 64-328, 66-110, 78-420, 79-50 and 81-198 – would be declared obsolete concurrently with the publication of the final regulations. Notice 2002-8 will govern the tax treatment of split-dollar arrangements entered into on or before the date of publication of final regulations; importantly, the rule in Notice 2002-8 providing favorable tax treatment of pre-January 28, 2002 arrangements terminated on or before December 31, 2003, is retained notwithstanding criticism in the press and elsewhere.

For more information, or if you have any questions concerning these issues, please feel free to contact one of the members of our Employee Benefits and Executive Compensation Practice. Please click HERE to obtain contact information for members of our Employee Benefits and Executive Compensation Practice, and click HERE to learn more about our Employee Benefits and Executive Compensation Practice. Click HERE to view other Sutherland Legal Alerts.