# SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENTS: A TAX MINIMIZATION STRATEGY WHOSE TIME HAS RETURNED

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## I. INTRODUCTION

A split-dollar life insurance arrangement (split-dollar arrangement) is a contract between a donor and a donee who share in the costs and benefits of a life insurance policy.[1] Prior to 2003, a split dollar arrangement was a method of dividing the tax and economic benefits of life insurance between a donor and donee and allowing the donor to subsidize the donee's insurance coverage while both avoided tax.[2] On September 11, 2003, the Internal Revenue Service (IRS or Service) issued final regulations designed to remove the tax benefits taxpayers previously received from investing in a split-dollar arrangement.[3] The regulations were supposed to have transformed split-dollar arrangements from vehicles for employee, stockholder, and estate tax avoidance, into vehicles for sharing of life insurance costs that were supposed to be devoid of tax advantages.

The IRS now either taxes the economic benefits received by donees from the donor's payment of insurance premiums, treats the payments as additional income to the donee (economic benefit regime), or treats the donor's premium payments as loans to the donee, imputing the interest to the loans, and taxing the imputed interest as additional income to the donee (loan regime). Even though the parties to the arrangement decide which approach to use, both are supposed to eliminate the tax benefits.[4] However, the loan regime continues to

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[1] Robert D. Swanson, *Is Split-Dollar Life Insurance Still a Fringe Benefit?*, 98 TAX ADVISER, 42, (1998).

[2] *Id.*

[3] Treas. Reg. §§ 1.61-22, 1.7872-15 (2010). Split dollar arrangements negotiated in effect prior to September 18, 2003, are governed by transition rules that are summarized in I.R.S. Notice 2002-8, 2002-1 CB 398.

[4] Treas. Reg. § 1.61-22(d)(4)(ii) (2010).

provide significant tax savings. Current low interest rates, which are expected to rise in the future, can be used for an insured's life; thus, properly structured split-dollar arrangements under the loan regime still provide attractive tax savings for employees, shareholders, and irrevocable life insurance trusts (ILIT). This paper summarizes the split-dollar arrangement rules, and demonstrates which techniques will provide those tax savings and which arrangements will not.

## II. WHAT IS A SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENT?

### A. *Description of a Split-Dollar Life Insurance Arrangement*

A split-dollar arrangement is an interest in a life insurance contract shared by multiple interest holders.[5] The arrangement can be between employer and employee, corporation and shareholder, an individual and an ILIT, or any other donor and donee.[6] Each contract specifies how the policy premiums are paid and how insurance benefits are shared.

The rules require that a split-dollar arrangement be between one party defined as the policy owner (who may be the party named as owner in the insurance contract or specified by regulation) and a second party (who is designated as the non-owner).[7] The parties to the arrangement decide who is designated as the policy owner. The arrangement requires that: (1) the arrangement must be other than a group term life insurance plan[8]; (2) one or both parties must pay the premiums directly or indirectly; and (3) the payor or payors of the premiums must recover a portion, all or more than all of the payments, from the insurance proceeds.[9] For example, an employer and employee may agree to jointly purchase a life insurance policy where the employer pays the cost of the policy and the employee pays income and employment tax each year on the cost of the term insurance portion of the coverage. At policy maturity the employer recovers either an amount equal to the cash surrender value of the policy or the amount of the premiums paid. The insured, the insured's beneficiary, or an ILIT receives the balance of the policy proceeds — cash value above that withdrawn by the employer and any applicable death benefit.[10]

There are two types of split-dollar arrangement: (1) those owned by the donor, who endorses specified rights to a donee (endorsement arrangement)

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[5] Treas. Reg. § 1.61-22(c)(4) (2010).
[6] Treas. Reg. § 1.61-22(b)(2) (2010).
[7] Treas. Reg. § 1.61(c)(1) (subject to some exceptions found in the statute or regulations).
[8] Group term life insurance is subject to separate regulations promulgated pursuant to I.R.C. § 79 (2010).
[9] Treas. Reg. § 1.61-22(b)(1)(i)-(iii) (2010) (sometimes substitutes for life insurance are used for split-dollar life insurance arrangements).
[10] Young v. Comm'r, T.C. Memo 1995-379.

under the economic benefit regime; and (2) those owned by the donee, who assigns an interest back to the donor (collateral assignment arrangement) under the loan regime. Under an endorsement arrangement the donor owns the split-dollar insurance policy and the donee is taxed on the economic benefits the donee receives.[11] Under a collateral assignment arrangement, the donee owns the split-dollar insurance policy, the donor is treated as loaning the premiums to the donee, and the donee is taxed on any negative difference between the present market value of the loan and the present value of the repayments made to the donor (the value of the donee's imputed income gain when loan is made to the donee at a below market rate of interest).[12]

### B. *The Evolution of Taxation of Split-Dollar Arrangements*

Under pre-2003 treasury regulations, tax savings were produced by permitting inside build-up of investment income to be sheltered from taxation, and by not taxing the value of interest associated with loans made to the donee at below market rates for life insurance premium costs (premiums paid by the donor who later recovered a below market rate of interest as a return at policy maturity or termination).

Typically, the schemes provided that the donor paid either the total premium or an amount equal to the annual increase in the policy's cash surrender value and the donee paid the balance of the cost. The donee was only subject to tax on income equal to the value of the term insurance component of the life insurance purchased by the donor. At the donee's death, the donor received the policy's cash value or the dollar value of premiums paid and the donee or donee's beneficiary received any remaining cash value and any death benefit.[13] Thus, a split-dollar arrangement created an interest-free loan to the donee and taxable income equal to only the annual cost of term insurance measured by the lower of IRS estimates of term insurance cost (originally contained in the P.S. 58 Tables, now 2001 Tables) published in Revenue Rulings or the lowest rate the donee could document.[14]

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[11] Treas. Reg. § 1.161-22 (2010).

[12] Treas. Reg. § 1.7872-15 (2010). The loan is subject to I.R.C. §7872 (2010) rules for below market loans and I.R.C. §§ 1271-75 (2010) rules for original issue discount (OID).

[13] Gerald H. Sherman, *Attorney Against Applying Imputed Interest to Split-Dollar Life Insurance,* Letter submitted to Asst. Sec. Treasury Re: I..R.S. Notice 2001-10, Reprinted in TAX NOTES TODAY, Sept. 25, 2001, at 36 [hereinafter Sherman]; Burgess J.W. Raby, William L. Raby, *The Split-dollar Life Insurance Regimes*, TAX NOTES , Jan. 17, 2002, at 353.

[14] Rev. Rul. 55-747, 1955-2 C.B. 228 prescribed the P.S. 58 Table rates for term insurance to be used to value the income imputed to an employee or shareholder when a corporation or employer purchased life insurance under a split-dollar arrangement unless the taxpayer could identify lower extant commercial rates. In 2001, the P.S. 58 Tables were replaced for subsequent transactions with an interim table contained in I.R.S. Notice 2001-10, 2001-1 C.B. 459. The table was revised by I.R.S. Notice 2002-8, 2002-1 C.B. 398 and is referred to as the

Prior to 1995, the Service had concluded that only the cost of term insurance was the economic benefit the donee received from a split-dollar arrangement.[15] The Service's initial determination of the non-taxability of such interest free loans was affirmed by the Tax Court in 1961.[16] Increases in the donee's share of the policy's cash value did not become subject to taxation until 1995.[17]

The 2003 regulations may have had their origin in the wide public exposure that split-dollar arrangement tax avoidance schemes received. For example, a 1995 *U.S. News and World Report* article described split-dollar arrangements where an employer purchased life insurance naming an employee as beneficiary.[18] The employee paid income tax on the cost of term life insurance and received the value of the paid-up whole life policy, net of the amount returned to the employer under the arrangement. The article illustrated the savings by describing an employee who paid income tax on $75,000 of premiums for the term life insurance component of a whole life policy that produced $1.6 million in benefits to the insured and the insured's beneficiaries.[19] Practitioner comments submitted to the IRS showed that the difference between the tax burden imposed prior to the then-proposed 2003 regulations and the burden under the proposed regulations was substantial. The tax incurred by a forty-percent bracket taxpayer on a hypothetical split-dollar contract under the proposed new rules, reflecting imputed interest based on a seven-percent demand loan was ten to twelve times that under the old rules.[20]

The move toward more regulation began in 1995 when the Service held that the economic benefit received from the life insurance policy included both the current value of the life insurance protection and any cash surrender value the donee would ultimately receive.[21] In addition, the Service held that life insurance issued pursuant to a split-dollar arrangement, which a donee placed in an ILIT, was subject to gift tax on both the annual cost of term insurance and the increase in cash value accruing to the donee under the split-dollar

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2001 Table, now used to identify the cost of term insurance imputed as income to an employee or stockholder.

[15] *See* Rev. Rul. 55-713, 1955-2 C.B. 23 (revoked by Rev. Rul. 64-328, 1964-2 CB 11); Rev. Rul. 64-328; 1964-2 C.B. 11; Rev. Rul. 66-110, 1966-1 C.B. 12.

[16] DEAN V. COMM'R, 35 T.C. 1083 (1961) (interest-free loans do not result in taxable income to a controlling shareholder or employee-insured).

[17] *See* Rev. Rul. 55-713, 1955-2 C.B. 23 (revoked by Rev. Rul. 64-328, 1964-2 C.B. 11).

[18] Jack Egan, *Split-Dollar Life Insurance Works Like a Super-Duper IRA* , U.S. NEWS & WORLD REPORT, June 12, 1995, at 79.

[19] *Id.*

[20] Sherman, *supra* note 13, at ¶¶ 2-3.

[21] P. L. R. 9604001, Sept. 8, 1995. The analysis in the P.L.R. is based on I.R.C. § 83 (2010) and Treas. Reg. § 1.83-1 (2010).

arrangement.[22] Unless retained by the employer or corporation, once the cash value exceeded the premiums paid by the donor, the additional cash value was taxable as imputed income to a donee employee or as a dividend to a donee shareholder.[23] In addition, the very low P.S. 58 table values for term insurance were replaced with a new table.[24] Commentators described the life insurance lobby as being "in an uproar" over the loss of tax benefits previously available from split-dollar arrangements.[25] More regulation was to come.

Imputed interest on interest free loans from the donor to the donee in the form of payment of the insurance premiums remained untaxed until 2003.[26] Under the current rules, when payments are made in exchange for economic benefits to the donor or loans are made to the donee at below-market interest rates, the donee is subject to tax on the economic value of those benefits.[27] When payments are neither made in exchange for economic benefits, nor split-dollar insurance loans, the taxation of premium payments is governed by the imputed interest rules associated with employment tax, dividend tax, or gift tax principles rather than the split-dollar arrangement regulations.[28] Payments made by debt instruments issued by the non-owner that are subsequently forgiven are treated as taxable compensation to an employee, a taxable dividend to a shareholder, or a gift to a donee that is subject to gift tax.[29]

Even under the 2003 regulations, four sources of potential tax benefits remain. The first three are likely to be minor, the fourth significant. First, the cost of term insurance in IRS tables may be lower than the actual cost of that insurance. Second, the interest rates imputed by the Service may be lower than the rate at which borrowers can borrow. Third, split interest gifts can be an effective vehicle for minimizing gift taxes on the establishment of ILITs. Finally, present economic conditions have produced low interest rates that are likely to rise in the future, which makes certain types of split-dollar life insurance arrangements set up under the loan regime a vehicle for significant lawful tax avoidance. The rules permit donees to lock in low current interest

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[22] I.R.C. § 2511 (2010); Rev. Rul. 78-420, 1978-2 C.B. 67; I.R.C. § 61 (2010), Treas. Reg. § 1.161-1 (2010). Cash surrender value not protected from the claims of general creditors would not be taxable to the employee until received. I.R.C. § 61 (2010).

[23] I.R.C. § 83(a) (2010); Treas. Reg. § 1.83-1(a)(2) (2010). In 2001 the Service issued a notice confirming its 1966 position in P.L.R. 9604001, Notice 2001-10; 2001-1 C.B. 459 (Jan. 29, 2001) (rev'g Rev. Rul. 64-328, 1964-2 C.B. 11, and Rev. Rul. 66-110; 1966-1 C.B. 12). The reasoning was based on the language of I.R.C. §§ 83, 7872 (2010).

[24] I.R.S. Notice 2001-10, I.R.B. 2001-5, 459 (Jan. 29, 2001).

[25] Brian T. Whitlock, Jill McNamara, *Significant Recent Developments in Estate Planning, (Part II*), The Tax Adviser , 32, Sept. 2001, at 618.

[26] Treas. Reg. § 1.7872-15 (2010).

[27] *Id.*

[28] Treas. Reg. § 1.61-22(b)(5) (2010).

[29] Treas. Reg. § 1.61-22(b)(6) (2010).

rates to impute income for the life of the split-dollar arrangement, even though rates are likely to rise in the future. No comparable benefit is available if the split-dollar arrangement is structured as an endorsement arrangement under the economic benefit regime.[30] The next section explains how the economic benefit regime works in order to show why it does not produce the same benefits as does the loan regime.

## III. THE MECHANICS OF SPLIT-DOLLAR ENDORSEMENT ARRANGEMENTS UNDER THE ECONOMIC BENEFIT REGIME.

### A. *How the Economic Benefit Regime Works*

Under the economic benefit regime, the donor (the party who pays for the insurance) must be the owner of the policy who endorses the benefits specified in the split-dollar arrangement contract to the non-owner donee.[31] The regulations describe economic benefit situations that include: (1) endorsement of some split-dollar insurance benefits to the donee[32]; (2) a collateral assignment arrangement where the donor pays some or all premiums in exchange for an interest in the cash surrender value and death benefit equal to the cash surrender value or premiums paid[33]; and (3) a collateral assignment arrangement between the donor and a donee's ILIT or another third-party (such as donee's children).[34] In each case, the donee is taxed on the value of the economic benefits received. The benefits include the value of term insurance plus any cash value accruing to the donee less any benefits paid for by the donee.[35] If the benefits accrue to an employee as compensation the benefits are subject to income and employment taxes; if they accrue to a shareholder the benefits are dividends subject to income tax; and if they accrue to an ILIT the benefits are a gift subject to gift tax.

The constructive or actual receipt of an economic benefit subject to tax is equal to: (1) the cost of current term life insurance protection (i.e. the cost of term life insurance); (2) any increase in cash value of the policy during the year to which the donee receives current access that was not taken into

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[30] When interest rates are high the process can work in reverse and increase tax liability.

[31] The economic benefit rules, Treas. Reg. §§ 1.61-22(b), 1.61-22(g) (2010); *see* Treas. Reg. § 1.61-22(b)(3)(ii)(A) (2010). An employer is always the owner of split-dollar insurance under Treas. Reg. § 1.61-22(c)(1)(ii) if at all times, "[t]he only economic benefit that will be provided under the arrangement is current life insurance protection."

[32] Treas. Reg. § 1.61-22(b) (2010).

[33] Treas. Reg. § 1.61-22(b)(2)(i)(C) (2010).

[34] To avoid inclusion in the employee's estate at death, Treas. Reg. § 1.61-22(b)(3)(ii)(B) (2010).

[35] Treas. Reg. § 1.61-22(d)(1) (2010).

account in a previous year; and (3) value of any other economic benefits to donee not taken into account in a previous year.[36]

Absent an alternative agreement, benefit valuation occurs on the last day of donee's tax year; however, donor and donee may agree to use the policy anniversary date as the valuation date instead. If the split-dollar arrangement terminates during the tax year of the donee, the termination date is used for valuation.[37] Dividends, loan proceeds, and surrender payments to the donee are treated as paid first to the donor then paid by donor to donee.[38]

### *B. Non-Equity and Equity Split-Dollar Insurance Arrangements*

When the donor keeps all benefits other than the donee's term life insurance benefit the arrangement is called a non-equity life insurance arrangement.[39] Upon termination of the arrangement or donee's death, donor is entitled to receive the greater of the aggregate premiums or the policy cash value of the contract. The death benefit provided by the term life insurance is paid to the donee's designated beneficiary.[40] The regulations require that donor be treated as owner of a non-equity life insurance arrangement.[41] The cost of annual life insurance protection is the amount shown in the applicable IRS term life insurance tables less whatever portion of the term premium is paid by the donee.[42]

When the donor provides term insurance protection and an interest in policy cash value (policy equity) to the donee the arrangement is an equity split-dollar insurance arrangement.[43] If donor pays all premiums and donee may borrow against or withdraw some portion of cash value (the amount exceeding the amount payable to donor),[44] donee has current access to the amount donor can withdraw or borrow against.[45] Both the value of the death

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[36] Treas. Reg. § 1.61-22(d)(3)(iii) (2010).
[37] Treas. Reg. § 1.61-22(d)(5)(i)(2010). Both must use the same termination date, Treas. Reg. § 1.61-22(d)(5)(ii) (2010).
[38] Treas. Reg. § 1.61-22(e)(1) (2010). A donee shareholder is taxed on dividends and interest under I.R.C. § 72 (2010).
[39] Final Regulations, Split-Dollar Life Insurance Arrangements, Background and Explanation of Provisions, 68 Fed. Reg. 54336, 543337 (Sept. 17, 2003) (codified at 26 CFR pts. 1, 31, and 602, now Treas. Reg. § 1.61-22(d)(2) (2010) [hereinafter Split-Dollar Life Insurance Arrangements, Background].
[40] Treas. Reg. §§ 1.61-22(b)(1), 1.61-22(b) (2), 1.61-22(d)(2)(i), 1.61-22(h), Ex. 1 (2010).
[41] Treas. Reg. §§ 1.61-22(c)(1)(i), 1.61-22(c)(1)(ii)(A)(1) (2010).
[42] Treas. Reg. § 1.61-22(d)(3)(ii) (2010). The guidance found in Treas. Reg. § 601.601(d)(2)(ii) (2020) currently specifies use of Table 2001, which replaced the former P.S. 58 Table.
[43] Split-Dollar Life Insurance Arrangements, Background, *supra* note 39, at 54337.
[44] Treas. Reg. § 1.61-22(d)(6)(i)(ii), Ex. 1 (2010).
[45] Treas. Reg. § 1.61-22(d)(4)(ii)(2010).

benefit and the increase in amount to which donee has current access during the year are economic benefits that must be included in donee's gross income and be subject to income and employment tax in that tax year.[46] If the parties negotiate changes to a split-dollar insurance arrangement, both gross income and donee's tax obligations may change as well.[47] Access to cash value or a right to borrow may be subject to sufficient restrictions on an employee's current access rights to delay inclusion in gross income until actual distribution.[48] However, if the cash value of the policy is inaccessible to donor's general creditors pursuant to state law, even if donee cannot immediately access policy cash value, donee is deemed to have future access to that portion of cash value exceeding the amount payable to donor because there is no substantial risk donee will forfeit access in future years.[49]

### C. *Taxation of Death Benefits Received by Donee's Beneficiaries*

The donor of an insurance contract is treated as having an investment in the policy equal to the payments, dividends, and interest (basis) in the contract. When a donee includes only the cost of term insurance in gross income and does not include dividends or interest in gross income, donee does not receive basis in the policy.[50] At donee insured's death, coverage benefits provided by the term insurance, even if paid for by other than the insured, are excluded from both the decedent's and the beneficiary's gross income because premiums were previously included in decedent donee's gross income; however, any dividends or interest not previously included in donee's gross income are subject to income tax.[51]

### D. *Transfer of Ownership of Split-Dollar Policy from Owner to Non-Owner*

For employment, dividend, and gift tax purposes transfer of ownership of a policy subject to a split-dollar arrangement occurs on the date the owner transfers ownership to the donee, who then becomes the owner of the

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[46] Treas. Reg. §§ 1.61-22(d)(2)(i), 1.61-22(d)(2)(ii) (2010). For example, if in the first year donee's economic benefit is only term life insurance protection, only the value of the term insurance is and economic benefit subject to tax. If in the second year donee receives term insurance protection plus $20,000 of cash value, donee is subject to tax on both the value of term insurance and $20,000, Treas. Reg. § 1.61-22(d)(6), Ex. 1 (2010).
[47] Treas. Reg. § 1.61-22(h), Ex. 4 (2010).
[48] Treas. Reg. § 1.61-22(d)(3)(i) (2010). *See* the summary of Example 2 from Treas. Reg. § 1.61-22(d)(6), Ex. 2 (2010).
[49] Treas. Reg. § 1.61-22(d)(6)(ii), Ex. 2 (2010). Employee must include the value of the economic benefits described in §§ 1.61-22(d)(1), 1.61-22(d)(4)(ii), 1.61-22(d)(2)(i) and 1.61-22(d)(2)(ii) (2010). *See* Treas. Reg. § 1.61-22(h), Ex. 3 (2010).
[50] I.R.C. § 72(e)(6) (2010); Treas. Reg. § 1.61-22(f)(2)(i) (2010).
[51] I.R.C. § 101(a); Treas. Reg. §§ 1.61-22(f)(3)(i), 1.61-22(f)(3)(ii) (2010).

insurance policy.[52] The fair market value of the insurance contract at transfer, less the value of current life insurance protection, is the contract's cash value.[53] A transfer of ownership of a split-dollar life insurance policy from owner–donor to non-owner-donee is taxed on the difference between the fair market value of the policy at transfer and the sum of: (1) donee's payment at transfer of the policy; (2) all of donee's previous payments; and (3) the portion of owner payments included in donee's gross income, including cash value of the policy to which donee previously had access, which donee included in taxable gross income.[54] When ownership is transferred from a donor employer or corporation to a donee employee or shareholder, the value of the insurance contract at the time of transfer is deductible to the employer or corporation to the extent provided under I.R.C. § 83. Employee or shareholder payments for current insurance protection are included in the employer or corporation policy owner's gross income,[55] as well as in the owner's basis in the insurance contract.[56]

Consider the following fact pattern. Donor purchases a life insurance contract on the life of donee under which donor is policy owner and pays all premiums until the termination of the arrangement or donee's death (a non-equity insurance arrangement). Donor will receive the greater of the aggregate premiums or the contract's policy cash value and the balance will be paid to the donee's beneficiary. In the fifth year donor and donee revise the arrangement to provide that donor will be entitled to receive the greater of the aggregate premiums or half of the cash value (an equity insurance arrangement). In the seventh year donee is designated policy owner, which substantially vests donee's rights to the contract.[57]

For the first five years donee must include in gross income the value of current life insurance protection. At the beginning of the fifth year donee may borrow or withdraw the cash value amount that that exceeds the amount payable to donor and therefore donee becomes subject to income and employment tax on the portion of cash value donee may now access. Upon transfer of ownership in the seventh year from donor to donee, donee must include in gross income the fair market value of the policy less the value of

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[52] Treas. Reg. § 1.61-22(c)(3) (2010). Similarly, transfer of ownership in an undivided interest in the policy occurs on the date the donee becomes owner of that interest. *Id.*

[53] Treas. Reg. § 1.61-22(g)(2) (2010). If a policy is transferred in exchange for services provided by the non-owner, the transfer date is the date on which the services are taxable under I.R.C. § 83 (Property transferred in connection with services). Treas. Reg. § 11.161-22(g)(3) (2010).

[54] Treas. Reg. § 1.61-22(g)(1) (2010).

[55] Treas. Reg. § 1.61-22(f)(2)(ii) (2010).

[56] Treas. Reg. § 1.61-22(f)(2)(iii) (2010).

[57] Treas. Reg. § 1.61-22(h), Ex. 8 (2010).

that portion of the policy already reported in donee's gross income.[58] If donor continues to make premium payments, they must either be accounted for under the loan regime (discussed infra) or under general income tax principles.[59] Donee's basis in the contract is the sum of what the donee paid to obtain the contract, plus unrecovered economic benefits previously taken into gross income and the donee's prior payments.[60] No amount allocable to current life insurance protection paid by donee is treated as consideration paid to acquire the contract.[61]

### E. *Tax Minimization Benefits under an Endorsement Arrangement*

Few tax benefits can be achieved under the economic benefit regime because the value of term insurance plus any increase in cash value is treated as income to a donee in the year received. If the expense of the policy is front loaded and is incurred when donee's income is relatively low there can be a tax savings; however, any hypothetical savings is offset by the likely time between the year when the savings was incurred and the year when benefits are recovered by the donee and/or donee's beneficiary. The only tax benefits are planning advantages associated with transfers to ILITs, and any difference between the Table 2001 cost of term insurance and the actual insurance cost. Under the economic benefit structure and its attendant endorsement arrangement, most, if not all, of the tax benefits that used to be associated with split-dollar arrangements are eliminated.

## IV. THE LOAN REGIME WITH INSURED AS POLICY OWNER

When the insured is owner of life insurance the split-dollar arrangement is regulated under loan regime. Donee-owner's gross income is determined under the loan regime by comparing the present value of the money returned to the donor against the present value of the amount donor loaned for premiums using the short-term, medium-term or long-term Applicable

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[58] Treas. Reg. § 1.61-22(g)(1) (2010).
[59] Treas. Reg. §§ 1.61-2(d)(2)(ii)(A), 1.61-22(b)(5), 1.61-22(h), Ex. 5 (2010).
[60] I.R.C. §§ 72(e)(6)(A), 72(g)(1) (2010); Treas. Reg. §§ 1.61-22(g)(4)(ii)(A), 1.61-22(g)(4)(B) (2010); Treas. Reg. § 1.61-22(g)(4)(ii)(D) (2010). If the transfer was a transfer of only an undivided portion of the contract, the basis would be found by computing the basis of a full transfer and multiplying multiplied by a fraction whose numerator is the fair market value of the portion transferred and whose denominator is the fair market value of the whole contract. Treas. Reg. § 1.61-22(g)(4)(ii)(C) (2010).
[61] I.R.C. § 72(g)(1) (2010); Treas. Reg. § 1.61-22(g)(4)(iii) (2010).

Federal Rate (AFR)[62], in effect when the split-dollar arrangement is reached to compute the present value of the interest imputed to the loan.[63] The donor expects to recover the deemed loans through owner-donee's collateral assignment of specified future insurance payments to the donor.[64] In its simplest form each premium payment by the non-owner donor is treated as a separate loan to the owner-borrower donee.[65]

A split-dollar demand loan is any split-dollar loan that is payable in full on demand of the lender (or within a reasonable time after the lender's demand).[66] A split-dollar term loan is any split-dollar loan other than a split-dollar demand loan.[67] Examples of split-dollar term loans include a loan repayable at a time certain, repayable on the death of the policy owner, or conditioned on the future performance of substantial services by the donee.[68] A demand split-dollar arrangement is reevaluated each year using the short-term AFR applicable for the year.[69] A term split-dollar arrangement for a specified term and is tested under the loan regime by comparing the present value of the payback to the donor against the present value of the amount loaned using the AFR in effect when the agreement is reached for the term from the loan date to the loan's maturity date.[70] A split-dollar arrangement until the death of the insured is tested using the AFR in effect when the agreement is reached for a term determined by examining the life expectancy of the insured when the arrangement is reached.[71]

> If a split-dollar loan is not a below-market loan, then … the loan is governed by the general rules for debt instruments (including the rules for original issue discount (OID) under [I.R.C.] sections 1271 through 1275 and the regulations thereunder. If a split-dollar loan

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[62] Each month the Service issues tables containing three AFRs; short-term, three years or less, mid-term, more than three years and not more than nine years, and long-term, more than nine years. I.R.C. § 1274(d)(1) (2010).
[63] Treas. Reg. §§ 1.7872-15(a), 1.7872-15(b) (2010).
[64] Treas. Reg. § 1.61-22(b)(3) (2010).
[65] The loan arises either under general tax law principles, or when a reasonable person would expect repayment by the owner to the non-owner, and repayment is secured by death benefit proceeds, cash surrender value, or both. Treas. Reg. §§ 1.7872-15(a)(2)(i), 1.7872-15(a)(2)(ii) (2010); *See* Treas. Reg. § 1.7872-15(a)(2)(iv), Ex. 1 (2010).
[66] Treas. Reg. § 1.7872-15(b)(2) (2010).
[67] Treas. Reg. § 1.7872-15(b)(3) *(2010).*
[68] Treas. Reg. § 1.7872-15(e)(5) *(2010).*
[69] Treas. Reg. § 1.7872-15(e)(3)(2) (2010).
[70] Treas. Reg. § 1.7872-15(e)(4)(iii)(A) (2010).
[71] Treas. Reg. §§ 1.7872-15(e)(4), 1.7872-15(e)(5)(ii) (2010). Split dollar arrangements that run to the death of the insured are tested under the term provisions of Treas. Reg. § 1.7872-15(e)(4)(ii), using the insured's expected life expectancy as the term of the arrangement and selecting the (AFR) that corresponds to that period. Life expectancy is determined using the applicable table in Treas. Reg. § 1.72-9 (2010).

> is a below-market loan, then … the loan is governed by [I.R.C.] section 7872.[72]

Below-market split-dollar loan*s* include gift loans,[73] compensation-related loans,[74] corporation-shareholder loans,[75] and any other type of loan whether or not enumerated in the statute.[76] The loans can be direct loans, indirect loans, stated interest loans,[77] contingent payment loans, or contingent payments.[78] The timing, amount, and characterization of the imputed transfers between the lender and borrower of a below-market split-dollar loan depend upon the relationship between the parties and upon whether the loan is a demand loan or a term loan."[79]

### A. *Split-Dollar Demand Loans*

The imputed loan amount[80] applied to below-market loans from donor to donee under a split-dollar arrangement is the difference between interest computed at the annual blended AFR that would have been payable on the loan for the calendar year and the interest that was paid (or did accrue) on the loan during the year.[81] A split-dollar demand loan generates sufficient interest if the rate at which interest accrues on the loan's adjusted issue price during the year is no lower than the short term blended AFR for the year.[82] The difference between interest at the blended annual AFR and interest actually charged in a calendar year is treated as transferred by the lender to the borrower (as income to an employee, a dividend to a shareholder, or a gift to a gift recipient), then retransferred by the borrower as an interest payment to the lender on the last day of the calendar year. If the borrower dies or terminates the loan the date of death or repayment is used.[83] Because

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[72] Treas. Reg. § 1.7872-15(a) (2010).
[73] I.R.C. § 7872(c)(1)(A) (2010).
[74] I.R.C. § 7872(c)(1)(B) (2010).
[75] I.R.C. § 7872(c)(1)(C) (2010).
[76] I.R.C. § 7872(c)(1)(E) (2010); Treas. Reg. § 1.7872-15(e)(1) (2010).
[77] *Id*.
[78] I.R.C. § 7872(c)(1)(E) (2010); Treas. Reg. § 1.7872-15(e)(1) (2010).
[79] Treas. Reg. § 1.7872-15(a)(1) (2010); *See* Treas. Reg. § 1.61-22 (2010) (for additional rules relating to the treatment of split-dollar life insurance arrangements).
[80] The imputed loan amount is the present value of all repayments required under the terms of the loan, determined when the loan is made, at a discount rate equal to the applicable short term, mid-term, or long-term AFR in effect on that date. Treas. Reg. § 1.7872-15(e)(4)(ii) (2010).
[81] Treas. Reg. § 1.7872-15(e)(3)(iii) (2010).
[82] Treas. Reg. § 1.7872-15(e)(3)(ii) (2010). The blended annual rate is published in the Internal Revenue Bulletin in July. Treas. Reg. § 601.601(d)(2)(ii) (2010).
[83] Treas. Reg. § 1.7872-15(e)(3)(iii) (2010).

the applicable short term AFR for each year is used to compute the imputed loan amount, there is no way to lock in low interest rates.

For split-dollar demand loans, where interest is forgiven for years in which the stated rate was a below-market rate, the amount deemed forgiven is the interest payable at the applicable AFR less interest actually paid allocated to the year of forgiveness. Where interest is forgiven in years where the loan was at or above the AFR, the amount forgiven less the difference between the interest charged and the interest that would have been charged at the AFR is treated as compensation to the borrower.[84] Thus, suppose employer pays a $100,000 premium on a split-dollar life insurance arrangement with employee, the policy owner, on January 1, 2009, repayable as a recourse loan on employer's demand at seven-percent compounded annually. The blended AFR is five-percent in 2009 and six-percent in 2010 and employer demands only repayment of $100,000 on December 31, 2010. The loan is not a below-market loan in either year employee is required to accrue interest. The interest deemed transferred to employer, then back to employee is the amount that would have been payable at the blended AFR in each year less the amount actually paid by employee. In 2009, the interest payable at the blended rate would have been $5,000 and in 2010, it would have been $6,000. Since employee paid no interest, the interest deemed transferred to employer then retransferred to employee is $11,000, which is treated as compensation to the employee, to which a deferral charge must be added.[85]

### B. *Split-Dollar Term Loans*

The interest imputed on a split-dollar term loan is the present value of all principal and interest payments, discounted to the date the loan is made, using a discount rate equal to the AFR applicable to the term of the loan in effect on the date the split-dollar arrangement was made.[86] If the present value of the repayment payments for the loan is equal to or exceeds the present value of the amount loaned, there is no imputed loan amount and the loan is addressed under general tax accounting principles.[87] If the present value of the stream of principal and interest payments is below the present value of the amount loaned, the split-dollar loan does not provide for a

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[84] "For each year that the split-dollar demand loan was outstanding in which the loan was not a below-market split-dollar demand loan, the excess, if any, of the amount of interest payable at the appropriate rate used for purposes of imputation for that year [less] the interest actually paid allocable to that year." Treas. Reg. § 1.7872-15(h)(3)(ii) (2010).

[85] Treas. Reg. § 1.7872-15(h)(4), Ex. 2 (2010).

[86] Treas. Reg. §§ 1.7872-15(e)(4)(ii), 1.7872-15(e)(4)(iii)(A) (2010).

[87] I.R.C. § 7872 (2010); Treas. Reg. § 1.7872-15(e)(4)(ii) (2010). *See* I.R.C. §§ 1271–75 (2010).

market rate of interest (sufficient interest). The difference between the discounted present value of the repayments and the present value of the loan is converted to imputed interest using OID principles, which is treated as a payment from donor to the donee (compensation, a dividend, or a gift) and a payment of interest back to the donor.[88] The advantage of this methodology to the taxpayer is that it provides the vehicle needed to apply current low AFR rates to multiple year split-dollar life arrangements for the life of the loan even though AFR interest rates rise in future years. Since the test is made when the loan is made, any later increase in interest rates is ignored.[89]

If a split-dollar arrangement contains options exercisable during the loan's term (for example, to extend an option or call a split-dollar loan) at specific dates, the loan's term is determined by projecting the exercise or non-exercise of options in a manner that minimizes the loan's overall yield. "If different projected patterns of exercise or non-exercise produce the same minimum yield, the parties are projected to exercise or not exercise an option or combination of options in a manner that produces the longest term."[90] However, if exercise or non-exercise of an option would affect the yield, the shortest option period is used to test the split-dollar loan. The loan is treated as retired and reissued on the option date and the reissued loan is then retested using the applicable AFR in effect at the option date.[91] Thus, if donee-owner is deemed to borrows from donor for ten years at one-percent for the first five years and ten-percent for the second five years, and donee-owner has a right to repay at the end of the first five years, the arrangement is treated as a five-year split-dollar term loan at one-percent interest.[92] If donee-owner does not exercise the option to terminate, the loan is treated as retired at the end of the fifth year and reissued for five more years. It is tested against the applicable AFR on the reissue date against the ten-percent interest rate.[93]

To effectively utilize the term loan rules to minimize tax liability, options to terminate can be included only if the exercise or non-exercise does not affect the yield. Thus, if donee-owner is deemed to receive a ten year split-dollar term loan at seven-percent per year from donor on which donor has the right to demand payment at the end of the second year, the loan is treated as a ten-year loan because the yield does not change whether or not donor demands payment.[94] Thus, a provision with a fixed interest rate and donor-employer's option to terminate the arrangement at termination of

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[88] Treas. Reg. § 1.7872-15(e)(4)(iv) (2010).
[89] *Id.*
[90] Treas. Reg. § 1.7872-15(e)(4)(iii)(B)(1) (2010).
[91] Treas. Reg. § 1.7872-15(e)(4)(iii)(B)(2) (2010).
[92] Treas. Reg. § 1.7872-15(e)(4)(iii)(B)(3), Ex. 1 (2010).
[93] Treas. Reg. § 1.7872-15(e)(4)(iii)(B)(3), Ex. 2 (2010).
[94] Treas. Reg. § 1.7872-15(e)(4)(iii)(B)(3), Ex. 3 (2010).

donee-employee's employment permits use of a term that runs beyond the date at which donor may exercise the option.

### *C. General Rules for Determining Split-Dollar Term Loan Interest Sufficiency and Tax Liability*

The difference between the present value of the loan at the interest rate actually received by the donor and the present value of the loan at the applicable AFR is the shortfall on which annual interest value is computed.[95] For example, assume that on July 1, 2009, corporation and shareholder enter into a split-dollar life insurance arrangement under which shareholder is named as the policy owner. On July 1, 2009, corporation makes a $100,000 premium payment, repayable without interest in fifteen years. Repayment of the premium payment is fully recourse to shareholder. The long-term AFR (based on annual compounding) at the time the loan is made is seven-percent.[96] The present value of the payments under the loan is $100,000 divided by [1+(0.07/1)]/15, which equals $36,244.60.[97] This loan is a below-market split-dollar term loan because the imputed loan amount of $36,244.60 (the present value of the amount required to be repaid to corporation is less than the amount loaned to shareholder ($100,000). Corporation is treated as transferring to shareholder $63,755.40 (the excess of $100,000 (amount loaned) over $36,244.60 (imputed loan amount)).[98] Corporation is treated as making an I.R.C. §301 distribution to shareholder on July 1, 2009, of $63,755.40 and must take into account as OID an amount equal to the imputed transfer each year.[99]

If, under the split-dollar arrangement a donor non-owner pays premiums and is entitled to be repaid eighty-percent of each premium payment, twenty-percent of the payment is treated as income to the donee-owner (employee or shareholder), or as a gift to a gratuitous recipient when made,[100] and eighty-percent is treated as a loan by the non-owner donor to the owner donee.[101] However, if less than eighty-percent of a premium payment is reasonably expected to be repaid, then none of the payment is treated as a loan for

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[95] I.R.C. § 1272 (2010); Treas. Reg. § 1.7872-15(e)(4)(v) (2010). The original issue discount rules are found at I.R.C. §§ 1271-75 and the associated regulations. Treas. Reg. § 1.1273-2 (2010).

[96] Treas. Reg. § 1.7872-15(e)(4)(vi), Ex. (i) (2010).

[97] Treas. Reg. § 1.7872-15(e)(4)(vi), Ex. (ii) (2010).

[98] In accordance with I.R.C. § 7872(b)(1) (2010); Treas. Reg. § 1.7872-15(e)(4)(iv) (2010).

[99] Treas. Reg. § 1.7872-15(e)(4)(vi), Ex. (iii). *See* Treas. Reg. § 1.1272-1 (2010) (treatment of OID).

[100] Treas. Reg. § 1.7872-15(a)(2)(ii) (2010). Not all payments need be repaid. Treas. Reg. §1.61-22(b)(5) (2010). General income or gift tax provisions are applicable. Treas. Reg. §1.61-22(b)(5)(2010). *See also* Treas. Reg. § 1.7872-15(a)(2)(iv) (2010).

[101] Treas. Reg. § 1.7872-15(a)(2)(i) (2010).

Federal tax purposes.[102] If the payment is not a loan, taxation of the entire premium payment is governed by general income tax principles.[103]

For example, employer and employee enter into a split-dollar arrangement under which employee is named as the policy owner. On January 1, 2009, employer makes a $100,000 premium payment, which is treated as a loan to employee repayable with five-percent interest compounded annually on December 31, 2011. The premium payment is a fully recourse split-dollar term loan. If the short-term AFR were also five-percent when made, the loan would not be a below market loan, and general tax principles would apply. Employer would be required to accrue compound interest of five-percent each year the loan remained outstanding.[104] However, employee would not be entitled to any deduction for payment of the interest.[105]

If, on December 31, 2011, employee repays employer $100,000 but employer waives the remainder due on the loan ($15,762.50 interest),[106] the amount of interest waived is treated as if it had been paid to employer then retransferred by employer back to employee as compensation.[107] The waived amount equals the excess of the amount of interest payable at the stated rate ($15,762.50) over the interest actually paid ($0), or $15,762.50.[108] In addition, the amount deemed retransferred to employee is increased by the prescribed deferral charge,[109] which is the amount forgiven under the rules for term loans multiplied by the highest rate of income tax applicable to the borrower for tax year in which the split-dollar term loan was made multiplied

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[102] Treas. Reg. § 1.7872-15(a)(2) (2010).
[103] Taxation of the entire premium payment is governed by Treas. Reg. § 1.61-22(b)(5) (2010). *See* Treas. Reg. § 1.7872-15(a)(2)(iv), Ex. 2(ii) (2010).
[104] Treas. Reg. § 1.7872-15(f) (2010).
[105] Treas. Reg. § 1.7872-15(c) (2010).
[106] *See* Treas. Reg. § 1.7872-15(h)(5), Ex. 1 (2010).
[107] *Id.* As required by Treas. Reg. § 1.7872-15(h)(1) (2010).
[108] The deferral charge is mandated by Treas. Reg. § 1.7872-15(h)(4)(ii) (2010).
[109] "[F]or each year the loan was outstanding, multiply the hypothetical underpayment computed pursuant to Treas. Reg. § 1.7872-15(h)(3) (2010) by the applicable underpayment rate, compounded daily. This hypothetical underpayment is multiplied by the highest rate of income tax applicable to the borrower for that year. The applicable underpayment rate is the average of the quarterly underpayment rates in effect under I.R.C. § 6621(a)(2) (2010) for the applicable period. The applicable period for a year is the period of time from the last day of that year until the date the interest is waived, cancelled, or forgiven." Treas. Reg. § 1.7872-15(h)(4)(ii) (2010). "[F]or each year the loan was outstanding, multiply the hypothetical underpayment computed pursuant to Treas. Reg. § 1.7872-15(h)(3) (2010) by the applicable underpayment rate, compounded daily. This hypothetical underpayment is multiplied by the highest rate of income tax applicable to the borrower for that year. The applicable underpayment rate is the average of the quarterly underpayment rates in effect under I.R.C. § 6621(a)(2) (2010) for the applicable period. The applicable period for a year is the period of time from the last day of that year until the date the interest is waived, cancelled, or forgiven." Treas. Reg. § 1.7872-15(h)(4)(ii) (2010).

by the Service's quarterly underpayment rates[110] for the applicable periods compounded daily from the loan date to the date interest was cancelled.[111] Even if a nonrecourse payment on a split-dollar loan would otherwise be a contingent payment,[112] since the life insurance policy is security for donee's loan payments, donee's repayment to donor is not treated as a contingent payment.[113]

### D. *Common Tax-Saving Term Split-Dollar Arrangements*

Tax savings derived from locking in current low AFR rates for the duration of the split-dollar arrangement are available in each of the following situations.

#### 1. Split-Dollar Term Loans Payable at Death of Insured

Below-market loans payable not later than the death of an individual[114] (as well as employment-related loans and gift-term loans payable on the later of a term certain or another specified date) are split-dollar term loans for purposes of determining whether the loans provide for sufficient interest.[115] Forgone interest is determined annually using an AFR that is appropriate for the loan's term and that is determined when the loan is issued.[116] The duration of a split-dollar term loan that ends on the death of an individual (or the last survivor of a group of individuals) is determined actuarially for the individual or group on the date the loan is deemed made.[117] If the individual outlives his or her life expectancy, the loan is treated as retired and reissued at the loan's adjusted issue price on that date, using the same AFR applied when the loan was originally made.[118] Thus, the initial interest rate is locked in for the life of the insured for purposes of calculating imputed income and the value of any gift involved.

If the loan is repayable on the earlier of the individual's death or some other date,[119] the shorter term is tested.[120] For example, a corporation's split-dollar life insurance arrangement requiring a $100,000 premium without

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[110] It is applied to any underpayment of taxes determined pursuant to IRC § 1 (2010), determined pursuant to IRC § 6621(a)(2) (2010).
[111] Treas. Reg. §§ 1.7872-15(h)(4)(i), 1.782-15(h)(4)(ii) (2010).
[112] Treas. Reg. § 1.7872-15(d)(1) (2010).
[113] Treas. Reg. § 1.7872-15(d)(2)(i) (2010).
[114] Treas. Reg. § 1.7872-15(e)(5)(ii) (2010).
[115] Treas. Reg. § 1.7872-15(e)(5)(i) (2010).
[116] Treas. Reg. § 1.7872-15(e)(5)(ii)(A) (2010).
[117] Treas. Reg. § 1.7872-15(e)(5)(ii)(B) (2010).
[118] Treas. Reg. § 1.7872-15(e)(5)(ii)(D) (2010).
[119] Determined pursuant to Treas. Reg. § 1.7872-15(e)(4)(iii) (2010).
[120] Treas. Reg. § 1.7872-15(e)(5)(ii)(C) (2010).

interest for a sixty-five-year-old shareholder, to be repaid from the death benefit is treated as a split-dollar term loan for shareholder's fifteen-year actuarial life expectancy. At a seven-percent AFR, the present value of the repayment is $36,244.60, a below-market loan;[121] however, the loan is treated as a payment to the shareholder of $7,000 and interest income to the corporation of $7,000 each year the shareholder survives.[122] If the insured outlives his life expectancy, the split-dollar loan is treated as retired and reissued at the loan value on the reissue date; however, the applicable AFR continues to be the rate originally determined.[123]

### 2. Split-Dollar Term Gift Loans

A split-dollar arrangement involving a loan from donor to donee who gifts the insurance to a child or ILIT can generate both income tax and gift tax liability. A gift split-dollar term loan is first tested to determine if the loan provides for sufficient interest. If the imputed interest is not sufficient, the loan is treated for income tax purposes as a below-market loan, the imputed interest is added to donee's gross income, and is subject to tax.[124] For gift tax purposes, the gift recipient is treated as having received a gift equal to the value of the term insurance plus the amount loaned, less the present value of all interest and principal repayments, discounted at the applicable AFR.[125]

Where a split-dollar arrangement provides for a transfer from an employer or corporation to an employee's (or shareholder's) child or ILIT, any below-market split-dollar loan transfers value from the lender to an indirect participant, the employee (or shareholder), and from the indirect participant to the borrower, the child (or ILIT). Any below market loan is restructured as two successive below-market deemed loans.[126] Each deemed loan is treated as having the same provisions as the original loan between the lender and the child (or ILIT), and the Treasury regulations are applied to each deemed loan.[127] To illustrate:

> [I]f, under a split-dollar life insurance arrangement, an employer (lender) makes an interest-free split-dollar loan to an employee's child, the loan is restructured as a deemed compensation-related below-market split-dollar loan from the employer to the employee

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[121] Treas. Reg. § 1.7872-15(e)(5)(ii)(B) (2010).
[122] The corporation is treated as making an I.R.C. §301 (2010) distribution to shareholder and receiving the imputed interest income. Treas. Reg. § 1.7872-15(e)(5)(vi) (2010).
[123] Treas. Reg. § 1.7872-15(e)(5)(ii)(D) (2010).
[124] Treas. Reg. § 1.7872-15(e)(5(iv)(B) (2010).
[125] I.R.C. § 7872(b) (2010).
[126] Treas. Reg. § 1.7872-15(e)(2) (2010).
[127] Treas. Reg. § 1.7872-15(e)(2)(ii) (2010).

(the indirect participant) and a second deemed gift below-market split-dollar loan from the employee to the employee's child.[128]

The restructuring reflects deemed compensation paid by the employer to the employee and a deemed gift of the insurance and the below-market split-dollar loan from employee to the recipient child or ILIT.[129]

If the loan is to an individual, the lender may deduct only the interest equal to the investment income received by the borrower; however, that restriction does not apply to gifts to an irrevocable trust.[130] If child's net interest accrual for 2009 is $1,100, the AFR for 2009 is five-percent, compounded annually, and the stated interest on the loan is zero, the forgone interest deemed paid to employee by child in 2009 is computed by multiplying $30,000 paid for the policy by .05 interest which is equal to $1,500.[131] However, because child is an individual and only earned $1,100 in net investment income for the year, child's deemed interest is limited to child's net income of $1,100.[132] As a result, employee's deduction (offsetting employee's imputed income in 2009 for interest deemed paid on employee's deemed loan from employer) is limited to $1,100, the interest deemed received from child.[133]

The result changes if the insurance policy is held by an ILIT or other irrevocable trust because a trust is not an individual.[134] As in the above example, the effect of the below-market split-dollar loan from employer to the trust is to transfer value from employer to employee then from employee to the trust.[135] The below-market split-dollar loan from the employer to the trust is restructured as two deemed below-market split-dollar demand loans, a compensation-related below-market split-dollar loan between employer and employee, and a gift below-market split-dollar loan between employee and trust.[136] While the forgone interest deemed paid to the employee by the trust is $1,100, employee may deduct $1,500 (interest deemed paid on the

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[128] *Id.*

[129] Treas. Reg. § 1.7872-15(e)(2)(ii) (2010). *See also* Treas. Reg. §1.7872-15(e)(2)(iv), Ex. (1) (2010).

[130] I.R.C.§ 7872(d) (2010). It imposes limits on interest accrual on gift loans for purposes of income taxes where loans do not exceed $100,000 to the net interest income received by the donee. *See also* Treas. Reg. §§ 1.7872-15(e)(2)(iii), 1.7872-15(e)(2)(iv), Ex. (2) (2010).

[131] Treas. Reg. § 1.7872-15(e)(2)(iv), Ex. (1)(iii) (2010).

[132] I.R.C. § 7872(d)(1) (2010); Treas. Reg. § 1.7872-15(e)(2)(iv), Ex. (1)(iii) (2010).

[133] Treas. Reg. § 1.7872-15(e)(2)(iii) (2010).

[134] I.R.C. § 7872(d)(1); Treas. Reg. §7872-15(e)(2)(iv), Ex. 2(iii) (2010).

[135] Treas. Reg. § 1.7872-15(e)(2)(iv), Ex. 2(ii) (2010).

[136] Treas. Reg. § 1.7872-15(e)(2) (2010).

employee's deemed loan) because the ILIT is not an individual and therefore IRC §7872(d)(1) does not apply.[137]

3. Split-Dollar Term Loans Conditioned on Future Performance of Services

If the benefits of a split-dollar arrangement are conditioned on the future performance of substantial services by an individual and are not transferrable.[138] Loan sufficiency is tested by applying the AFR applicable to the loan's term that was in effect when the loan is made.[139] If the loan does not provide for sufficient interest the loan is treated as a below market demand loan for each year that the loan is outstanding at the applicable AFR.[140] The term is based on the period from the date the loan is made until the loan's stated maturity date. However, if the loan does not have a stated maturity date, the term of the loan is presumed to be seven years.[141] If the loan remains outstanding longer than the stated term or presumed term, because of the continued performance of substantial services, the split-dollar loan is treated as retired and reissued as a split-dollar demand loan at that time for an amount of cash equal to the loan's adjusted issue price on that date and retested at the original interest rate to determine whether the loan provides for sufficient interest.[142]

E. *Computation of Interest under the Loan Regime when the Stated Interest Rate Varies*

If the lender applies a floating interest rate to the split dollar arrangement, computation becomes somewhat more complicated. A split-dollar term loan with a floating interest rate is tested using the values of the floating rate on the date the split-dollar term loan is made for each accrual period to which a floating rate applies.[143] The term of the loan is determined

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[137] Interest is deductible pursuant to I.R.C. §163(d) (2010); the deduction is allowed pursuant to Treas. Reg. § 1.7872-15 (e)(2)(iii) (2010); Treas. Reg. § 1.7872-15(e)(2)(iv), Ex. (2)(ii) (2010).
[138] Treas. Reg. § 1.7872-15(e)(5)(iii)(A) (2010).
[139] Treas. Reg. § 1.7872-15(e)(5)(iii)(B) (2010). The term is from the date the loan is made until the loan's stated maturity date; however, if there is no stated maturity date, the term of the loan is presumed to be seven years. Treas. Reg. §1.7872-15(e)(5)(iii)(C) (2010).
[140] Treas. Reg. § 1.7872-15(e)(5)(iii)(B) (2010).
[141] Treas. Reg. § 1.7872-15(e)(5)(iii)(C) (2010).
[142] Treas. Reg. § 1.7872-15(e)(5)(iii)(D) (2010).
[143] Treas. Reg. §§ 1.7872-15(g)(3)(i), 1.782-15(g)(3)(ii) (2010). A variable interest rate is a qualified variable interest rate that may be applied to a split-dollar loan so long as there are no interest rate restrictions, such as a rate cap, that cause the expected yield of the loan to be lower than the expected yield without the restrictions. Treas. Reg. §§ 1.7872-15(g)(2)(i), 1.782-15(g)(2)(ii) (2010).

using the rules in Treas. Reg. §1.1274-4(c)(2). If the loan provides for interest that adjusts at varying intervals, the loan term is determined by reference to the longest interval between interest adjustment dates.[144] A projected fixed rate is used to determine accrual of interest each period and the amount of any imputed transfers are adjusted ex post to take into account any difference between the projected fixed rate and the actual rate.[145]

For example, employer issues a ten-year split-dollar term loan to employee which employee may prepay at the end of the fifth year at one percent for the first five years and at ten-percent for the remaining five years. The arrangement is treated as a five-year split-dollar term loan from employer to employee with interest payable at one percent.[146] If employee does not prepay the split-dollar loan at the end of year five the first loan is treated as retired at the end of year five and a new five-year split-dollar term loan is issued at that time, with interest payable at ten-percent.[147] However if employer issues a ten-year split-dollar term loan on which employer has the right to demand payment at the end of the second year with interest payable on the split-dollar loan at seven-percent each year that the loan is outstanding,[148] the arrangement is treated as a ten-year split-dollar term loan because the yield of the loan is seven-percent, compounded annually, whether or not employer demands payment.[149] Similarly, consider an employer and employee who enter into a split-dollar arrangement under which employee is named policy owner and on January 1, 2010, employer makes a $100,000 premium payment repayable in fifteen years with interest payable each year on January 1, starting January 1, 2011, at a rate equal to

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[144] Treas. Reg. §§ 1.7872-15(g)(3)(ii), 1.7872-15((e)(5) (2010).

[145] Treas. Reg. § 1.7872-15(g)(4) (2010).

[146] Treas. Reg. § 1.7872-15(e)(4)(iii)(B), Ex. 1 (2010). When an employee has the right to terminate at the end of five years and the interest rate changes, the ten-year loan is tested for five years, then retested if not terminated. Treas. Reg. § 1.7872-15(e)(4)(iii)(B)(1) (2010) ("For purposes of determining a split-dollar loan's term, the borrower is projected to exercise or not exercise an option or combination of options in a manner that minimizes the loan's overall yield. Similarly, the lender is projected to exercise or not exercise an option or combination of options in a manner that minimizes the loan's overall yield.").

[147] Treas. Reg. § 1.7872-15(e)(4)(iii)(B), Ex. 2 (2010). The second five year term at 10 percent is tested for five years at the applicable APR prevailing at that time. Treas. Reg. § 1.7872-15(e)(4)(iii)(B)(2) (2010) ("[T]he split-dollar loan is treated for purposes of this section as retired and reissued on the date the option is or is not exercised for an amount of cash equal to the loan's adjusted issue price on that date. The reissued loan must be retested using the appropriate AFR in effect on the date of reissuance to determine whether it is a below-market loan.").

[148] Treas. Reg. § 1.7872-15(e)(4)(iii)(B), Ex. 3 (2010).

[149] Because under Treas. Reg. § 1.7872-15(e)(4)(iii)(B)(1) the loan's overall yield does not change and as a result the entire ten-year period is tested at the applicable AFR in effect when the split-dollar term loan was made.

the value of one-year London Interbank Offered Rate (LIBOR).[150] The short-term AFR (based on annual compounding) at the time of the loan is seven-percent. Assume that the value of the one-year LIBOR on January 1, 2010, is eight-percent, compounded annually. The loan bears interest at a qualified floating rate.

Because the interest rate is reset each year, the short-term AFR (based on annual compounding) is used to determine whether the loan provides for sufficient interest.[151] The loan is treated as if it provided for a fixed rate of interest equal to eight-percent, compounded annually. Based on a discount rate of seven-percent, compounded annually (the short-term AFR), the present value of the payments under the loan is $109,107.91 while the amount loaned is $100,000 so the loan provides for sufficient interest and is not a below-market split-dollar term loan.[152]

If accrued interest is forgiven by the lender, the forgiveness is treated as if the interest computed under the split-dollar loan rules had been paid to the lender by the borrower then given by the lender to the borrower.[153] For example, On January 1, 2009, when the AFR is five-percent, employer makes a $100,000 premium payment on a split-dollar life insurance arrangement as a recourse loan to employee, the policy owner, repayable on December 31, 2011, at five-percent annual interest. On the repayment date employer waives payment of interest. Under the split-dollar rules for stated interest and OID, employer accrued compound interest at five-percent each year and employee was not entitled to an interest deduction. The interest payable less the interest actually paid is the waived interest, which is treated as a deemed transfer of interest to employer, then a retransfer of the interest as compensation to employee.[154] In addition to three years interest at five-percent compounded annually is $15,762.50 and treated as income paid to employee a deferral charge is added.[155]

## V. CONCLUSION

Because interest rates are low today and expected to rise in the future, funding a split-dollar arrangement owned by the employee, shareholder, or ILIT under the term loan regime locks in today's low interest rates and provides increasing tax benefits as interest rates rise in the future. The tax savings are not available under the economic benefit regime because the

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[150] Treas. Reg. § 1.7872-15(g)(5), Ex. (i) (2010).
[151] Treas. Reg. § 1.7872-15(g)(5), Ex. (ii) (2010).
[152] *Id.*
[153] Treas. Reg. § 1.7872-15(h)(1)(iv) (2010).
[154] *Id.*
[155] Treas. Reg. §§ 1.7872-15(h)(1)(i), 1.782-15(h)(1)(iii) (2010); Treas. Reg. § 1.7872-15(h)(4) , Ex. 1 (2010).

terms of the economic benefit regime measure imputed income by examining changes in cash value and term premiums directly rather than identifying below market interest charged on loans. To take advantage of the tax benefits, the donor and donee must structure the split dollar arrangement so as to lock in current interest rates for a long term, or for the life of the insured. Adroit use of the loan regime rules permit tax planners to produce favorable results for their clients by complying with the IRS rules and regulations.