



The Comprehensive Guide to Split Dollar Life Insurance



NFP BUSINESS PLANNING SERIES: THE COMPREHENSIVE GUIDE TO SPLIT DOLLAR LIFE INSURANCE

The world of split dollar life insurance agreements is a complicated one where old rules and regulations collide with newly issued rules and regulations, leaving planners wondering what to do next. Given the convoluted nature of the rules controlling split dollar life insurance agreements, there was no single source to turn to for answers — until now.

NFP Life is proud to present “The Comprehensive Guide to Split Dollar Life Insurance.”

NFP Life has always sought to provide the most relevant and useful tools to its members and producers. In keeping with that tradition, NFP Life teamed up with Greenberg Traurig to author the ultimate split dollar resource. This industry-leading publication addresses all types of split dollar arrangements, both pre- and post-final regulation, and the interplay of the split dollar rules with other related tax law in a user-friendly series of questions and answers.

TABLE OF CONTENTS

A. Overview of split dollar arrangements and this guide

- A.1. What Is Split Dollar?
- A.2. Why Use Split Dollar?
- A.3. What Is the Main Difference Between Business and Private Split Dollar Arrangements?
- A.4. What Rules Govern the Taxation of Split Dollar Arrangements?
- A.5. How to Use This Guide

B. General Concepts in Structuring Split Dollar Arrangements

KEY COMPONENTS

- B.1. What Are the Key Components in a Split Dollar Arrangement?

POLICY OWNERSHIP

- B.2. Who Owns the Policy Under a Split Dollar Arrangement?
- B.3. What Is the Endorsement Method?
- B.4. What Is the Collateral Assignment Method?
- B.5. Why Use the Endorsement Method Versus the Collateral Assignment Method?

PREMIUMS

- B.6. Who Pays the Policy Premiums Under a Split Dollar Arrangement?
- B.7. What Is a Non-contributory Plan?
- B.8. What Is a Contributory Plan?
- B.9. What Is “Bonus” Split Dollar?

POLICY EQUITY

- B.10. What Is Policy Equity?
- B.11. What Is an Equity Split Dollar Arrangement?
- B.12. What Is a Non-equity Arrangement?
- B.13. Why Use an Equity Arrangement Versus a Non-equity Arrangement?

ECONOMIC BENEFIT AND LOAN REGIME SPLIT DOLLAR

- B.14. What Do References to Economic Benefit or Loan Regime Split Dollar Mean?

C. Grandfathered Split Dollar Arrangements

DEFINITIONS

- C.1. What Is a “Grandfathered” Split Dollar Arrangement?

- C.2. What Is the “Entered Into” Date for a Split Dollar Arrangement?
- C.3. What Does “Materially Modified” Mean for a Grandfathered Split Dollar Arrangement?

FORMATION/STRUCTURE

- C.4. How Are Grandfathered Split Dollar Arrangements Typically Structured?
- C.5. How Are Equity and Non-equity Grandfathered Split Dollar Arrangements Identified?

TAXATION

- C.6. How Are Grandfathered Split Dollar Arrangements Taxed?
- C.7. How Is the Annual Economic Benefit Measured?
- C.8. What Term Insurance Rates Are Used to Determine the Annual Economic Benefit?
- C.9. Will Insurance Carriers Certify Their Insurer Term Rates for IRS Compliance?
- C.10. What Is the Impact of Using Table 2001 Rates Versus Insurer Term Rates to Determine the Annual Economic Benefit?
- C.11. Does the Annual Economic Benefit Change Each Year?
- C.12. What Is the Impact of an Increasing Annual Economic Benefit?
- C.13. What Happens When the Policy Is Paid up or the Business No Longer Needs to Advance Premiums?
- C.14. How Is the Annual Economic Benefit Taxed Under Contributory Plans?
- C.15. Does an Insured Receive Basis in the Policy for Reporting or Contributing the Annual Economic Benefit?
- C.16. Are Policy Dividends or Other Policy Benefits Taxed to the Insured Under Grandfathered Arrangements?
- C.17. How Is Policy Equity Taxed?
- C.18. What Does “No-inference” Mean with Regard to the Taxation of Policy Equity?
- C.19. What Are the Tax Consequences if an Insured’s Trust Owns the Policy?
- C.20. Do Imputed Gifts of the Annual Economic Benefit to an ILIT Qualify for the Annual Exclusion from Gift Tax?
- C.21. How Is the Imputed Income from the Arrangement Taxed to the Insured?
- C.22. Can the Business Take a Deduction for Premiums Paid Under a Grandfathered Split Dollar Arrangement?
- C.23. Are the Death Benefits Paid from the Policy Under a Grandfathered Split Dollar Arrangement Income-tax-free?

MATERIAL MODIFICATIONS

- C.24. What About “Material Modifications” to Grandfathered Split Dollar Arrangements?
- C.25. Why Does a Material Modification Matter?
- C.26. What Qualifies as a Material Modification?

- C.27. What Are the Tax Consequences of the Loss of Grandfathered Status?
- C.28. Does a 1035 Exchange Constitute a Material Modification?
- C.29. Will the IRS Privately Rule on What Qualifies as a Material Modification?
- C.30. Should 1035 Exchanges Still Be Considered for Grandfathered Arrangements?

MAINTENANCE AND ADMINISTRATION

- C.31. Should a Grandfathered Split Dollar Arrangement Be Maintained?
- C.32. What Are the Administration and Maintenance Requirements for Grandfathered Split Dollar Arrangements?

EXITS/TERMINATIONS/ROLLOUTS

- C.33. What Is an “Exit,” a “Termination” or a “Rollout”?
- C.34. Why Are Exits Important for Grandfathered Split Dollar Arrangements?
- C.35. What Are the Key Factors in Selecting and Implementing an Exit Strategy?
- C.36. What Are Potential Exit Strategies for a Grandfathered Arrangement?

CASE STUDIES

- C.37. Rollout from a Grandfathered Collateral Assignment Split Dollar (with Equity)
- C.38. Rollout from a Grandfathered Collateral Assignment Split Dollar (No Policy Equity)
- C.39. Termination of a Grandfathered Collateral Assignment Split Dollar (with Equity) and 162 Bonus of the Corporate Interest in the Policy

D. Post-regulation Split Dollar Arrangements

DEFINITIONS

- D.1. What Is a “Post-regulation” Split Dollar Arrangement?
- D.2. What Do the Terms “Entered into” and “Materially Modified” Mean for Purposes of the Final Regulations?
- D.3. What Is a “Split Dollar Arrangement” Under the Final Regulations?
- D.4. What Arrangements Are *Not* Split Dollar Arrangements?
- D.5. Who Is the “Owner” of a Policy Under a Split Dollar Arrangement?
- D.6. Who Is a “Non-owner”?
- D.7. Why Does Policy Ownership Matter?

TAXATION

- D.8. How Are Split Dollar Arrangements Taxed Under the Final Regulations?
- D.9. How Are Split Dollar Arrangements Taxed for Estate Tax Purposes?

ECONOMIC BENEFIT REGIME

- D.10. How Does the Economic Benefit Regime Tax Split Dollar Arrangements?

- D.11. What Are Recognizable Economic Benefits Under the Economic Benefit Regime?
- D.12. What Is the Cost of Current Life Insurance Protection Under the Economic Benefit Regime?
- D.13. How Is the Cost of Current Life Insurance Protection Calculated Under a Split Dollar Arrangement?
- D.14. What Is the Amount of Current Life Insurance Protection Provided Under a Split Dollar Arrangement?
- D.15. What Is the Impact of Using Table 2001 Rates Versus Insurer Term Rates to Calculate the Cost of Current Life Insurance Protection?
- D.16. Will Insurance Carriers Certify Their Insurer Term Rates for IRS Compliance?
- D.17. Will the Cost of Current Life Insurance Protection Increase Each Year?
- D.18. What Is the Impact of the Increasing Cost of Current Life Insurance Protection?
- D.19. What Happens When the Policy Is Paid Up or the Business No Longer Needs to Advance Premiums?
- D.20. What Is Current Access to Policy Cash Value (Equity Arrangements)?
- D.21. When Does the Non-owner Have Direct or Indirect Access to Policy Cash Value?
- D.22. How Is the Value of Current Access to Policy Cash Value Calculated?
- D.23. Can the Policy Cash Value or the Valuation Date Be Adjusted to Limit or Reduce the Value of the Non-owner's Current Access to Policy Cash Value?
- D.24. How Are Economic Benefits Taxed Under a Contributory Arrangement?
- D.25. Does the Non-owner Receive Basis in the Policy Under a Contributory Arrangement?
- D.26. How Are Distributions, Loans or Other Non-death Benefit Proceeds Received Under the Policy Taxed in the Economic Benefit Regime?
- D.27. Can the Business Take a Deduction for Premiums Paid Under an Economic Benefit Split Dollar Arrangement?
- D.28. How Are Policy Death Benefits Taxed Under The Economic Benefit Regime?
- D.29. What Are The Tax Consequences Upon a Transfer of the Policy to the Non-Owner?
- D.30. What Is the Policy's Fair Market Value for Purposes of a Transfer from an Owner to the Non-owner?
- D.31. What Is the Non-owner's Investment in the Contract After a Transfer of the Policy to the Non-owner?
- D.32. How Is the Income from the Split Dollar Arrangement Taxed to the Insured?
- D.33. What Are the Tax Consequences if an ILIT Owns or Has an Interest in the Policy Under the Economic Benefit Split Dollar Arrangement?
- D.34. Do Imputed Gifts of Economic Benefits to an ILIT Qualify for the Annual Exclusion from Gift Tax?

LOAN REGIME

- D.35. When Does the Loan Regime Apply to Split Dollar Arrangements?

- D.36. How Does the Loan Regime Tax Split Dollar Arrangements?
- D.37. What Payments Create Split Dollar Loans Under Loan Regime Split Dollar Arrangements?
- D.38. What Is a “Reasonable Expectation” of Repayment for a Split Dollar Loan?
- D.39. What if There Is No Reasonable Expectation of Repayment?
- D.40. Are Most Split Dollar Loans Considered Nonrecourse for Purposes of the Final Regulations?
- D.41. What Is the Impact of Having a Nonrecourse Split Dollar Loan?
- D.42. Can Parties to a Nonrecourse Split Dollar Loan Avoid Contingent Payment Treatment?
- D.43. What Is Adequate Interest for Purposes of Testing a Split Dollar Loan?
- D.44. What if a Split Dollar Loan Does Not Charge Adequate Interest?
- D.45. What Is a Split Dollar Demand Versus a Term Versus a Hybrid Loan?
- D.46. How Is a Split Dollar Demand Loan Tested for Adequacy of Interest?
- D.47. How Is a Below-market Split Dollar Demand Loan Taxed?
- D.48. How Are Split Dollar Term Loans Tested for Adequacy of Interest?
- D.49. How Is a Below-market Split Dollar Term Loan Taxed?
- D.50. How Are the Term and Adequacy of Interest Determined for Split Dollar Hybrid Loans?
- D.51. What Happens if a Split Dollar Hybrid Loan Exceeds Its Original Term?
- D.52. What if the Non-owner/Business Forgives, Cancels, Waives or Otherwise Pays the Outstanding Interest on a Split Dollar Loan?
- D.53. What if the Non-owner/Business Waives or Forgives Repayment of Loan Principal?
- D.54. How Is the Non-owner/Business Taxed on Interest and Other Payments Under a Split Dollar Loan?
- D.55. Who Accrues Policy Basis/Investment in the Contract for Premiums Paid Under Split Dollar Loans?
- D.56. How Is the Owner Taxed on Distributions, Withdrawals, Death Benefits or Other Proceeds Received from the Policy Underlying the Split Dollar Loan?
- D.57. Can the Non-owner/Business Deduct Premium Payments?
- D.58. How Is Imputed Income Under a Split Dollar Loan Taxed to the Insured?
- D.59. Can the Policyowner, as Borrower, Deduct Interest on the Split Dollar Loan?
- D.60. What if a Below-market Split Dollar Loan Is Made to a Third-party Owner (e.g., the Insured’s Trust)?

FORMATION AND ADMINISTRATION

- D.61. What Is the Typical Structure for Economic Benefit Split Dollar Arrangements?
- D.62. Why Use an Endorsement Arrangement Versus a Non-equity Collateral Assignment Arrangement?

- D.63. What Are the Formation Requirements for Economic Benefit Arrangements?
- D.64. What Are the Maintenance Requirements for Economic Benefit Arrangements?
- D.65. How Are Split Dollar Loans Typically Structured?
- D.66. Why Use a Demand Versus a Term Versus a Hybrid Split Dollar Loan?
- D.67. What Are the Formation and Administrative Requirements for a Split Dollar Loan?
- D.68. What Are the Maintenance Requirements for a Split Dollar Loan?

SELECTING REGIMES

- D.69. What Are the Main Factors in Selecting a Split Dollar Regime?
- D.70. When Should the Business and Insured Consider the Economic Benefit Regime?
- D.71. When Should the Business and Insured Consider a Split Dollar Loan?
- D.72. Are There Special Considerations for Split Dollar Arrangements Between Corporations and Majority Shareholders?

PRODUCT CONSIDERATIONS

- D.73. Why Are Cash Value Products Often Used in Split Dollar Arrangements?
- D.74. Should a MEC Be Used in a Split Dollar Arrangement?
- D.75. Are There Any Issues with Using Split Dollar Loans in Conjunction with Variable Policies?

EXIT/TERMINATION/ROLLOUT

- D.76. What Is a Split Dollar “Exit,” “Termination” or “Rollout”?
- D.77. Why Are Exits Important for Split Dollar Arrangements?
- D.78. What Are the Key Factors in Selecting and Implementing an Exit Strategy for a Split Dollar Arrangement?
- D.79. What Are Potential Exit Options for a Split Dollar Arrangement?
- D.80. What if Additional Premiums Are Required on the Policy After the Exit?

CASE STUDIES

- D.81. Loan Regime Split Dollar Between Business, as Employer, and Insured Executive’s ILIT — First Year
- D.82. Termination of a Loan Regime Split Dollar (with Equity)
- D.83. Termination of a Loan Regime Split Dollar (Without Equity)

E. Other Issues Under the Tax Code

IRC § 409A AND TAXATION OF NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENTS

- E.1. What Is IRC § 409A?
- E.2. When Did IRC § 409A Take Effect and Are There Any “Grandfathering” Protections?
- E.3. Does IRC § 409A Apply to Split Dollar Arrangements?

- E.4. What Happens if a Split Dollar Arrangement Is Not in Compliance with § 409A?
- E.5. What Specific Types of Compensatory Split Dollar Arrangements Are Affected by IRC § 409A?
- E.6. What Happens to Compensatory Equity Arrangements That Were in Place Before the Effective Date of IRC § 409A?
- E.7. How Are § 409A Grandfathered Benefits Taxed upon the Lifetime Termination of a Compensatory Equity Split Dollar Arrangement?

IRC § 101(J) AND TAXATION OF EMPLOYER-OWNED LIFE INSURANCE (EOLI)

- E.8. What Is an EOLI Contract?
- E.9. Does the EOLI Classification Apply to All Policies Meeting the EOLI Requirements, Regardless of When Issued?
- E.10. What Are the Consequences to EOLI Contract Status?
- E.11. Are Policies Underlying Split Dollar Arrangements EOLI Contracts?
- E.12. Are There Any Exceptions to Death Benefit Inclusion for EOLI Contracts?
- E.13. What Are the Notice and Consent Requirements for Taking Advantage of the Exceptions to EOLI Contract Taxation?
- E.14. Are There Any Corrective Actions the Employer Can Take if It Fails to Obtain the Employee's Notice and Consent Prior to Policy Issuance?
- E.15. Are There Any Reporting Requirements Associated with EOLI Contracts?

SARBANES-OXLEY ACT OF 2002

- E.16. How Does Sarbanes-Oxley Impact Split Dollar Planning?

Appendix of Charts and Select Sample Forms

- AP.1. CHART: Decision Tree for Grandfathered Split Dollar Arrangements
- AP.2. CHART: Taxation — Grandfathered Versus Post-regulation Arrangements
- AP.3. CHART: Post-regulation Arrangements — Economic Benefit Versus Loan Regime
- AP.4. CHART: Post-regulation Split Dollar — Types of Split Dollar Loans
- AP.5. CHECKLIST: Review Need for and Maintenance of Grandfathered Split Dollar Arrangement
- AP.6. CHECKLIST: Formation/Documentation of Economic Benefit Split Dollar Arrangement
- AP.7. CHECKLIST: Formation/Documentation of a Split Dollar Loan Arrangement
- AP.8. CHECKLIST: Questions for Reviewing/Selecting Split Dollar Exit Strategies
- AP.9. SAMPLE FORM: Nonrecourse Representation for Post-regulation Split Dollar Loan
- AP.10. SAMPLE FORM: Notice and Consent Form for IRC § 101(j) Employer-owned Life Insurance

DISCLAIMERS AND COPYRIGHT

Legal Disclaimer. This work and any forms and agreements herein are intended for educational and informational purposes only and not for use as legal, tax or financial advice. This work cannot be used by any taxpayer for the purpose of avoiding penalties that may be imposed on such taxpayer. Nothing contained in this work is to be considered as the rendering of legal, tax or financial advice, either generally or in connection with any specific issue, question or case. Readers are responsible for obtaining independent legal, tax or financial advice from their own lawyers or other professionals or advisors.

Financial Disclaimer. Any projections and illustrations provided herein are hypothetical approximations only, based on various factual, actuarial and tax assumptions. Actual results will vary and cannot be guaranteed. The authors do not sell investment or financial products nor provide financial or investment advice.

© 2014 Jonathan M. Forster and Jennifer M. Smith ("**Authors**"). All rights reserved. This work may be used, reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, by NFP Corp. ("**NFP**") (including branding with and transmission under the name of NFP) solely for the distribution to NFP and its owned and member firms ("**NFP Firms**") and the owners and employees of NFP and the NFP Firms. This work may not otherwise be used, reproduced, stored or transmitted without the express written consent of the Authors. No alterations, modifications, additions or supplements may be made to, or provided for, this work without the express written permission of the Authors.

THE COMPREHENSIVE GUIDE TO SPLIT DOLLAR LIFE INSURANCE

Section A: Overview of Split-Dollar Arrangements and This Guide

A.1. What Is Split-Dollar?

A split-dollar arrangement is an agreement between two parties (such as a business and employee) to split the costs and benefits of a life insurance policy insuring the life of one of the parties (e.g., the employee).

One party funds all or most of the policy premiums, retaining a right to repayment upon termination of the arrangement, which is generally paid from or secured by the proceeds of the policy.

At the death of the insured, or the prior termination of the arrangement (sometimes referred to as split-dollar “exit” or “rollout”), the premium advancer is reimbursed for the premiums it paid, plus any additional amounts required by the agreement, while the other party retains the remaining death benefit or, in the case of a lifetime termination, the policy (and depending on the arrangement, any remaining policy cash value).

A.2. Why Use Split-dollar?

The general goal behind a split-dollar arrangement is to lower the cost and/or tax burden of providing insurance coverage to the benefited party (i.e., the insured and/or the policy beneficiary).

The specific reasons for using a split-dollar arrangement depend in large part on whether the arrangement is entered into for business or private purposes. Business split-dollar arrangements (the focus of this guide) involve a business (typically a private, closely held or family-owned business)¹ and an owner or key employee and can be designed to achieve a wide variety of business planning and/or succession goals. For example:

- **Compensation/Benefits:** A business may enter into a split-dollar arrangement as part of a compensation package to recruit, retain and reward key employees, executives and officers. Depending on the structure of the arrangement, the insured receives death benefit protection and may also have ownership of the policy, including rights to cash value in excess of any amounts owed to the business to reimburse it for premiums paid on the policy.
- **Retirement Benefits/Deferred Compensation:** A business also may use a split-dollar arrangement in conjunction with a nonqualified deferred compensation arrangement, in which the business uses life insurance to informally fund future compensation payments or retirement benefits on a tax-efficient basis. For example, the business may use the cash value of a policy purchased on an executive or key employee to fund retirement benefits for the insured, as through a supplemental executive retirement plan (**SERP**). At the insured’s retirement, the business may access the cash value to pay the benefit.²
- **Buyout Funding:** A business and its owners may enter into split-dollar arrangements to acquire life insurance that will support the buyout of a business owner at death. For instance, in “cross-purchase” arrangements, each owner of the business buys life insurance on the other business

¹ Since implementation of the Sarbanes-Oxley Act of 2002 (“**SOX**”) and its restrictions on loans by public corporations to covered executives and directors, split-dollar arrangements have become far less common in a public company context. See **Question E.16** for a discussion of the impact of SOX on split-dollar arrangements.

² Note that the SERP arrangement and agreement will need to comply with IRC § 409A. See the discussion beginning at **Question E.1** for a more detailed review of IRC § 409A.

owner(s). If an owner dies, the surviving owner(s) must use the life insurance proceeds to purchase the deceased owner's interests. The business can enter into a split-dollar arrangement with each owner to pay part of the premium due on the policies purchased, retaining a reimbursement right for the amounts paid. This arrangement may assist if there are premium disparities among the policies due to age or health conditions of the various owners (e.g., one owner must pay more for a policy insuring another owner who is older or ill).

In a private context, split-dollar arrangements are designed to advance estate or wealth transfer planning goals and generally involve family members or trusts for their benefit. For example, an insured/grantor will often enter into a split-dollar arrangement with his or her irrevocable life insurance trust (**ILIT**) in order to reduce the potentially taxable contributions that the grantor must make to the ILIT to fund policy premiums.

A.3. What Is the Main Difference Between Business and Private Split-dollar Arrangements?

Apart from the different motivations for using a split-dollar arrangement, the main difference between business and private split-dollar arrangements is that the tax consequences related to typical private arrangements will be gift tax- rather than income tax-related. Otherwise, many of the same issues and considerations apply to both business and private split-dollar arrangements, and, in some cases, the planning goals will converge. For example, a business executive who wants to avoid inclusion of the life insurance death benefits in her estate may create an ILIT to receive or own the policy death benefits. To provide an added benefit to the executive (e.g., assistance with her estate planning goals), the business may enter into the split-dollar arrangement with the executive's ILIT rather than the executive. As discussed further in this guide, any income tax consequences from the arrangement will still apply to the executive, with corresponding gift taxation of the deemed transfer of benefits from the executive to her ILIT.

A.4. What Rules Govern the Taxation of Split-dollar Arrangements?

Effective Sept. 17, 2003, the IRS issued final Treasury Regulations regarding the employment, income and gift taxation of split-dollar arrangements (the "**final regulations**").³ Accordingly, the tax rules applicable to a particular split-dollar arrangement largely depend on the date the parties entered into the arrangement⁴:

- Split-dollar arrangements entered into on or before Sept. 17, 2003, and *not materially modified thereafter* (**grandfathered split-dollar arrangements**) are governed by a series of Revenue Rulings, Notices and other guidance issued by the IRS prior to the final regulations (**pre-regulation guidance**).⁵
- Split-dollar arrangements entered into or *materially modified* after Sept. 17, 2003, (**post-regulation split-dollar arrangements**) are subject to taxation based on the final regulations.⁶

³ See T.D. 9092, 68 *Fed. Reg.* 54,336 (Sept. 17, 2003).

⁴ See **Question C.2** for a definition of "entered into" for purposes of determining application of the final regulations to a split-dollar arrangement.

⁵ See Rev. Rul. 55-747 (revoked by Notice 2001-10); Rev. Rul. 64-328, as amplified by Rev. Rul. 66-110 and Rev. Rul. 78-420, and modified by Notice 2001-10 (generally the seminal ruling for taxing grandfathered split-dollar arrangement based on an "economic benefit" theory, the ruling was obsoleted for split-dollar arrangements entered into or materially modified after Sept. 17, 2003, by Rev. Rul. 2003-105); Rev. Rul. 66-110, as amplified by Rev. Rul. 67-154 and Rev. Rul. 78-420, and modified by Notice 2001-10 (obsoleted by Rev. Rul. 2003-105 for post-regulation split-dollar arrangements); Notice 2001-10, which revoked Rev. Rul. 55-747 and modified Rev. Ruls. 64-328 and 66-110 (this Notice was revoked by Notice 2002-8, except for the modifications made by Notice 2001-10 to Rev. Rul. 64-328 and Rev. Rul. 66-110 to the extent that those revenue rulings indicate that an employer's premium payments under a split-dollar arrangement may not be treated as loans); and Notice 2002-8 (while revoking Notice 2001-10, Notice 2002-8 provides that taxpayers may rely on either Notice 2001-10 or Notice 2002-8 for split-dollar arrangements entered into before Sept. 17, 2003 (see also T.D. 9092, 68 *Fed. Reg.* 54336 (9/17/03)). Accordingly, taxpayers may rely on Rev. Ruls. 64-328 and 66-110, as modified by Notice 2001-10, for grandfathered split-dollar arrangements, to the extent described in Notice 2002-8. Parties may also rely on the proposed regulations, if certain requirements are met (see 67 *Fed. Reg.* at 45422).

⁶ Regs. § 1.61-22(j)(1) and (2).

Given the significant differences that exist in taxation between grandfathered and post-regulation split-dollar arrangements, this guide separately analyzes the taxation, formation, administration and termination of each type of split-dollar arrangement, including changes to grandfathered arrangements that can trigger application of the final regulations.

See **Appendix AP.2** for a chart comparing grandfathered and post-regulation split-dollar arrangements.

A.5. How to Use This Guide

This guide is organized as a series of questions and answers that address common tax issues associated with grandfathered split-dollar arrangements and post-regulation split-dollar arrangements, which are used in a business or employment context. Citations to applicable source materials and technical comments are noted at the end of each section. An appendix with comparison charts and select sample forms is included for convenience and reference.

Section B: General Concepts in Structuring Split-dollar Arrangements

KEY COMPONENTS

B.1. What Are the Key Components in a Split-dollar Arrangement?

While there are numerous variations in split-dollar arrangements, their structure and documentation depend primarily on three major factors:

1. The ownership of the life insurance policy (**policy**)
2. The split of premium payments on the policy
3. The division of policy equity

POLICY OWNERSHIP

B.2. Who Owns the Policy Under a Split-dollar Arrangement?

Depending on the ownership structure selected, the business, the insured employee or business owner (the **insured**), or a third party chosen by the insured, such as his or her ILIT, is named as the owner on the policy. The most typical ownership structures are the endorsement method, where the business is the named policy owner, and the collateral assignment method, where the insured (or, commonly, his or her ILIT) is the designated policyowner.⁷

Note that the final regulations may treat the business as the “deemed” policy owner for purposes of taxation of the split-dollar arrangement, even if the insured or the insured’s ILIT is actually named as owner on the policy (e.g., as in a non-equity split-dollar arrangement (discussed in **Question B.12**) entered into between a business and employee, where the only benefit to the employee is current life insurance protection).⁸

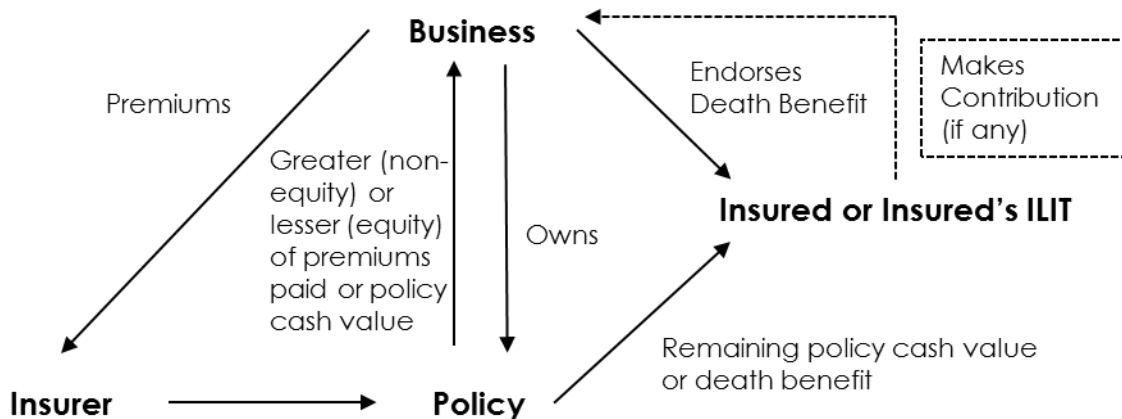
B.3. What Is the Endorsement Method?

In an endorsement split-dollar arrangement, the business owns and is the beneficiary of the policy on the insured.⁹ The business files a policy endorsement with the issuing insurance carrier, endorsing the insured’s interest in the policy death benefit (i.e., amounts in excess of the premiums advanced by the business). The insured has the sole right to designate the beneficiary for the endorsed portion of the death benefit.

⁷ Other, less-common ownership structures include 1) the unsecured method and 2) the co-ownership method. The unsecured method involves a purely contractual arrangement between the parties where the policy is not used to secure the business’ repayment right. This approach may minimize some problems associated with the traditional methods (such as the appearance of a loan), but the income tax treatment of the benefits provided to the employee is uncertain. The co-ownership method divides ownership of both the policy cash value and death benefit between the business and the employee (or other third-party owner), which attempts to address the potential taxation of the policy equity to the employee (as discussed at **Questions C.17** and **C.18**). The income tax impact of the arrangement is uncertain, however, and the arrangement is not conducive to managing the estate tax exposure of the insured if he or she is the controlling shareholder of the business. Both methods are deemed split-dollar arrangements for purposes of the final regulations. For a more detailed discussion of these alternate documentation arrangements, see Brody, Richey, and Baier, 386-4th BNA T.M Portfolio, *Insurance-Related Compensation*, Art. IV.B.2.

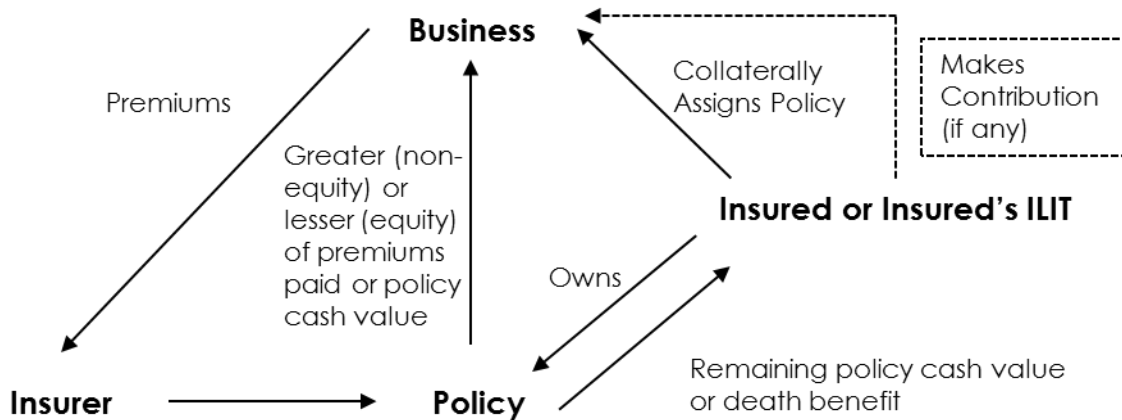
⁸ See **Questions D.5** and **D.6** for a detailed discussion of the rules identifying the “owner” and “non-owner” of a policy under the final regulations.

⁹ Note that whenever a business entity owns a life insurance policy, including under a policy subject to the terms of a split-dollar arrangement, the potential application of IRC § 101(j) should be reviewed. IRC § 101(j) provides for the income taxation of death benefits paid to owners of certain “employer-owned life insurance” contracts insuring the life of a business’ employee or other key individuals. Tax can be avoided in most situations if certain notice and consent requirements are met prior to contract issuance. IRC § 101(j) does *not* apply to policies issued prior to April 18, 2006, or received in an IRC § 1035 exchange for a policy issued prior to that date unless there is a material increase in the death benefit or other material change to the contract. See **Questions E.8-E.15** for a detailed discussion of IRC § 101(j) and the potential application to policies involving split-dollar arrangements.



B.4. What Is the Collateral Assignment Method?

Under a typical collateral assignment split-dollar arrangement, the insured (or, more commonly, the insured's ILIT) owns the policy and designates the beneficiary. The business pays the agreed-upon portion of the premiums, as specified in the split-dollar arrangement. The insured files a collateral assignment of the policy with the issuing insurance carrier, securing the business' right to repayment of its premium advances. The documentation under this method generally resembles a loan transaction.



B.5. Why Use the Endorsement Method Versus the Collateral Assignment Method?

As discussed in **Question D.8**, the selection of the documentation method for a post-final split-dollar arrangement will depend in part on the tax consequences associated with naming as the policy owner either the business (the endorsement method) or the insured (the collateral assignment method), including whether the insured will have any right to policy equity (see discussion of policy equity at **Question B.10**). Certain practical considerations, however, also impact the selection of the documentation method.

Endorsement. The selection of an endorsement arrangement depends on whether the business wants greater control over the policy or whether the business intends to retain ownership of the policy at the arrangement's termination. The business can retain the policy as key person coverage when the

arrangement terminates and use the policy's cash values and death proceeds to informally fund a nonqualified deferred compensation arrangement.

The endorsement method also is generally easy to implement and administer because the business is primarily responsible for all aspects of the policy management. A business can more easily convert an existing business-owned policy to a split-dollar arrangement by simply endorsing the death benefit to the insured, rather than by transferring ownership of the contract.

Further, in some cases, a business may wish to avoid the appearance of a loan or debt transaction with the insured because of applicable securities laws or existing lending agreements that restrict corporate loans to employees, such as the Sarbanes-Oxley Act of 2002 for public corporations (SOX).¹⁰ In these situations, a business may prefer the endorsement method, since the associated documentation looks less like a loan than the collateral assignment method.

Collateral Assignment. The collateral assignment method is generally employed when the insured 1) desires control over the policy and/or rights to the policy's equity (see discussion of policy equity at **Question B.10**), 2) already owns the policy or has a trust that owns the policy, and/or 3) will retain the policy, either directly or through his or her trust, upon termination of the arrangement. The collateral assignment method also can complement the insured's estate tax planning, since the insured's ILIT can directly apply for the policy and enter into the arrangement with the business. This keeps the policy death benefits out of the insured's estate and away from both the insured's and business' creditors, which may not be possible when the business owns the life insurance.

Prior to issuance of the final regulations, the collateral assignment method was the structure of choice for many grandfathered split-dollar arrangements. That structure provided the insured with control over the policy and attempted to provide income tax-free access to the policy's equity, which was expected to increase over time. Post-final split-dollar arrangements structured and taxed as loan arrangements generally will be documented as collateral assignment arrangements (see discussion at **Question D.8**).

PREMIUMS

B.6. Who Pays the Policy Premiums Under a Split-dollar Arrangement?

With regard to premiums, split-dollar arrangements are either structured as 1) non-contributory plans, where the business pays all premiums, or 2) contributory plans, where the premiums are split between the business and insured.

As discussed in **Questions C.14** and **C.15**, prior to the issuance of the final regulations, contributory plans not only allowed the insured to offset any imputed taxable income by an amount equal to the contribution made by the insured (or by the insured's ILIT), but also, according to many, provided the insured (or his or her ILIT) with an income tax basis in the policy. Further, such contributions were income-tax-neutral with regard to the business. The final regulations, however, changed the tax benefits associated with contributory plans, significantly impacting their use in structuring premium splits. Thus, while certain contributory plans will no longer make sense for new arrangements, they may still be found in certain grandfathered split-dollar arrangements.

B.7. What Is a Non-contributory Plan?

Under non-contributory plans (also called "employer-pay-all" plans), the split-dollar agreement requires the business to pay each premium on a policy, in full, for the duration of the arrangement, without any

¹⁰ Federal and state securities laws can impact split-dollar arrangements involving publicly traded companies, with potentially serious consequences. In particular, a split-dollar arrangement resembling a loan transaction may cause issues under SOX due to its prohibition on personal loans to directors and covered executives. See **Question E.16** for a more extensive discussion of the impact of SOX on split-dollar arrangements. Note that although SOX does not technically apply to nonprofit organizations, many of these organizations have voluntarily adopted certain SOX-like provisions, including prohibitions on personal loans to directors and executives. If working with a nonprofit, be sure to review the organization's policies and whether a split-dollar arrangement with an organization's director or executive would be in compliance.

offsetting contributions from the insured. At the earlier of the insured's death or other termination of the arrangement, the business recoups its premium advances (and any other amounts specified under the split-dollar agreement) from the policy death benefit or cash value, as applicable, with any excess passing to the insured or his or her designated beneficiary.¹¹

Practice Note: To offset the continual reduction in the employee's portion of the death benefit due to the increase in the business's premium reimbursement rights over time, the parties may agree to purchase a type of policy that would supplement the total death benefit amount payable to the employee. This can be accomplished through the purchase of a policy with an increasing death benefit, a return of premium rider or an agreement that policy dividends will be applied to the purchase of one-year term insurance on the employee.

B.8. What Is a Contributory Plan?

A contributory plan is any split-dollar arrangement in which the insured (or his or her ILIT) contributes a portion of the premium payments. While there are numerous ways to divide the premium obligations between the business and the insured, common premium splits include the following¹²:

- **“Classic” Split:** In a classic split, the business pays only that part of the annual premium equal to the annual increase in the policy's cash value (or the entire premium, if lower), with the insured paying the balance.
 - **Example:** X Co. and executive, E, enter into a contributory split-dollar arrangement to acquire a \$1 million policy on E, with a classic premium split. The annual premium is \$10,000. In the first year, the policy's cash value increases by \$1,500. X Co. pays \$1,500 and E pays the balance of the premium, \$8,500. In the next year, the cash value increases by \$3,000. X Co. pays \$3,000 and E pays \$7,000 of the premium. When the policy's cash value eventually increases by \$10,000, X Co. pays the total premium.

This premium split minimizes the business' exposure by trying to ensure that the policy always has sufficient cash value to reimburse the business' premium advances. The insured, however, must initially bear a larger share of the premiums, until there is sufficient growth in the policy's cash value. These initial contributions by the insured may exceed the actual income that would otherwise be taxable to the insured under the split-dollar arrangement, which typically is based on the annual cost of the term life insurance protection provided to the insured. The insured, however, cannot apply the excess contributions to offset future imputed income.

- **Level Outlay Plan¹³:** A level outlay plan is designed to minimize the initial premium burden to the insured from the classic split. Under this premium split, the parties specify a term during which the insured's share of the premiums will remain the same. The insured's share is determined by taking an average, over the specified term, of the portion of the annual premium equal to the value of the term life insurance protection provided on the insured's life (the **“term cost”**), generally as determined under tables issued by the IRS (currently, Table 2001).¹⁴ The insured annually pays this average term cost during the leveling period, with the business covering the balance.
 - **Example:** X Co. and executive, E, enter into a contributory split-dollar arrangement to acquire a \$1 million policy on E, and agree to a 10-year level-outlay split. E is age

¹¹ In some cases, since the business is the only party invested in the policy, a non-contributory arrangement may require the insured to personally reimburse the business for premiums paid but not recovered due to early termination of the insured's employment, although the insured will likely view this as an undesirable financial burden.

¹² For a more detailed discussion of possible premium split arrangements, see Zaritsky & Leimberg, *Tax Planning With Life Insurance: Analysis With Forms*, § 6.05 [1][a] and [b] (Thomson Reuters/WG&L, 2d Ed. 1998, with updates through May 2013)(online version accessed on Checkpoint (www.checkpoint.riag.com); Brody, Richey, and Baier, 386-4th T.M., *Insurance-Related Compensation*, Art. VI.B.1.

¹³ See Zaritsky & Leimberg, *Tax Planning with Life Insurance: Analysis with Forms*, § 6.05 [1][b][i], *supra*, note 12.

¹⁴ See **Questions C.7-C.9** for a discussion of the determination of the annual term cost.

45 at the start, and the annual premium is \$10,000. Based on Table 2001, the average annual term cost of \$1 million of life insurance on E for 10 years is \$2,360. For each of the first 10 years of the arrangement, E will pay \$2,360 of the annual premium, with X Co. paying \$7,640.

As compared to the classic-split, the level-outlay plan substantially lessens the premium share initially attributable to the insured, better matching the amount that would otherwise be taxable income to the insured. The plan, however, increases the business' exposure, because there will be insufficient cash value in the early policy years to reimburse the business if the insured's employment is terminated. As with a non-contributory plan, the business may require personal reimbursement from the insured for unrecovered premiums due to early termination.

- **Contributory Offset or Zero-tax Split¹⁵:** In this premium split, the insured pays the portion of the premium equal to the value of the annual term cost. The business pays the balance of the annual premium, if any.
 - **Example:** Assume the same facts as above, except the X Co. and E agree to a zero-tax premium split. In the first year, E is 45 years old. The Table 2001 cost per \$1,000 of term life coverage for an individual age 45 is \$1.53, so E's portion of the premium is \$1,530. X Co. pays the remaining \$8,470.

The insured's contribution offsets the imputed taxable income equal to the term cost of the insurance coverage, which should minimize or eliminate the insured's tax liability with regard to the arrangement.

B.9. What Is "Bonus" Split-dollar?

As a variation of the contributory offset plan, a business may bonus the amount of the insured's tax liability with respect to the benefits under the split-dollar arrangement. Alternatively, the business may bonus both the tax liability and the tax on the bonus, eliminating all tax costs to the insured (sometimes called a "gross-up").

POLICY EQUITY

B.10. What Is Policy Equity?

A cash value life insurance product effectively has three parts: 1) cash value reflecting the total premiums paid, 2) gain in the contract, or cash value in excess of premiums paid and 3) the death benefit in excess of the total cash value.¹⁶ While the term "equity" may refer generally to the gain portion of the contract,¹⁷

¹⁵ Confusingly, a reference to a "contributory plan" may specifically mean this type of economic benefit offset plan. Such plans also were formerly known as "P.S. 58 offset" or "P.S. 58 contribution" arrangements, because the value of the taxable benefit provided to the employee (i.e., the annual cost of life insurance coverage) was based on the P.S. 58 mortality tables originally published in 1946. In 2001, the IRS replaced the P.S. 58 tables with Table 2001 (see Notices 2001-10, 2001-1 CB 459, and 2002-8, 2002-1 CB 398).

¹⁶ See David Houston and Maggie Mitchell, "Skeletons in the Closet: What to Do with "Grandfathered" Split-Dollar Arrangements," *The AALU Quarterly*, Spring 2012.

¹⁷ *Id.* Some discussions of split-dollar arrangements will reference "equity" as the difference between the premiums paid and the policy's cash value. See e.g., David Houston and Maggie Mitchell, "Skeletons in the Closet: What to Do with "Grandfathered" Split-Dollar Arrangements," *supra* note 16 ("Equity refers to the [policy] cash value in excess of [total] premiums paid."); Kathryn G. Henkel, "Estate Planning and Wealth Preservation: Strategies and Solutions," § 2.06 (Thomson Reuters/WG&L 1997, with updates through Nov. 2013) (online version accessed on Checkpoint (www.checkpoint.riag.com) Feb. 2014) ("An equity split-dollar arrangement generally involves an arrangement where the term portion owner also receives benefits attributable to investment performance of the policy (e.g., cash surrender value in excess of premiums paid)."); William P. Streng and Mickey R. Davis, "Retirement Planning: Tax and Financial Strategies," § 17.02[2][c][iv] (ThomsonReuters/WG&L, 2013 ed., updated Sept. 2013 and visited Feb. 2014) (At the "crossover point," when the investment returns on the assets within the insurance policy overcome the insurance charges, commissions, and administration charges that initially eroded the cash value, the policy cash value exceeds the amount of premiums paid, creating "equity" in the contract.").

in the context of split-dollar arrangements, it also may refer specifically to the portion of the policy cash value in excess of the premiums advanced by the business under the arrangement.¹⁸

Example: X Co. and executive, E, have an employer-pay-all split-dollar arrangement for a \$1 million policy insuring E. The policy has a current cash value of \$500,000. The business has advanced \$300,000 in premiums. The policy “equity” is \$200,000.

B.11. What Is an Equity Split-dollar Arrangement?

In an equity split-dollar arrangement, the insured has an interest in or right to some or all of the policy equity during and/or after termination of the arrangement, in addition to current life insurance protection.¹⁹ Although equity arrangements can be structured as endorsement split-dollar, they are more typically documented under the collateral assignment method.

In a typical equity split-dollar arrangement, the business’ reimbursement right is for the *lesser of* 1) the total premiums it paid or 2) the policy’s cash value. Any policy equity passes to the insured when the split-dollar arrangement terminates.

Example: Using the facts of the example in **Question B.10** above, if X Co. and E decide to terminate the arrangement, X Co. will be reimbursed for \$300,000 (the premiums it advanced), with E being entitled to the policy equity of \$200,000.

Practice Note: Not all policies underlying equity split-dollar arrangements will have an equity component. For example, an underperforming policy may fail to develop any cash value over the premiums paid by the business.

B.12. What Is a Non-equity Arrangement?

As the converse to an equity arrangement, a non-equity split-dollar arrangement is one in which the business provides the insured solely with current life insurance protection, but no interest in the policy equity. The business pays the premiums and retains the right at termination of the split-dollar arrangement to receive the *greater of* 1) the total premiums paid or 2) the policy’s cash value. The insured has the right to designate the beneficiary for the portion of the death benefit in excess of the business’ interest in the policy.

¹⁸ See e.g., Charles L. Ratner and Stephan R. Leimberg, “A Planner’s Guide to Split-Dollar After the Final Regulations,” *Estate Planning Journal* (WG&L), Jan. 2004 (In equity split-dollar, “the employer is usually repaid the lesser of 1) the total premiums it advanced or 2) the policy’s cash value. Any cash value greater than the employer’s share is the equity, which is, from inception, nonforfeitable by the employee but physically passes to the employee when the arrangement is terminated.”); Lawrence Brody and Michael D. Weinberg, “The Side Fund Split-Dollar Solution: A New Technique for Split-Dollar,” note 11, *Estate Planning Journal* (WG&L), Jan. 2006 (“Equity” means cash value in excess of the amount necessary to repay the corporation or the grantor for their premium outlays.”). See also TAM 9604001 (where, in an effort to currently tax the buildup of policy “equity” under a grandfathered split-dollar arrangement to the insured, the IRS refers to the portion potentially taxable to the insured as “any cash surrender buildup in the policies that exceeds the amount that is returnable to [business] when the arrangement is discontinued”) and Notice 2002-8, Sec. IV.1. (where, in setting forth certain safe harbors for the taxation of grandfathered split-dollar arrangements, the IRS states that “For split-dollar life insurance arrangements entered into before the date of publication of final regulations, the Service will not treat a service recipient as having made a transfer of a portion of the cash surrender value of a life insurance contract to a service provider for purposes of section 83 solely because the interest or other earnings credited to the cash surrender value of the contract cause the cash surrender value to exceed the portion thereof payable to the service recipient.”).

¹⁹ See e.g., Zaritsky & Leimberg, “Tax Planning With Life Insurance: Analysis With Forms,” § 6.05[1][b][v], *supra* note 12 (“An equity split-dollar life insurance arrangement allows the employee to retain some or all of the excess of the cash surrender value above the amounts contributed by the employer.”); Lawrence Brody and Mary Ann Mancini, “Sophisticated Life Insurance Techniques,” ABA Section of Taxation Meeting, May 2011, Art. II.C.1.a. (“The taxation of policy equity in pre-final regulation arrangements – Defined: An arrangement where there are policy cash values in excess of cumulative premiums due back to the premium provider and the premium provider is only to get back its premiums, so that those excess cash values belong to the policyowner.”).

B.13. Why Use an Equity Arrangement Versus a Non-equity Arrangement?

The decision to use an equity or non-equity split-dollar arrangement will depend primarily on the purpose of the arrangement and the benefits the business desires to provide the insured. Where the business needs or wants to retain full access to, or control over, policy cash value, as a form of golden handcuffs or to fund later retirement benefits for a key employee, a non-equity arrangement will likely be used. If the business wants the insured to benefit and/or have current/future access to the growth within the policy, then an equity arrangement likely will make sense.

ECONOMIC BENEFIT AND LOAN REGIME SPLIT-DOLLAR

B.14. What Do References to Economic Benefit or Loan Regime Split-dollar Mean?

As discussed in detail in **Section D**, the final regulations provide two mutually exclusive regimes to determine the taxation of post-regulation split-dollar arrangements²⁰: 1) the economic benefit regime²¹ and 2) the loan regime.²² Which regime applies to the post-regulation arrangement depends on which party is the deemed owner of the policy for purposes of the final regulations — where the business is the deemed owner, the economic benefit regime generally applies, and when the insured (or his or her ILIT) is the deemed owner, the loan regime applies.

In most cases, the endorsement method will correspond to taxation under the economic benefit regime (because the business is the policy owner) and the collateral assignment method to taxation under the loan regime (because the insured or his or her ILIT is the policy owner). Under a special rule, however, a collateral assignment arrangement between a business and insured that only provides the insured with current life insurance protection (and no access to or rights to policy cash value) will still be governed by the economic benefit regime, even if the insured (or his or her ILIT) is named as the policy owner.²³

Example: X Co. and executive E's ILIT enter into a split-dollar arrangement governed by the final regulations. X Co. owns the policy and, upon termination of the arrangement, is entitled to the greater of premiums advanced or the policy's cash value. E's ILIT is entitled to any death benefits paid under the policy in excess of the amounts owed to X Co. This is a non-equity endorsement, economic benefit arrangement. Consider, however, if E's ILIT owned the policy, but with X Co. still entitled to receive, upon termination of the arrangement, the greater of the policy cash value or the premiums it advanced upon termination of the arrangement, secured by a collateral assignment of the policy. Even though documented as a collateral assignment arrangement with the policy owned by the insured's ILIT, the arrangement would be taxed under the economic benefit regime, because the only value provided to the insured (through his or her ILIT) is current life insurance protection.

Practice Note: Although a post-regulation split-dollar arrangement will often be identified or referred to by the tax regime that applies to it, the documentation of the policy ownership under the post-regulation arrangement generally will still be based on the endorsement method or the collateral assignment method.

²⁰ See Regs. §1.61-22(a)(2) and (b)(3).

²¹ Governed by Reg. §1.61-22.

²² Governed by Reg. §1.7872-15.

²³ See Reg. §1.61-22(c)(1)(ii)(A)(1), which provides that an employer or service recipient is treated as the owner of a policy underlying a split-dollar arrangement that is entered into in connection with the performance of services, even if not the named owner of the policy, if, at all times, the *only* economic benefit that will be provided under the arrangement is current life insurance protection. In such a case, the economic benefit regime would apply, regardless of the ownership documentation method used. See **Questions D.5-D.8**.

Section C: Grandfathered Split-dollar Arrangements

DEFINITIONS

C.1. What Is a “Grandfathered” Split-dollar Arrangement?

A grandfathered split-dollar arrangement is an arrangement entered into on or before, and not “materially modified” after Sept. 17, 2003, the effective date of the final split-dollar Treasury Regulations (“**final regulations**”).²⁴ See comparison of grandfathered and post-regulation split-dollar arrangements at **Appendix AP.2**.

Practice Note: Parties to grandfathered arrangements and post-regulation arrangements can experience significant differences in the determination and taxation of the benefits provided to the insured under the arrangement. For example, an insured’s access to policy equity (i.e., cash value in excess of premiums paid, see **Question B.10**) is currently taxable to the insured under the final regulations, but not necessarily under a grandfathered arrangement, while the arrangement is in effect (see **Question C.17**). Thus, a critical first step when dealing with any existing split-dollar arrangement is to confirm whether you are dealing with a grandfathered or post-regulation arrangement (see **Question C.2** below), since the administration, potential taxation and recommendations for modifying or terminating an arrangement will vary significantly depending on this initial classification.

C.2. What Is the “Entered Into” Date for a Split-dollar Arrangement?

For purposes of determining whether the final regulations apply, a split-dollar arrangement is entered into upon the *latest to occur* of the following:

1. The date on which the life insurance policy is issued
2. The effective date of the policy
3. The date on which the first premium on the policy is paid
4. The date on which the parties enter into a split-dollar arrangement
5. The date the arrangement satisfies the definition of a split-dollar arrangement under the final regulations²⁵

Thus, the backdating of the effective date of a life insurance policy would not have prevented application of the final regulations to a split-dollar arrangement involving that policy if any of the other actions noted above occurred at a date later than the policy’s effective date.

C.3. What Does “Materially Modified” Mean for a Grandfathered Split-dollar Arrangement?

A material modification to a grandfathered split-dollar arrangement is a change to the terms or economics of the arrangement significant enough to result in application of the final regulations to the arrangement. For a discussion of what constitutes a material modification to a grandfathered split-dollar arrangement, and the potential consequences resulting from such a modification, see the discussion beginning at **Question C.24**.

Practice Note: When dealing with a grandfathered split-dollar arrangement, always review and consider the potential for a material modification if recommending any adjustment or change to the arrangement, whether to the agreement itself or the underlying policy. Such changes may include an Internal Revenue

²⁴ See Regs. § 1.61-22(j)(1) and (2).

²⁵ See Reg. § 1.61-22(j)(1)(ii). For meeting the definition of a split-dollar agreement under the final regulations, see Reg. § 1.61-22(b).

Code (IRC) §1035 tax-free policy exchange, a reduction to or increase in the policy death benefit, a change in any party to the agreement or assignment of any rights under the agreement to a different party, etc.

FORMATION/STRUCTURE

C.4. How Are Grandfathered Split-dollar Arrangements Typically Structured?

The typical structure for a grandfathered split-dollar arrangement generally depends on whether the arrangement intended for any equity build-up in the policy to benefit the insured (see discussion of policy equity beginning at **Question B.10**):

- *Non-equity Arrangements*: More likely structured as endorsement arrangements, with the business owning the underlying policy.
- *Equity Arrangements*: Typically structured as collateral assignments, although endorsement arrangements are possible, with the insured (or frequently, the insured's ILIT) owning the policy. Many grandfathered split-dollar arrangements include an equity component, since they were commonly used as part of employee compensation packages to provide additional retirement benefits to key employees and executives through access to the policy's cash value.

C.5. How Are Equity and Non-equity Grandfathered Split-dollar Arrangements Identified?

Included at **Appendix AP.1** is a decision tree that outlines the key questions for determining whether an existing split-dollar arrangement is a grandfathered split-dollar arrangement, with or without an equity component.

TAXATION

C.6. How Are Grandfathered Split-dollar Arrangements Taxed?

The taxation of grandfathered split-dollar arrangements is governed by a series of overlapping Revenue Rulings, Notices, and other guidance issued by the IRS prior to its publication of the final regulations, with Notice 2002-8 generally controlling the application of this prior guidance (collectively the “**pre-regulation guidance**”).²⁶

Parties to a grandfathered split-dollar arrangement also may rely on the proposed regulations issued prior to the final regulations, provided that all parties to the split-dollar arrangement treat the arrangement consistently. For example, an owner and a non-owner of a policy subject to a grandfathered split-dollar arrangement may not rely on the proposed regulations if one party treats the arrangement as subject to the economic benefit rules of Prop. Reg. §1.61-22, and the other party treats the arrangement as subject to the loan rules of Prop. Reg. §1.7872-15.²⁷ In addition, parties to an equity split-dollar arrangement subject to the economic benefit regime may rely on the proposed regulations only if the value of all economic benefits taken into account by the parties exceeds the value of the economic benefits the parties would have taken into account if the arrangement were a non-equity split-dollar life insurance

²⁶ See Rev. Rul. 55-747 (revoked by Notice 2001-10); Rev. Rul. 64-328, as amplified by Rev. Rul. 66-110 and Rev. Rul. 78-420, and modified by Notice 2001-10 (generally the seminal ruling for taxing grandfathered split-dollar arrangements based on an “economic benefit” theory, the ruling was obsolete for split-dollar arrangements entered into or materially modified after Sept. 17, 2003, by Rev. Rul. 2003-105); Rev. Rul. 66-110, as amplified by Rev. Rul. 67-154 and Rev. Rul. 78-420, and modified by Notice 2001-10 (obsolete by Rev. Rul. 2003-105 for post-regulation split-dollar arrangements); Notice 2001-10, which revoked Rev. Rul. 55-747 and modified Rev. Ruls. 64-328 and 66-110 (this Notice was revoked by Notice 2002-8, except for the modifications made by Notice 2001-10 to Rev. Rul. 64-328 and Rev. Rul. 66-110 to the extent that those revenue rulings indicate that an employer's premium payments under a split-dollar arrangement may not be treated as loans); and Notice 2002-8 (while revoking Notice 2001-10, Notice 2002-8 provides that taxpayers may rely on either Notice 2001-10 or Notice 2002-8 for split-dollar arrangements entered into on or before Sept. 17, 2003 (see also T.D. 9092, 68 Fed. Reg. 54336 (9/17/03)). Accordingly, taxpayers may rely on Rev. Ruls. 64-328 and 66-110, as modified by Notice 2001-10, for grandfathered split-dollar arrangements, to the extent described in Notice 2002-8.

²⁷ See 67 Fed. Reg. at 45422.

arrangement (determined using the Table 2001 rates in Notice 2002-8), thereby reflecting the fact that such an arrangement provides the non-owner with economic benefits that are more valuable than current life insurance protection.

Taken in its entirety, the pre-regulation guidance focuses on the taxation of two components of grandfathered split-dollar arrangements:

1. **Economic Benefit:** Measurement and taxation of the annual “economic benefit” of current life insurance coverage provided to the insured
2. **Equity:** Taxation of the insured’s interest in or access to policy equity, if any

C.7. How Is the Annual Economic Benefit Measured?

For parties to a grandfathered split-dollar arrangement that continues to provide an annual economic benefit to the insured,²⁸ the value of the economic benefit generally equals the current value of the life insurance protection provided for the insured, based on the one-year term insurance rates (“**term insurance rates**”) for insuring an individual of the insured’s age.

The insured’s annual economic benefit, once determined under the applicable term insurance rate, is reduced by any contribution made by the insured towards the premiums, as in a “contributory plan” (see discussion of contributory plans at **Question B.8**). This net amount is reportable by and taxable to the insured.

C.8. What Term Insurance Rates Are Used to Determine the Annual Economic Benefit?

The term insurance rates available to determine the annual economic benefit vary depending on the “entered into” date of the grandfathered split arrangement, assuming no material modification of the agreement thereafter:

- **Arrangements Entered into Before Jan. 28, 2002.**²⁹ These arrangements can take advantage of the following measuring term insurance rates:
 - *Table 2001.* Issued with Notices 2001-10 and 2002-8, the Table 2001 rates replace the prior “P.S. 58” mortality tables issued by the IRS in 1946 and measure the value of current life insurance protection on a single life policy provided under a split-dollar arrangement. The Table 2001 rates are much lower than the P.S. 58 rates, reflecting currently longer life expectancies for individuals but are typically higher than most insurance carriers’ annually published alternative term rates.
 - Table 2001 does not provide for survivorship rates, although Notice 2002-8 instructs taxpayers to make “appropriate adjustments” to these premium rates if the life insurance protection covers more than one life. Survivorship rates will generally be lower than single life rates until the death of the first insured, at which point the insurance rates generally will experience a significant increase.
 - **Practice Note:** Many practitioners believe the “Greenberg to Greenberg” formula should be used to determine survivorship rates, as updated with Table 2001 rates.³⁰

²⁸ As discussed *infra* in note 26, Notice 2002-8 gave parties to grandfathered split-dollar arrangements certain options to convert or terminate certain grandfathered split-dollar agreements by Dec. 31, 2003.

²⁹ See Notice 2002-8, Sec. III.

³⁰ Based on the letter dated August 10, 1983, from IRS actuary Norman Greenberg (in response to a request from Morton Greenberg, Counsel and Director of Advanced Underwriting, Manufacturer’s Life), in converting individual PS 58 rates to PS 38 survivorship rates. See Michael F. Amoia, Kristen E. Simmons, and Robert C. Slane, “Private Split-dollar - What’s New about an Old Opportunity,” *NAEPC Journal of Estate & Tax Planning* (June 2009); Lawrence Brody, Michael D. Weinberg, and Myron Kove, “Practice Alert: Experts’ Critical Analysis of Final Split-Dollar Regulations,” *Estate Planners Alert Newsletter (RIA)* (Dec. 2, 2003).

- *Insurer's Alternative Published Term Rates ("Insurer Term Rates")*. Insurer term rates may be used if they 1) are lower than the Table 2001 rates and 2) represent the issuing insurer's published premium rates available to all **standard risks** for \$1,000 of initial issue one-year term life insurance.³¹
- *P.S. 58 Rates*. The P.S. 58 rates may be used if the split-dollar arrangement specifically authorizes their use to measure the value of current life insurance protection provided to the insured. Both the Table 2001 rates and the Insurer Term Rates, however, are much lower than the P.S. 58 rates, and the use of the lower of those rate tables will be preferred in almost all cases.³²
- **Entered into After Jan. 28, 2002, but Before the Final Regulations.**³³ These arrangements have more limited options, as follows:
 - *Table 2001*. Parties to these arrangements may use the Table 2001 rates.
 - *Insurer Term Rates With Restrictions*. After Dec. 31, 2003, the Insurer Term Rates also may be used, *but they must meet these additional requirements to be considered available to all standard risks*:
 - The insurer generally makes the availability of such rates known to persons who apply for term coverage from the insurer, and
 - The insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels.³⁴

Practice Note: The requirement that the insurer regularly sell term insurance at the published, generally available rates may pose a problem for post-Jan. 28, 2002, grandfathered arrangements involving policies issued by insurance carriers that no longer issue life insurance products or are no longer in business. Parties to these grandfathered arrangements may need to use the Table 2001 rates to determine the annual economic benefit under the arrangement.

C.9. Will Insurance Carriers Certify Their Insurer Term Rates for IRS Compliance?

No, insurance carriers generally will not opine as to whether their Insurer Term Rates comply with the additional restrictions imposed on the use of such rates for grandfathered split-dollar arrangements after Dec. 31, 2003.³⁵

³¹ See Notice 2002-8, Sec. III.3, referencing Rev. Rul. 66-110, as amplified by Rev. Rul. 67-154.

³² See Notice 2002-8, Sec. III.1. The higher P.S. 58 rates generally were only attractive for use in measuring the benefit provided to the business in "reverse" split-dollar arrangements, where the business pays the share of the premium equal to the annual term insurance cost, determined under IRS tables (i.e., the P.S. 58 rates), and the insured pays the balance. As reverse split-dollar was effectively eliminated by the IRS with the guidance issued in Notices 2001-10, 2002-8 and 2002-59, such arrangements are not reviewed in detail in this guide. For more information on reverse split-dollar generally and the use of P.S. 58 rates, see Zaritsky & Leimberg, *Tax Planning With Life Insurance: Analysis With Forms*, §6.05[1][b][iv] (Thomson Reuters/WG&L, 2d Ed. 1998, with updates through May 2013)(online version accessed on Checkpoint (www.checkpoint.riag.com) on June 2013); Brody, Richey, and Baier, 386-4th T.M., *Insurance-Related Compensation*, Art. VI.C.3.c.; Harris, "Reverse Split-Dollar Entered Into Before Notice 2002-59: Legitimate or Not?" 31 *Est. Plan.* 69 (Feb. 2004); and Leimberg, "Split-Dollar: Split, Rip, or Tear?" 31 *U. Miami Est. Plan. Inst. ch. 11* (1997).

³³ See Notice 2002-8, Sec. III, which, interestingly, specifies requirements for the use of Insurer Term Rates for split-dollar arrangements entered into before Jan. 28, 2002, and after Jan. 28, 2002, but not on Jan. 28, 2002. Thus, it "is unclear what happens if the arrangement is entered into on Jan. 28, 2002." Louis A. Mezzullo, "Life Insurance Planning," dated April 9, 2012, Art. VI. F.1.b.(1) in materials for The American Law Institute Continuing Legal Education and American College of Trust and Estate Counsel Telephone Seminar/Webcast: "How to Handle the Toughest Issues in the Operation and Succession of a Family Business," Sept. 11, 2012.

³⁴ See Notice 2002-8, Sec. III.3.

³⁵ See Lawrence Brody and Charles L. Ratner, "What To Do With Those Existing Split-Dollar Plans," *Trusts & Estates* (March 2007), stating, "In practice today, some carriers use 'old' rates; others do not. While carriers using old term rates might tell planners they're confident those rates qualify under Notice 2002-8, they generally don't provide a guarantee. Some carriers let the planner decide which rate, old or new, to use."

Practice Note: While, in practice, advisors and clients may continue to use the lower Insurer Term Rates, the client bears the risk of whether the IRS will accept these rates.

C.10. What Is the Impact of Using Table 2001 Rates Versus Insurer Term Rates to Determine the Annual Economic Benefit?

Since Insurer Term Rates are generally much lower than the Table 2001 rates, the inability to use the Insurer Term Rates can significantly increase the taxable economic benefit to the insured.

Example: Under Table 2001, the term rate for an insured, age 65, is \$11.90 per \$1,000 of death protection. Assume an insurer who issues a policy underlying a split-dollar arrangement has published Insurer Term Rates for the same age of \$2.03 per \$1,000. On \$1 million of current life insurance protection, the difference in the taxable economic benefit under the two rates would equal almost \$10,000.

Presumably, if the IRS challenges the use of an Insurer Term Rate, the annual economic benefit would be re-determined based on the higher Table 2001 rate, with any corresponding federal income and gift tax liability adjusted accordingly.³⁶

Practice Note: If the insured is deemed to make a gift of the annual economic benefit to a third party, as when the insured's ILIT owns the policy (see **Question C.19**), the insured may want to consider adequately disclosing on a Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return" the use of the Insurer Term Rates to determine the annual economic benefit and corresponding gift. This will start the running of the return's statute of limitations, particularly if there is any allocation of federal generation-skipping transfer ("GST") tax exemption to the gift.³⁷

C.11. Does the Annual Economic Benefit Change Each Year?

Yes, the annual economic benefit increases each year with the age of the insured, and, in the case of a survivorship policy, will generally rise steeply at the death of the first insured.

Example: Under Table 2001, the term rate for an insured, age 45, is \$1.53 per \$1,000 of death protection, but rises to \$11.90 for an insured at age 65. If a split-dollar arrangement provides \$1 million of current life insurance protection, the annual economic benefit is \$1,530 for the 45-year-old and \$11,900 for the 65-year-old, a difference of over \$10,000.

Practice Note: The constantly rising rates will make the imputed tax burden to the insured increasingly difficult to bear, often necessitating a planned termination or "exit" of the arrangement, as discussed in **Question C.12**.

C.12. What Is the Impact of an Increasing Annual Economic Benefit?

The continual increase in the annual economic benefit as the insured ages means most grandfathered split-dollar arrangements need "exit" strategies to terminate the arrangement before the economic benefit becomes overly burdensome. This often occurs when the insured reaches an age with significant annual term rates or at the death of the first insured in a survivorship policy.

For example, in a typical grandfathered equity split-dollar arrangement, the business would pay premiums for the initial 15 years, at a level projected to be sufficient to generate enough cash value for the insured (or his or her ILIT) to thereafter terminate the arrangement, use the cash value, through loans or withdrawals, to repay the business for the premiums advanced and avoid the need for additional cash premiums from the business or insured to support the policy into the future.

Practice Note: In some cases, however, policy cash value may not have grown as projected, leaving insufficient value to support a rollout of the policy or termination of the arrangement. The parties will need to consider other exit strategies, which may have varying and potentially unanticipated tax consequences.

³⁶ *Id.*

³⁷ See IRC §6501(c)(9); Reg. §301.6501(c)-1(f).

See the discussion of possible exit (also referred to as “rollout”) strategies and related issues for grandfathered split-dollar arrangements beginning at **Question C.33**.

C.13. What Happens When the Policy Is Paid up or the Business No Longer Needs to Advance Premiums?

The annual economic benefit attributable to the current life insurance protection under the grandfathered split-dollar arrangement must be contributed or reported and taxed to the insured for each year that the arrangement remains in place, even if the business is no longer advancing premiums to the insurance carrier.³⁸ If an ILIT owns the policy, the annual economic benefit also will continue to be a gift to the trust (see **Question C.19**).

C.14. How Is the Annual Economic Benefit Taxed Under Contributory Plans?

As discussed in **Question B.8**, in a “contributory plan,” the insured contributes a part of the premium payment, while the business pays the balance. The insured’s contribution offsets the otherwise taxable annual economic benefit to the insured.³⁹

Example: E, a 50-year-old executive, has a grandfathered split-dollar arrangement with his company, which provides him with \$1 million of death benefit protection. The Table 2001 cost for \$1 million of term life coverage for an individual age 50 is \$2,300, so E’s reportable income from the arrangement is \$2,300. E contributes \$2,300 toward the policy’s premium, leaving him with \$0 of taxable income from the arrangement.⁴⁰

Accordingly, if the insured contributes an amount equal to the total annual economic benefits received under the arrangement, he or she completely offsets the resulting taxable income.⁴¹ Note that the insured likely cannot carry forward any excess contributions to offset the annual economic benefits provided under the grandfathered arrangement in future years, so there is little tax benefit in making contributions in excess of the amount taxable to the insured.⁴²

As discussed in **Questions D.24** and **D. 25**, the final regulations change the treatment of contributory plans by treating any contributions made by the non-owner of the policy under the split-dollar arrangement (e.g., an insured in an endorsement arrangement) as taxable income to the business.⁴³ The final regulations should not affect grandfathered contributory split-dollar arrangements, however, which should be able to continue indefinitely without generating tax to the business, unless the arrangement is materially modified.

C.15. Does an Insured Receive Basis in the Policy for Reporting or Contributing the Annual Economic Benefit?

Most parties to grandfathered split-dollar arrangements have taken the position that each party has an “investment in the contract” (i.e., basis in the policy) for purposes of policy surrenders or withdrawals from

³⁸ See e.g., TAM 9604001.

³⁹ See Rev. Rul. 64-328.

⁴⁰ See Zaritsky & Leimberg, *Tax Planning with Life Insurance: Analysis with Forms*, §6.05[1][b][iii], *supra* note 32.

⁴¹ Note that, as discussed at **Question C.16**, the employee also must include in gross income any policyholder dividends or benefits applied for his or her benefit, such as to purchase additional term insurance, paid-up insurance, or waiver of premiums. If the employee wants to fully offset his or her reportable income from a grandfathered split-dollar arrangement that provides such benefits, their value must be included in the contribution amount.

⁴² See Zaritsky & Leimberg, *Tax Planning with Life Insurance: Analysis with Forms*, §6.05[3][a][ii], *supra* note 32.

⁴³ Reg. §1.61-22(f)(2)(ii).

policy cash value, etc. under IRC §72⁴⁴ in an amount equal to each party's actual or deemed contributions to policy premiums.⁴⁵

Example: X Co. and executive E entered into a grandfathered split-dollar agreement for a policy providing \$1 million of death benefit protection. The annual premium is \$10,000. Each year, E contributes the annual economic benefit that would otherwise be imputed to him as income under the arrangement. In the first year, E was 50 years old. Under Table 2001, the cost of term life coverage for E, and his portion of the premium, was \$2,300. X Co. paid the remaining \$7,700. At the end of Year 1, each party takes a position that their respective investment in the contract is as follows: E's – \$2,300; X Co.'s – \$7,700.

For noncontributory grandfathered split-dollar arrangements, an insured's inclusion and reporting of the annual economic benefit amount as taxable income also may provide the insured with corresponding basis in the policy.⁴⁶

Note that the final regulations drastically alter the rules regarding the accumulation of basis in a policy subject to a split-dollar arrangement (see discussion at **Question D.25**). For purposes of IRC §72, basis in the policy only accrues for the benefit of the deemed owner of the policy, regardless of how the parties split the premiums. Under the final regulations, a party to a split-dollar agreement can be a "deemed" policy owner, even if not named as such on the policy (see discussion at **Question D.5**).

For example, an employer or service recipient is treated as the owner of a policy under a split-dollar arrangement that is entered into in connection with the performance of services, even if not the named owner of the policy, if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection.⁴⁷ These rules, however, should not impact grandfathered split-dollar arrangements unless they are materially modified.

⁴⁴ See IRC §72(e)(6), which defines "investment in the contract" for purposes of amounts not received as an annuity under a life insurance contract (including policy surrenders, cash value withdrawals and dividends), as the aggregate amount of premiums or other consideration paid for the contract before such date, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

⁴⁵ See e.g., PLRs 7916029 and 8310027. See also Charles L. Ratner and Stephan R. Leimberg, "A Planner's Guide to Split-Dollar After the Final Regulations," *Estate Planning Journal* (WG&L), Jan. 2004 (stating that, in the context of traditional grandfathered endorsement split-dollar arrangements, "[c]onventional wisdom was that the employee received a basis in the policy for those contributions."). But see Charles L. Ratner and Stephan R. Leimberg, "Planning for Split-Dollar Under the Latest Prop. Regs.: 20 Questions," *Estate Planning Journal* (WG&L), Aug. 2003 (stating in a discussion of grandfathered arrangements that "[a]s to basis, our concern is that the IRS may not give basis credit to a taxpayer's payment of economic benefit costs against policy equity and will argue that what was paid (i.e., the cost of term insurance) was used up in obtaining that term coverage — and cannot be double-credited against policy cash values.").

⁴⁶ See, e.g., *G. S. Neff, et ux., et al. v. Comm'r*, T.C. Memo 2012-244, where the Tax Court stated, in footnote 9 of its opinion, that if the taxpayers had reported any taxable income relating to the economic benefits of their grandfathered split-dollar arrangements and the insurance policies, they could have asserted and would have been entitled to a reduction in their potential tax exposure for their resulting tax bases in the policies. See also LISI Employee Benefits and Retirement Planning Newsletter 613, Sept. 4, 2012, at <http://www.leimbergservices.com> (in discussing the *Neff* decision, stated that "Footnote 9 [of the *Neff* case] affirms the view that for grandfathered [split-dollar arrangements], a taxpayer may claim that reporting economic benefit income increases the taxpayer's 'basis' in the contract."); Brody, Richey, and Baier, *Insurance-Related Compensation*, Art. VI.G.1.g, *supra* note 8 (stating that "although neither [PLR 7916029 or 8310027] dealt with the issue of reporting of the economic benefit as income in an employer pay-all plan, that should also constitute basis for this purpose (under the general income tax theory that basis is created by including an item in income as well as by paying cash for its acquisition). This concept is used to reinforce the policy equity ownership concept generated by the employee's contributions."); Lawrence Brody, "Cutting Edge Split-Dollar – After the Notices and Proposed Regulations," 2002 ACTEC Southeast Regional Fall Meeting, Nov. 10, 2002 (stating that "[w]ithdrawals are tax-free only up to the owner's basis — for collateral assignment arrangements, only the contributed or taxed economic benefit amounts."). But see discussion at note 20 regarding concerns over whether basis credit will apply for amounts attributable to the economic benefit costs, which were used to obtain term insurance coverage.

⁴⁷ See Reg. §1.61-22(c)(1)(ii)(A)(1), an employer or service recipient is treated as the owner of a policy under a split-dollar arrangement that is entered into in connection with the performance of services, even if not the named owner of the policy, if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection.

C.16. Are Policy Dividends or Other Policy Benefits Taxed to the Insured Under Grandfathered Arrangements?

The insured must include in gross income “all the benefits” received under the grandfathered split-dollar arrangement for the given year (less any amount contributed by the insured), including any policyholder dividends or “other benefits” paid in cash to the insured or used to provide the insured with additional term insurance, paid-up insurance, waiver of premiums, etc.⁴⁸

Any application of policy dividends for the benefit of the insured is includible in the insured's taxable income to the extent of the benefit provided, as follows:

- Dividends paid in cash are taxable in full.
- Dividends used to buy paid-up insurance or term insurance solely for the benefit of the insured or his or her designated beneficiary are taxable in full.
- Dividends used to buy paid-up insurance in which the business and the insured each have an interest under the split-dollar arrangement (e.g., the business retains rights in the cash surrender value of the additional insurance) produce an added economic benefit for the insured based on the cost of the current life insurance protection provided by the additional insurance purchased. In other words, as determined by applying applicable term insurance rates to the additional insurance protection.

Example: A closely held business is party to a grandfathered split-dollar arrangement with K, a 45-year-old key employee who is the insured under a \$1 million policy. The business has paid cumulative premiums of \$80,000, with no contributions by K, leaving \$920,000 at risk. A policy dividend of \$500 is applied as follows: 1) \$120 to purchase one-year term insurance of \$80,000 to offset the decrease in the death benefit payable to K after reimbursement of the business and 2) \$380 to reduce the business' current annual premium payment. The taxable amount to K can be calculated as follows:

○ Annual Economic Benefit to K	\$1,407.60
(\$920,000/\$1,000) x \$1.53 (Table 2001 rate)	
○ Policy Dividend Applied to One-year Term Insurance	<u>\$ 120.00</u>
○ Total Taxable Benefit to K	\$1,527.60

Universal or variable life insurance products would appear to avoid the dividend issue, since they use internal policy crediting, rather than dividends, to increase cash values or death benefits.⁴⁹

C.17. How Is Policy Equity Taxed?

In equity split-dollar arrangements, the insured receives an interest in the policy cash value in excess of the total premiums paid by the business. Many grandfathered split-dollar arrangements were created as equity arrangements to take advantage of the perceived ability to transfer that policy equity to the insured on a tax-free basis. Under this theory, premiums advanced by the business in excess of the term cost of life insurance escaped treatment as taxable compensation or as an interest-free loan, as long as the

⁴⁸ See Rev. Rul. 66-110. These principles apply to all split-dollar plans for income tax purposes regardless of whether documented as endorsement or collateral assignment arrangements (Rev. Rul. 64-328). Presumably, this reasoning would include any taxable benefits (e.g., stock) received by the employee through the demutualization of an insurance carrier that issued the policy underlying the split-dollar arrangement (although the determination and calculation of the taxable amount, and whether it would be offset by any basis in the policy attributable to the employee, is an unsettled area, see e.g., *Dorrance v. U.S.*, 111 AFTR 2d 2013-1280 (DC AZ, 3/19/2013); *Reuben v. U.S.*, 111 AFTR 2d 2013-620 (DC CA, 1/15/2013)).

Note that this use of “all the benefits” language also may be critical to the positions taken regarding the taxation of equity arrangements, as discussed in **Question C.17** and **C.18**, as the IRS may cite it as existing guidance for currently taxing the equity made available to the employee under such an arrangement.

⁴⁹ Brody, Richey, and Baier, *Insurance-Related Compensation*, Art. VI.C.2, *supra* note 32.

business had the right to reimbursement for its advances. This arguably allowed the policy equity to accrue for the benefit of the insured (or his or her ILIT) without income taxation, unless withdrawals were made in excess of policy basis. For policies owned by an ILIT, the accumulating value of policy equity also avoided gift tax.

In grandfathered non-equity split-dollar arrangements, the employee has no interest in or access to policy equity, so a termination of the arrangement prior to the insured's death should involve no deemed taxable transfer of policy equity, unless and to the extent that the business forgives its right to be paid the amounts due it under the arrangement.

The tax treatment of policy equity eventually became a focal point for the IRS in its review of split-dollar arrangements, and the final regulations specifically provide for the current taxation of policy equity in post-regulation split-dollar arrangements.⁵⁰ For grandfathered arrangements, however, the pre-regulation guidance does not provide a consistent theory for equity taxation,⁵¹ which has generated significant uncertainty. Notice 2002-8 offered some relief through the provision of limited safe harbors for the termination or conversion of grandfathered equity split-dollar arrangements, most of which expired on Dec. 31, 2003.

For grandfathered split-dollar arrangements entered into before Jan. 28, 2002, Notice 2002-8 provided safe harbors for avoiding taxation of the policy equity ("**equity safe harbors**") if, before Jan. 1, 2004, the arrangement was terminated or was converted to a loan under IRC §7872 or other applicable tax law provisions. If the parties elected to convert the arrangement to a loan, all payments by the business from inception of the arrangement, reduced by any prior repayments to the business, before the first taxable year in which such payments were treated as loans for federal tax purposes must be treated as loans entered into at the beginning of that first year in which such payments are treated as loans. Note that these equity safe harbors were not available for grandfathered split-dollar arrangements entered into after Jan. 28, 2002, but before the effective date of the final regulations.

For grandfathered equity arrangements that continue to remain in place:

No Tax for Duration of Arrangement. As long as the arrangement is not materially modified,⁵² the parties to the arrangement continue to treat and report the value of the current life insurance protection as an economic benefit provided to or on behalf of the insured, and the business retains some reimbursement interest in the arrangement, the IRS should not seek to tax the insured on the policy equity.⁵³

⁵⁰ See Reg. §1.61-22(d)(2)(ii), discussed in **Questions D.20-D.23**.

⁵¹ See Brody, Richey, and Baier, *Insurance-Related Compensation*, Art. VI.C and Art. VI.G.1, *supra* note 32, for a general discussion of the various taxation theories for equity split-dollar arrangements.

⁵² See discussion at **Questions C.24** through **C.30** regarding material modifications of a grandfathered split-dollar agreement.

⁵³ See Notice 2002-8, which provides that:

"1. For split-dollar life insurance arrangements entered into before the date of publication of final regulations, the Service will not treat a service recipient as having made a transfer of a portion of the cash surrender value of a life insurance contract to a service provider for purposes of section 83 solely because the interest or other earnings credited to the cash surrender value of the contract cause the cash surrender value to exceed the portion thereof payable to the service recipient.

2. For split-dollar life insurance arrangements entered into before the date of publication of final regulations, in cases where the value of current life insurance protection is treated as an economic benefit provided by a sponsor to a benefited person under a split-dollar life insurance arrangement, the Service will not treat the arrangement as having been terminated (and thus will not assert that there has been a transfer of property to the benefited person by reason of termination of the arrangement) for so long as the parties to the arrangement continue to treat and report the value of the life insurance protection as an economic benefit provided to the benefited person. This treatment will be accepted without regard to the level of the remaining economic interest that the sponsor has in the life insurance contract."

It appears that this rule applies during any period of time that the business has any right to recover premium advances under the arrangement. See Andrew C. Liazos, "Split-Dollar Life Insurance Arrangements," Sec. III.B., *Joint Committee on Employee Benefits, 23rd Annual Institute on Compensation for Executive and Directors* (Nov. 11, 2008).

Potential Tax upon Termination/Rollout. The IRS may seek to tax the insured on any policy equity upon a termination of the existing grandfathered equity arrangement during the insured's lifetime, since it took this position in various pieces of pre-regulation guidance released prior to Notice 2002-8.⁵⁴

Until Notice 2002-8, certain pre-regulation guidance indicated that the IRS would seek to tax the equity build-up in a policy subject to a grandfathered split-dollar arrangement, but still provided little detail as to when or how the equity would become taxable to the employee. Specifically, in TAM 9604001, the IRS considered the income and gift tax implications of a collateral assignment equity split-dollar arrangement in which an irrevocable trust owned the policy. The IRS concluded that growth in policy equity was taxable income to the employee and also constituted a gift from the employee to the trust. The IRS applied IRC §83, which addresses the timing and taxation of the transfer of property to an employee in connection with performance of services. Pursuant to IRC §83, an employee is taxable on such property once it becomes transferable or free of substantial risk of forfeiture. Because the business' creditors could only attach the amount of cash value that equaled the cumulative premiums paid by the business, the IRS found that the excess cash value belonged to the employee without a risk of forfeiture.

Note that there may be some uncertainty as to when policy equity develops for purposes of a grandfathered split-dollar arrangement. The IRS, when discussing the taxability of policy equity, makes reference to the "cash surrender buildup" and "cash surrender value" respectively, in excess of amounts due to the business.⁵⁵ However, with regard to the current taxation of policy equity under the economic benefit regime of the final regulations, Reg. §1.61-22(d)(4)(i) provides that, for purposes of determining the portion of the policy cash value accessible and thus taxable to the non-owner, the policy cash value is determined without regard to surrender or similar charges (see discussion at **Question D.22**). It also may be interesting to note that, with regard to distributions of life insurance policies from nonqualified employee benefit plans, the valuation safe harbors in Rev. Proc 2005-25 do not permit potential surrender charges to be taken into account in valuing the policies for purposes of distribution. However, the decisions in *Lowe v. Comm'r* and *Schwab v. Comm'r*, which both dealt with policy distributions from nonqualified employee benefit plans prior to the issuance of Rev. Proc. 2005-25, both held that, in certain circumstances, it may be appropriate to take into account surrender charges when valuing a distributed policy.⁵⁶ Perhaps the terms of the agreement underlying the grandfathered split-dollar arrangement will control, if they specify that the insured/insured's ILIT is entitled to policy cash *surrender* value in excess of amounts due as repayment to the business.

Example: X Co. and executive, E, have an employer-pay-all equity split-dollar arrangement for a \$1 million policy insuring E. The policy has a current cash value of \$500,000, and X Co. has paid total premiums of \$300,000. If X Co. and E decide to terminate the arrangement, X Co. will be reimbursed for the \$300,000 (the premiums advanced). E is entitled to the policy and the policy equity of \$200,000. The IRS may attempt to tax the full amount of policy equity, less any basis E has in the policy, as compensation to E,⁵⁷ at maximum income tax rates of up to 39.6 percent as of 2014 — a top tax liability of up to \$79,200.

As discussed in **Question C.18** below, however, the "no-inference" language of Notice 2002-8 arguably allows parties to the arrangement to take a contrary position.

⁵⁴ See Ratner and Leimberg, "A Planner's Guide to Split-Dollar After the Final Regulations," *supra* note 45 (stating "[b]ut when does equity occur? The answer to this seemingly simple question may not be simple. For instance, is it measured with – or without – consideration of any surrender charges? (In the authors' opinion, the fair response should be that surrender charges should be considered, but that may not be the IRS position.)" See TAM 9604001 and Notices 2001-10 and Notice 2002-8.

⁵⁵ See TAM 9604001 and Notices 2001-10 and Notice 2002-8.

⁵⁶ See T.C. Memo 2011-106 (May 19, 2011) and 136 T.C. No. 6 (Feb. 7, 2011).

⁵⁷ See e.g., Howard M. Zaritsky and Stephan R. Leimberg, *Tax Planning With Life Insurance: Analysis With Forms* (Thomson Reuters/WG&L, 2d Ed. 1998, with updates through Jan. 2014)(online version accessed on Checkpoint (www.checkpoint.riag.com) Feb. 2014), §6.05[3][e][ii], noting, under the discussion of Notice 2002-8, that the "IRS will not currently tax the employee on the equity value of the policy, but the employee will be taxed when the split-dollar arrangement is terminated, to the extent that the cash value of the policy distributed to the employee exceeds the employee's contributions to the purchase price."

C.18. What Does “No-inference” Mean with Regard to the Taxation of Policy Equity?

Notice 2002-8 specifically states that, except for the standards used to measure the value of current life insurance protection provided under a grandfathered split-dollar arrangement:

No inference should be drawn from this notice regarding the appropriate Federal income, employment and gift tax treatment of split-dollar life insurance arrangements entered into before the date of publication of final regulations.

Essentially, this language means that Notice 2002-8, Notice 2001-10 and the proposed or final regulations *cannot be used by either the IRS or a taxpayer* to argue that the policy equity is or is not taxable upon termination of a grandfathered equity arrangement. Both sides can rely only on the guidance and laws as they existed before Notice 2001-10.

Practically speaking, the “no-inference” language allows parties to a grandfathered equity split-dollar arrangement to take a reporting position, based on pre-Notice 2001-10 law, that policy equity is not taxable upon rollout. *The language, however, does not offer, nor should it be interpreted to offer, any guarantee, that the IRS will agree with or forgo a challenge to a no-tax position.*⁵⁸ Unfortunately, since Notice 2008-8, the IRS has not confirmed in any published guidance or opinion whether or how it would attempt to tax the policy equity.⁵⁹

C.19. What Are the Tax Consequences if an Insured’s Trust Owns the Policy?

In many grandfathered split-dollar arrangements, particularly collateral assignment arrangements, an ILIT created by the insured owns the policy in order to keep the death benefit proceeds out of the insured’s estate.⁶⁰ In such a case, the annual economic benefit provided under the arrangement will not only constitute taxable income to the insured, but will be an imputed gift by the insured to the ILIT, subject to gift tax (e.g., if the reportable annual economic benefit to an insured under a grandfathered arrangement is \$2,300, he or she is deemed to make a \$2,300 gift to the ILIT that holds the underlying policy).⁶¹

If the ILIT contributes to the premium payments, as with a contributory plan, the contributions will offset the otherwise taxable income to the insured. The contributions presumably also offset any deemed gift by the insured to the ILIT for gift tax purposes. The impact of these tax benefits is reduced if the insured must make gifts to the ILIT to provide it with funds to make premium contributions under the split-dollar arrangement. The significant increase in the federal gift and GST tax exemptions over the years,

⁵⁸ See Brody, Richey, and Baier, 386-4th T.M., *Insurance-Related Compensation*, Art. VI.C.4.d., *supra* note 32. See also Ratner and Leimberg, “A Planner’s Guide to Split-Dollar After the Final Regulations,” *supra* note 45 (“Just because the IRS will presumably press for taxation of the equity as taxable income and taxable gift does not mean that the IRS is right or that it will prevail in court. On the other hand, [Notice 2002-8] does not indicate that the IRS will not find taxable income under Section 61!”).

⁵⁹ For example, although policy equity taxation was a possible issue, the IRS apparently did not raise it in *Neff v. Comm’r* (*supra* note 21), which involved the termination of several grandfathered split-dollar arrangements between founding owners/employees and their company. At termination, the company had advanced \$842,345 in premiums, and the policies’ cash surrender values totaled \$877,432. The owners’ advisors calculated that the “present value” of the company’s \$842,345 reimbursement right was \$131,969, relying on the premise that premium reimbursement was only due upon the death of an insured. The owners paid the discounted amount to the company and did not include in their taxable income any amounts relating to the premiums paid by the company or the \$710,376 difference between the \$131,969 paid to company and the \$842,345 the company actually paid in policy premiums. On audit, the IRS determined that the owners realized taxable compensation income of \$710,376, which was upheld by the Tax Court.

The deficiency of \$710,376 assessed by the IRS, however, only represented the difference in the total premiums advanced by the company and the amount reimbursed to it upon termination of the split-dollar arrangements. Apparently, the taxation of the \$35,087 of policy equity (cash value of \$877,432 less \$842,345 of premiums) was not mentioned or addressed. It is unclear whether the failure of the IRS to raise the issue indicates anything about its beliefs regarding the taxation of policy equity in grandfathered arrangements, or whether the IRS simply choose not to address the issue because of the relatively small amount of equity involved or a reluctance to litigate the “no inference” provision, discussed below.

⁶⁰ The structure is intended to avoid the application of IRC §§2042 (which includes the death benefits payable under a policy in the insured’s estate if he or she retained any incidents of ownership in the policy at death) and 2035 (which includes the death benefits payable under a policy in the insured’s estate if he or she relinquishes, within three years of death, all such incidents of ownership in the policy).

⁶¹ Rev. Rul. 81-198; Rev. Rul. 78-420; TAM 9604001; PLR 8003094.

however, likely facilitates making large gifts to ILITs that can cover annual contributions for numerous years.

Example: E, a 50-year-old executive, has an ILIT that entered into a grandfathered split-dollar arrangement with his company, providing for \$1 million of death benefit coverage. The Table 2001 cost for this protection is \$2,300. E made annual exclusion gifts to his ILIT, which contributed the annual economic benefit each year, leaving E with \$0 reportable income from the arrangement. To reduce the hassle of dealing with annual exclusion gifts and to make use of the larger federal transfer tax exemptions, E gives \$1 million to the ILIT, applying a corresponding portion of his federal gift and GST tax exemption to shelter the gift. Assuming the ILIT assets generate a conservative 2-percent annual return and the death benefit coverage remains level, the ILIT should have sufficient income to make the annual contributions for many years without additional gifts from E. For example, in 15 years, when E is 65, the ILIT should have the income to pay the annual economic benefit of \$11,900.

As with the annual economic benefit, if the policy equity under a grandfathered equity arrangement becomes taxable, such as upon rollout of the arrangement, not only will the equity be imputed income to the insured, but it also likely will be treated as an imputed, taxable gift from the insured to the trust.⁶²

Example: X Co. and an ILIT created by executive E have an employer-pay-all equity split-dollar arrangement for a \$1 million policy insuring E. The policy has a current cash value of \$500,000, and X Co. has paid total premiums of \$300,000. If X Co. and ILIT decide to terminate the arrangement, X Co. will be reimbursed for the \$300,000 (the premiums advanced). ILIT is entitled to the policy and the policy equity of \$200,000. The IRS may attempt to tax the \$200,000 of policy equity, less any applicable basis in the policy (see **Question C. 15**), both as compensation income to E, at maximum income tax rates of up to 39.6 percent (in 2014) — a top tax liability of up to \$79,200, and as a gift to the ILIT, a potential liability of up to \$80,000 at a top gift tax rate of 40 percent (in 2014).

These imputed gifts also will constitute GSTs for GST tax purposes and are potentially subject to an immediate GST tax if they are made to a “skip” person. A skip person is an individual more than one generation removed from the insured or to a trust solely benefiting such individuals.⁶³

Practice Note: If the imputed gifts are made to skip persons or to an ILIT that the insured intends to be GST tax exempt, the insured should consider allocating his or her GST tax exemption to such transfers by filing a Form 709, “United States Gift (and Generation-Skipping Transfer) Tax Return,” reporting the transfer and the commensurate GST allocation. This allocation of GST tax exemption may be required even if the imputed gift to the ILIT qualifies for the annual exclusion from gift tax (as discussed below in **Question C.20**). Annual exclusion gifts to many trusts do not automatically qualify for the annual exclusion from GST tax, since those requirements are far more restrictive.⁶⁴

Practice Note: As noted at **Question C.10**, if the parties to the grandfathered split-dollar arrangement use the Insurer Term Rates to determine the annual economic benefit and corresponding gift (see **Question C.8** for a discussion of applicable Insurer Term Rates), the insured may want to consider adequately disclosing this on Form 709 to start the running of the return’s statute of limitations, particularly if there is any allocation of GST tax exemption to the gift.

⁶² See TAM 9604001.

⁶³ For 2014, the federal GST tax exemption amount is \$5,340,000, which is indexed annually for inflation. See Rev. Proc. 2014-18.

⁶⁴ See IRC §2642(c).

C.20. Do Imputed Gifts of the Annual Economic Benefit to an ILIT Qualify for the Annual Exclusion from Gift Tax?

In 2014, a person's first \$14,000 of annual gifts to a donee is generally exempt from federal gift tax ("annual exclusion gifts").⁶⁵ A gift only qualifies as an annual exclusion gift if the donee has a "present interest" in the gift, as with an outright gift.⁶⁶

Gifts to trusts, including ILITs, however, typically do not meet this requirement unless the trust gives the beneficiaries the power to withdraw all or part of the gift, up to the gift tax annual exclusion amount (a "Crummey power"). The trust beneficiaries commonly receive notice of the gifts and their corresponding Crummey powers. Unexercised Crummey powers lapse after a specified period of time, and the gift remains in the trust.

A donor may not always make direct gifts to the trust so that assets are available to satisfy exercised Crummey powers. For example, in a non-contributory split-dollar arrangement involving an insured's ILIT, the insured does not make any contributions to the ILIT. Rather, the business pays the premiums directly to the insurance carrier. Income is imputed to the insured in the amount of the economic benefit provided under the agreement, with a corresponding imputed gift by the insured of those economic benefits to the ILIT. Often, the ILIT will only hold the policy and have no other assets from which to pay any potential withdrawal demand.

In cases where the ILIT holds the policy and no other assets, the availability of the annual exclusion to shelter the imputed gift to the ILIT most likely depends on 1) whether the beneficiaries received notice of their withdrawal rights,⁶⁷ 2) the availability of the policy or its cash value for use in satisfying exercised Crummey powers and 3) the flexibility provided by the terms of the ILIT.

This issue is more straightforward under a contributory plan, since the insured typically makes an annual contribution to the ILIT so the trustee can apply it to the ILIT's portion of the premium. Thus, there is a direct contribution of cash to the ILIT from which to satisfy any exercised Crummey powers, which should facilitate qualification of the gift as a present interest gift.⁶⁸

Practice Note: In reviewing an ILIT in connection with a non-contributory split-dollar arrangement, consider whether the ILIT:

- Provides the Crummey power holders with an absolute right of withdrawal with regard to a transfer to the ILIT, with or without receiving notice
- Broadly defines what constitutes a "contribution" to the trust for Crummey power purposes; ideally, the definition of "transfer" would include any direct or indirect transfer that is deemed a gift, including any premium payment made, directly or indirectly, by any person other than the trustee to the insurer
- Allows the trustee to satisfy, or at least does not prohibit the trustee from satisfying exercised Crummey powers by distributing any asset of the ILIT (including a fractional interest in a policy) or by borrowing.⁶⁹

⁶⁵ This is the amount of the annual exclusion gift set for 2014 and is indexed for inflation. See Rev. Proc. 2013-35.

⁶⁶ IRC §2503(b)(1).

⁶⁷ Note that courts considering this issue have not mandated a notice requirement, and the Tax Court has specifically rejected the requirement in two instances (see *Turner v. Comm'r*, TC Memo 2011-209 and *Est. of Cristofani v. Comm'r*, 97 TC 74, 80 (1991)). The IRS, however, has consistently taken the position that a trustee must give notice to all adult Crummey power holders, informing them of their withdrawal rights and of the gift upon which they can exercise such rights (see e.g., Rev. Rul. 81-7, TAM 9532001). Thus, ideally, notice would be provided to a trust's Crummey power holders of any imputed gifts made by the employee to a trust under a split-dollar arrangement for which annual exclusion treatment is sought.

⁶⁸ See e.g., PLR 8051128. Again, ideally, Crummey power holders would receive notice when the employee makes the contribution to the ILIT (or will have received advanced notice of anticipated, scheduled contributions).

⁶⁹ Crummey powers may not be sufficient to provide a present interest for annual exclusion purposes if the ILIT trustee cannot satisfy potential withdrawal demands from trust assets other than cash contributions (see e.g., PLR 8126047 and PLR 8103074). The trust agreement may avoid this issue if it allows the trustee to satisfy withdrawal rights through distributions of cash, other

If the ILIT that is part of a non-contributory split-dollar arrangement satisfies the above, it has a greater likelihood that the imputed gifts to the ILIT will qualify for the annual exclusion.

C.21. How Is the Imputed Income from the Arrangement Taxed to the Insured?

The taxation of benefits provided to the insured under the grandfathered split-dollar arrangement, whether from the annual economic benefit or policy equity (if deemed taxable), depends on the insured's tax status vis-à-vis the business and in what capacity the insured receives the benefits under the arrangements, for example as an employee or business owner (see **Question C.19** for additional tax considerations if the policy under the arrangement is owned by an ILIT).

Employee. If the insured receives the benefits as an employee, those benefits will be taxable to the insured as compensation income, at ordinary income tax rates.⁷⁰ The imputed compensation also should constitute wages for employment tax purposes (e.g., FICA and FUTA).⁷¹

Business Owner. If the insured receives the benefits in his or her capacity as an owner of the business, the benefits will be treated as a distribution, which may be taxable as a dividend, a return of capital, guaranteed payments, etc., depending on the type of business entity and the nature of the distribution. For example:

- *C corporations:* The benefits provided under the grandfathered split-dollar arrangement to a non-employee shareholder likely are taxable as dividends, to the extent the corporation has earnings and profits.⁷² If there are no earnings and profits, the basis on which the shareholder will be taxed is unclear, because not having earnings and profits may not sustain dividend taxation, in which case, another theory may apply.⁷³
- *S corporations:* A distribution to a non-employee shareholder of an S corporation will be treated similarly to a C corporation shareholder, to the extent the S corporation has accumulated C corporation profits or earnings. If there are no such accumulated profits or earnings, then, as with C corporations, the basis for taxation is unclear, although another theory may apply.⁷⁴ As a side note, due to the pass-through income tax treatment of S corporations, unlike C corporations, the insured shareholder under the split-dollar arrangement will report income on the amounts used by the S corporation to pay the insurance premiums (which are non-deductible, see **Question C.22**) and also will receive a taxable economic benefit from the arrangement (unless a contributory plan is used). Due to this effective "double taxation," the perception of some advisors is that business split-dollar arrangements work only for S corporation employees, not shareholders. Since significant personal wealth transfer planning could be achieved through grandfathered split-dollar arrangements, particularly arrangements that attempted to transfer policy

property (including a fractional interest in a life insurance policy), or even borrowing against an insurance policy's cash value (see e.g., PLR 8021058 and PLR 8006109). Older private letter rulings have ruled that Crummey powers over the gifts made to a trust created gifts of present interests even though the trusts held only term or group term life insurance policies lacking cash value (see e.g., PLRs 8118051, 8006109, 8006048, 7947066, 7935091, and 7826050).

⁷⁰ Rev. Rul. 66-110 and Rev. Rul. 64-328. Similar tax provisions also should apply to non-employee/non-owners, such as directors or independent contractors.

⁷¹ See discussion of employment taxes in Zaritsky & Leimberg, *Tax Planning With Life Insurance: Analysis With Forms*, §6.05[2][g], *supra* note 32.

⁷² Rev. Rul. 79-50; IRC §301(c). Any policy equity in a grandfathered arrangement, if and when taxable under Notice 2002-8, would be treated and taxed similarly to the economic benefit (e.g., as a dividend).

⁷³ See Brody, Richey, and Baier, 386-4th T.M., *Insurance-Related Compensation*, Art.VI.G.5, *supra* note 32 (stating that "[i]n a C corporation with no current or accumulated earnings and profits or in an S corporation with no prior C corporation earnings and profits, it would appear that the economic benefit would not be taxable to a nonemployee shareholder because of the absence of earnings and profits to support dividend taxation. Whether some other theory would be available to tax a nonemployee shareholder on that benefit is not clear.")

⁷⁴ As indicated in note 75, if the S corporation does not have accumulated C corporation earnings or profits to support dividend taxation, it is unclear on what basis the economic benefit will be taxed to the shareholder (*id.*).

equity, advisors may still discover existing grandfathered split-dollar arrangements with S corporations and non-employee shareholders.

- Several private letter rulings (“PLRs”) involving primarily contributory split-dollar arrangements between a shareholder and an S corporation have found that the benefits provided under the arrangement did not create an impermissible second class of stock. Those PLRs generally espouse the theory that the split-dollar arrangements are fringe benefits, similar to the payment of health insurance premiums, not a vehicle to circumvent the one class of stock requirement.⁷⁵
- Use of a contributory plan would offset any taxation to the shareholder based on the deemed distribution of the economic benefit under the arrangement.⁷⁶ Thus, grandfathered split-dollar arrangements between S corporations and their non-employee shareholders may often be structured as contributory plans.
- *Partnerships/LLCs*: The tax treatment of benefits provided to a partner under a grandfathered split-dollar arrangement with a partnership (or limited liability company (“LLC”) taxed as a partnership)⁷⁷ should be based on principles similar to those for arrangements between corporations and shareholders.⁷⁸ The classification of the distribution, however, may affect the taxation. For example, if the distribution is considered as payment to a partner for services, without regard to the income of the partnership, it may be treated and taxed as a guaranteed payment to the insured partner.⁷⁹

Practice Note: Depending on the entity type and the relationship between the entity and the insured, benefits under a grandfathered arrangement that are treated as a distribution (e.g., from an S corporation to a shareholder) may require *pro rata* distributions to the other non-insured shareholders/owners.

C.22. Can the Business Take a Deduction for Premiums Paid Under a Grandfathered Split-dollar Arrangement?

No, the business cannot take an income tax deduction for any portion of the premiums it pays under a grandfathered arrangement,⁸⁰ even the portion reported by and taxed to the insured as compensation income.⁸¹ IRC §264 generally prohibits a business deduction for the premiums paid, since the business, either directly or indirectly, benefits from the policy.

In “bonus plans,”⁸² where the business bonuses the amount of the insured’s tax liability with respect to the benefits under the split-dollar arrangement, the bonus amount may be deductible as compensation, assuming the insured’s overall compensation, including the bonus, is ordinary, necessary, and

⁷⁵ See e.g., PLRs 200441023, 9803008, 9735006, 9709027, 9651017, 9331009 (replacing PLR 9309046), 9318007, and 9248019, all involving contributory arrangements, and PLR 9413023, involving a non-contributory arrangement. See also Zaritsky & Leimberg, *Tax Planning with Life Insurance: Analysis with Forms*, §6.05[5][e], *supra* note 32. But see Eustice & Kuntz, *Federal Income Taxation of S Corporations*, §3.08[3][c], Thomson Reuters/WG&L (4th Ed. 2001, with updates through April 2013) (online version accessed on www.checkpoint.thomsonreuters.com on June 2013), which notes a concern that an S corporation could encounter issues regarding a second class of stock if a non-contributory plan is used.

⁷⁶ But, as noted, *supra*, in note 75, it would not offset any taxable policy equity.

⁷⁷ See PLR 9625013.

⁷⁸ See PLRs 9639053 and 9204041. See also Louis A. Mezzullo, “Life Insurance Planning,” dated April 9, 2012, in materials for The American Law Institute Continuing Legal Education and American College of Trust and Estate Counsel Telephone Seminar/Webcast: “How to Handle the Toughest Issues in the Operation and Succession of a Family Business,” Sept. 11, 2012.

⁷⁹ See Rev. Rul. 91-26, treating a partnership’s health care premium payments on behalf of a partner as guaranteed payments for purposes of IRC §707. See also Brody, Harris, and Shenkman, “Split-Dollar Insurance and the Closely Held Business,” *RPTE eReport*, American Bar Association Section of Real Property, Trust and Estate Law, Oct. 2009.

⁸⁰ Rev. Rul. 64-328; IRC §264(a)(1); Reg. §1.264-1(a).

⁸¹ See Streng & Davis, *Retirement Planning: Tax and Financial Strategies*, §17.02[2][c][iv] (ThomsonReuters/WG&L, 2012 ed., updated Sept. 2012 and visited on June 2013).

⁸² See discussion at **Question B.9**.

reasonable.⁸³ The bonus may not be deductible, however, if it mirrors too closely the employee's contribution amount or is otherwise deemed to be an insurance premium payment.⁸⁴

C.23. Are the Death Benefits Paid from the Policy Under a Grandfathered Split-dollar Arrangement Income-tax-free?

In the case of a grandfathered split-dollar arrangement, death benefits received, either directly or indirectly (e.g., as reimbursement of the business' premiums) are income-tax-free to both the business and the insured's designated beneficiary (or ILIT), unless the transfer-for-value rules apply.⁸⁵ The business only receives reimbursement for prior, after-tax expenditures, and the insured's beneficiary receives the policy proceeds as income-tax-free death benefits pursuant to IRC §101(a)(1).⁸⁶

MATERIAL MODIFICATIONS

C.24. What About "Material Modifications" to Grandfathered Split-dollar Arrangements?

As noted in **Question C.3**, grandfathered split-dollar arrangements "materially modified" after Sept. 17, 2003, are subject to tax based on the final regulations rather than the provisions of pre-regulation guidance.⁸⁷

C.25. Why Does a Material Modification Matter?

There are significant differences between the tax rules applicable under the pre-regulation guidance and those under the final regulations. As illustrated below, the application of the final regulations to a grandfathered split-dollar arrangement due to a material modification may produce substantially different and adverse tax consequences for the parties to the grandfathered agreement.

C.26. What Qualifies as a Material Modification?

Unfortunately, the final regulations do not define the term "materially modified." They only provide a "non-exclusive list of changes" that will *not* constitute material modifications for purposes of grandfathered split-dollar arrangements, including changes solely:

- In the mode of premium payment (e.g., from monthly to quarterly)
- In the policy beneficiary, unless the beneficiary is a party to the split-dollar arrangement
- In the interest rate payable on a policy loan
- Necessary to preserve the status of the life insurance contract under IRC §7702
- To the ministerial provisions of the policy (e.g., a change in payment address)
- Made under the non-discretionary terms of any agreement (other than the policy) that is a part of the split-dollar arrangement and in effect on or before Sept. 17, 2003

⁸³ IRC §162(a).

⁸⁴ See Streng & Davis, *Retirement Planning: Tax and Financial Strategies*, §17.02[2][c][iv], *supra* note 52; Brody, Richey, and Baier, 386-4th T.M., *Insurance-Related Compensation*, Art.VI.C.1, *supra* note 8.

⁸⁵ The transfer for value rule under IRC §101(a) will include in gross income otherwise excludable death benefits if the policy is transferred for valuable consideration (which can include the satisfaction and release of obligations under a split-dollar agreement). The transfer of a policy to the insured, an ILIT that is a wholly owned grantor trust with regard to the insured, a partner of the insured, a partnership in which the insured is a partner or a corporation in which the insured is a shareholder or officer will be exempt from the inclusion rule. A transfer of the policy to anyone else (e.g., to the insured's child or spouse) could inadvertently run afoul of these rules, resulting in taxation of the death benefit in excess of any consideration paid by the transferee for the transfer.

⁸⁶ See Zaritsky & Leimberg, *Tax Planning with Life Insurance: Analysis with Forms*, §6.05[3][c], *supra* note 32.

⁸⁷ See Reg. § 1.61-22(j)(1) and (2).

- In the policy owner as a result of a IRC §381(a) transaction (dealing with corporate acquisition of assets in certain liquidations or reorganizations) and in which substantially all the former owner's assets are transferred to the new policyowner
- To the policy if required by a court or a state insurance commissioner as a result of the insolvency of the carrier that issued the policy
- To the administering insurance carrier as a result of an assumption reinsurance transaction that did not involve the parties to the arrangement⁸⁸

The final regulations authorize the IRS to provide additional guidance regarding other non-material modifications for purposes of split-dollar arrangements,⁸⁹ and, in 2007, the IRS issued Notice 2007-34, which addresses the impact of modifications of split-dollar arrangements necessary to address compliance issues associated with IRC § 409A (dealing with nonqualified deferred compensation).⁹⁰ Apart from this guidance, the IRS has remained almost silent on this issue.

C.27. What Are the Tax Consequences of the Loss of Grandfathered Status?

The potential tax consequences due to the loss of grandfathered status for a split-dollar arrangement will vary depending on the structure of the grandfathered arrangement and whether it involves an equity component.

Loss of Certainty in Using Insurer Term Rates to Determine Economic Benefit. Pre-regulation guidance taxes both grandfathered endorsement and collateral assignment split-dollar arrangements⁹¹ based on the annual economic benefit provided (e.g., the annual term cost of the current life insurance protection). As discussed at **Question C.8**, this benefit is measured by the annual term rates under Table 2001 or the Insurer Term Rates published by the issuing insurance carrier, if they are lower than the IRS table rates (which they typically are) and available to all standard risks. Post-regulation split-dollar arrangements subject to the economic benefit regime under the final regulations (see discussion beginning at **Question D.10**) are similarly taxed with regard to the annual cost of current life insurance protection provided to the insured.

Split-dollar arrangements entered into after Jan. 28, 2002,⁹² however, including post-regulation arrangements, are subject to stricter limitations on the ability to use the Insurer Term Rates, and carriers generally will not opine as to whether their rates are compliant (see discussion at **Questions C.8 - C.10**). The difference between the use of the Table 2001 rates and Insurer Term Rates can be substantial.

Example: A \$1 million policy insuring a 65-year-old employee is subject to a grandfathered endorsement split-dollar arrangement. Under Table 2001, the cost of insurance for an insured age 65 is \$11,900, while using the Insurer Term Rates, the cost of insurance would be \$2,030. A material modification to the agreement could result in an additional taxable economic benefit of up to \$9,870 (with further increases each year).

Thus, if a material modification of a grandfathered arrangement results in application of the economic benefit tax regime under the final regulations, as with modification of a grandfathered endorsement arrangement, the loss of certainty regarding the use of Insurer Term Rates to determine the annual economic benefit could have a significant tax impact. In addition, for contributory arrangements, where the insured contributes or pays the portion of the premium equal to the annual economic benefit, (see **Questions B.8** and **C.14**), the insured's contribution will now be considered taxable income to the business, which will increase the business' (but not the insured's) tax basis in the policy (see **Questions D.24** and **D.25**).

⁸⁸ Reg. § 1.61-22(j)(2)(ii).

⁸⁹ Reg. § 1.61-22(j)(2)(iii).

⁹⁰ See discussion beginning at **Question E.1** for a review of the application of IRC § 409A to split-dollar arrangements.

⁹¹ See **Questions B.3-B.5** for a discussion of endorsement and collateral assignment arrangements.

⁹² See note 33 regarding the lack of certainty of which Insurer Term Rates may be used for split-dollar arrangements entered into on Jan. 28, 2002.

Current Taxation of Built-up Equity. As discussed at **Question C.17**, for grandfathered equity arrangements, pre-regulation guidance protects the policy equity from current taxation as long as the grandfathered split-dollar arrangement remains in force. The IRS considers the arrangement in force as long as the parties continue to report the annual economic benefit provided to the insured, the business retains some reimbursement right under the arrangement, and the agreement is not materially modified.

A material modification to the grandfathered equity arrangement, however, will subject the arrangement to tax under the final regulations, which may dramatically affect the taxation of any policy equity to the insured, as follows:

- **Endorsement Arrangements.** A material modification of a grandfathered endorsement arrangement likely will result in taxation under the economic benefit regime of the final regulations, and the IRS may seek to currently tax the economic benefit provided by the insured's access to the policy's existing cash value. Where the focus is on death benefit protection, not access to cash value, the parties may want to consider modifications to eliminate the insured's/ILIT's access to cash value.
- **Collateral Assignment Arrangements.** A material modification to a grandfathered equity collateral assignment arrangement likely will subject it to tax under the loan regime of the final regulations (see discussion starting at **Question D.35**). Under a safe harbor in pre-regulation guidance,⁹³ the parties to the split-dollar arrangement may elect to include all premiums paid by the employer to date as a loan entered into as of the beginning of the year of the modification, and subsequent premium payments by the business will be treated as additional loans. If the loan does not charge adequate interest, such as at the appropriate applicable federal rate ("AFR") for the date and term of the loan, the foregone interest will be taxed to the insured as income (and as a gift to the ILIT, if it holds the policy). See discussion beginning at **Question D.35** for the treatment of split-dollar loans. Depending on the age of the policy, this loan amount could be quite large.

In addition, if the policy has developed any equity, the IRS may attempt to tax the equity to the insured at the time of the modification, less the insured's basis in the policy, if any. Note that the final regulations provide that, for economic benefit regime plans, a non-owner (e.g., the employee) does not receive any investment in the contract. It is unclear whether and to what extent this same rule will apply to a materially modified grandfathered split-dollar arrangement. (See **Question C.15** for a discussion of obtaining basis in the policy.)⁹⁴

Example: X Co. has paid \$1 million of premiums on a policy subject to a grandfathered collateral assignment arrangement, which currently has \$2.1 million of cash value. A material modification is made to the split-dollar arrangement. E, the insured employee, may now have an outstanding loan balance of \$1 million bearing interest at the AFR for the duration of the split-dollar arrangement, which interest he must take into income as compensation if not paid or accrued. In addition, E may be subject to income tax on some portion of the \$1.1 million of policy equity in the policy. If an ILIT holds the policy, not only will E not have access to the policy's cash value to pay taxes, but a corresponding taxable transfer may have been made to the ILIT for gift and GST tax purposes.

Practice Note: This issue typically also arises upon rollout of a policy at termination of a split-dollar arrangement. Until definitive guidance is issued, parties to a grandfathered split-dollar arrangement who contemplate a 1035 exchange should weigh the potential benefits of the exchange versus the tax consequences of the loss of grandfathered status.

C.28. Does a 1035 Exchange Constitute a Material Modification?

⁹³ See Notice 2002-8.

⁹⁴ See Reg. §1.61-22(f)(2).

The parties to a grandfathered split-dollar arrangement may wish to exchange the original policy for another in a tax-free exchange under IRC §1035 (a “**1035 exchange**”). That section generally provides that no gain or loss is recognized on the exchange of one life insurance policy for another insuring the same insured.⁹⁵ The ability to make such a tax-free policy exchange provides significant flexibility for policy owners to modify their coverage as needed to adapt to changing circumstances and to take advantage of new product developments.

Unfortunately, the lack of IRS guidance on material modifications creates a significant risk that a 1035 exchange of a policy subject to a grandfathered arrangement will result in a material modification, causing the loss of grandfathered status. The “non-material” modifications listed in the final regulations provide little guidance, as they are generally ministerial, administrative, or non-discretionary in nature. Notably, even though comments to the proposed regulations requested that the IRS include 1035 exchanges as non-material modifications, the final regulations failed to do so.

Some commentators have suggested that the IRS could test 1035 exchanges of policies subject to grandfathered split-dollar arrangements on a facts and circumstances basis, potentially considering whether the 1035 exchange significantly affects the economics of the policy or the parties to the arrangement. Without additional guidance, it is difficult to generalize what the IRS would consider as a significant economic change for purposes of a material modification. Further, some practitioners believe the omission of a 1035 exchange from the list of non-material modifications implies that the IRS considers it a material modification.⁹⁶

Practice Note: Until definitive guidance is issued, parties to a grandfathered split-dollar arrangement who contemplate a 1035 exchange should weigh the potential benefits of the exchange versus the tax consequences of the loss of grandfathered status. As better insurance products come on the market, however, the existence of a grandfathered split-dollar arrangement should not cause an automatic rejection of a 1035 exchange but should be a factor in the review (see **Question C.30**). Given the fiduciary duties often associated with trust administration and investment management, ILIT trustees, in particular, will want to ensure they review all the pros and cons of a 1035 exchange in this situation, including the potential for loss of grandfathered status, and document their deliberations and final decision. See **Questions C.31** and **C.35** and **Appendix AP.5** for a list of questions to consider when reviewing grandfathered split-dollar arrangements.

C.29. Will the IRS Privately Rule on What Qualifies as a Material Modification?

It is unlikely. Since 2005, the IRS has refused to rule on whether a split-dollar arrangement has been “materially modified” for purposes of the final regulations, which means parties to a grandfathered split-dollar arrangement likely cannot obtain comfort for a proposed transaction, including a 1035 exchange, through a private letter ruling.⁹⁷

C.30. Should 1035 Exchanges Still Be Considered for Grandfathered Arrangements?

Yes, since a change in the grandfathered status of a split-dollar arrangement may not be detrimental in every situation, depending on the particular facts and circumstances.

For example, with a grandfathered equity split-dollar arrangement where the policy is owned by the insured or his or her ILIT, the major determining factors likely will be 1) whether the policy has significant equity, 2) the reimbursement amount then due to the business and 3) the need or desire for an ongoing split-dollar arrangement to fund premiums on continuing life insurance coverage. If the policy has no equity, the parties could consider modifying the grandfathered agreement by switching it to a split-dollar loan arrangement under the final regulations (see discussion of “Switch to Loan” at **Question C.36**). The

⁹⁵ See IRC §1035.

⁹⁶ See, e.g., Zaritsky & Leimberg, *Tax Planning With Life Insurance: Analysis With Forms*, §6.05[3][c], *supra* note 32, for consideration of the application of a facts and circumstances test to 1035 exchanges as material modifications. See, e.g., Brody and Harris, “Private Split-dollar Arrangements,” *Trusts and Estates Magazine*, May 1, 2010, for the idea that the IRS omission of 1035 exchanges from the list of non-material modifications implies it is a material modification.

⁹⁷ See e.g., Rev. Proc. 2014-3, § 3.01(6).

existing reimbursement right due to the business will become a split-dollar loan under the final regulations. The parties then could accomplish a 1035 exchange of the policy and fund future premiums through additional split-dollar loans (see discussion of split-dollar loans under the final regulations beginning at **Question D.35**).

Practice Note: Each case will warrant an analysis of the potential tax consequences of a material modification, the policy owner's current coverage and premium funding requirements, income and gift tax consequences of future premium payments or the measure of annual economic benefits provided, and the options for a current or subsequent exit of the arrangements.

MAINTENANCE AND ADMINISTRATION

C.31. Should a Grandfathered Split-dollar Arrangement Be Maintained?

Whether a grandfathered arrangement should remain in place will depend on several issues, including the following:

1. Do the arrangement and policy continue to fulfill the insured's coverage needs?
2. What are the ongoing premium requirements and projected annual economic benefit costs? Are they manageable and do they continue to make economic sense for both of the parties?
3. Does the policy's projected performance continue to support withdrawals or loans sufficient to make the originally desired income flow, employer repayment and/or future premium/insurance costs?
4. Was the policy intended to have equity and does it have any equity?
5. If the policy values are less than originally illustrated, can the policy be effectively rehabilitated with additional premiums, change of investment philosophy, or an exchange of contracts without resulting in a material modification? Will any such policy changes eliminate guarantees or otherwise change the terms of coverage?

If the parties want to maintain the plan, then the administration of the plan should be reviewed and corrective action taken as needed.

Practice Note: While all parties to a grandfathered split-dollar arrangement should conduct periodic reviews of the ongoing need for the arrangement and its overall administration, ILIT trustees, in particular, should conduct such reviews on a regularly scheduled basis with the assistance of experienced, independent advisors, and document their conclusions to provide evidence of compliance with their fiduciary duties to the trust and trust beneficiaries.

C.32. What Are the Administration and Maintenance Requirements for Grandfathered Split-dollar Arrangements?

Since grandfathered split-dollar arrangements must have been formed on or before Sept. 17, 2003, these arrangements and the underlying policies will have been in force for some time. Accordingly, if the plan will be maintained, the arrangement's documentation and administration should be reviewed to ensure proper maintenance and reporting and to implement any required fixes. An administrative compliance review of an existing grandfathered arrangement should confirm and/or correct the following:

1. Existence of a written agreement or other documentation confirming the arrangement, as well as proper filing of collateral assignments or death benefit endorsements with the carrier that issued the underlying policy.
 - a. If not, determine if the agreement can be created now to reflect the operative terms of the arrangement. File appropriate collateral assignment or endorsement forms with the carrier.

2. The insured and business have properly accounted for, reported and paid income/employment taxes with regard to the annual economic benefits provided to the insured under the arrangement (if not fully offset under a contributory plan).
 - a. If not, ensure proper reporting for current and future tax years. Review with an experienced accountant which previous tax years may have had reporting errors or issues and discuss the risks for amending those returns to correct prior reporting. Such risks may include, the increased chance for IRS scrutiny, starting a new statute of limitations, etc.
3. If the policyowner is an ILIT or other third party, the insured has also properly reported and paid gift taxes on any corresponding imputed gifts to an ILIT or other third-party owner of the policy, as well as allocated any required GST tax exemption (if the ILIT is intended to be GST-tax-exempt).
 - a. If not, review the tax years affected and consider filing amended or late returns to reflect gifts and allocation of GST tax exemption.
4. The arrangement has been reviewed and, if necessary, brought into compliance with IRC §409A regulations dealing with deferred compensation arrangements (see discussion beginning at **Question E.1** reviewing the impact of IRC §409A on split-dollar arrangements in general).
 - a. Amend arrangements that violate IRC § 409A. No loss of grandfathered status should result from the amendment. Report any employee equity accrued since 2005 as income, and pay associated penalties. The insured employee's basis in the policy should increase due to the tax reporting.
5. There have been no changes to the arrangement or the underlying policy that could constitute material modifications and subject the arrangement to tax under the final regulations.
 - a. If there has been a material modification, determine the year of occurrence and correct prior reporting to reflect modified tax consequences under the applicable regime of the final regulations (i.e., the economic benefit or loan regime, see **Section D**).

Practice Note: As noted in **Question C.30**, all parties to a grandfathered split-dollar arrangement should conduct periodic reviews of the ongoing need for the arrangement and its overall administration. ILIT trustees, in particular, should conduct such reviews on a regularly scheduled basis with the assistance of experienced, independent advisors, and document their conclusions to provide evidence of compliance with their fiduciary duties to the trust and trust beneficiaries.

EXITS/TERMINATIONS/ROLLOUTS

C.33. What Is an “Exit,” a “Termination” or a “Rollout”?

An exit, a termination, or a rollout (collectively, an “exit”) of any split-dollar arrangement generally refers to the unwinding of the arrangement during the insured’s lifetime. The exit generally involves two components:

1. Repayment of the business’ interest in the underlying policy, which is the total premiums paid, or, in non-equity arrangement, the policy’s cash value, if greater
2. Release of the business’ interest in the policy or a transfer of the policy, or an amount equal to the insured’s interest in the policy, to the insured or other third-party owner (e.g., the insured’s ILIT)

C.34. Why Are Exits Important for Grandfathered Split-dollar Arrangements?

Rising Term Costs. The term insurance cost used to measure the annual economic benefit provided by the current life insurance protection will increase each year as the insured ages. For joint policies, the

annual economic benefit cost will increase significantly after the death of the first insured (see **Question C.11**). Eventually, the costs to the insured, either as contributions under a contributory plan or tax on the imputed income, as well as any corresponding gift tax costs if there is an imputed gift to a third-party owner, such as an ILIT, may become too uneconomical to bear.

Reimbursement Obligation. The reimbursement amount due to the business will grow with each premium it pays, reducing the death benefit due to the insured from the policy, unless paid-additions, a return of premium rider, or an increasing death benefit option are used to maintain the death benefit level.

Insured's Retirement/Termination. In employment relationships, employers will often want, or the agreement will provide, for termination when the employee retires or otherwise leaves employment. Parties to the arrangement will want to ensure that there are sufficient proceeds to reimburse the business if the arrangement is terminated prior to the insured's death.

Equity Considerations. For grandfathered equity split-dollar arrangements, terminating the arrangement prior to the development of significant policy equity could avoid unfavorable income tax consequences to the insured, as discussed at **Question C.17**.

C.35. What Are the Key Factors in Selecting and Implementing an Exit Strategy?

To select an appropriate strategy and timing for implementation, an advisor should analyze the following (see checklist attached at **Appendix AP.8**)⁹⁸:

1. **Policy Ownership.** Who owns the policy — the business (endorsement method) or the insured, his or her ILIT, or another third-party (collateral assignment method)?
 - a. If the business, is it a public company, a C corporation, an S corporation, a partnership, an LLC or a tax-exempt organization? And what is the relationship of the insured? Executive, key employee, shareholder, owner? The business organization and its relationship to the insured will affect the tax consequences. For example, if the business is a public company, then considerations on the prohibition of personal loans to directors and covered executives under SOX must be reviewed to see if they apply to the insured (See **Question E.16**).
 - b. If an ILIT, is it a grantor trust for federal income tax purposes with regard to the insured?
2. **Insurance Need.** Does the insured still have a need or desire for the insurance? Has the insured experienced a health change?
 - a. If so, how much death benefit was provided under the arrangement, and based on what duration and assumptions?
 - b. Is the insurance coverage amount still appropriate for the situation?
3. **Policy Performance.** Does the policy have cash value sufficient to support repayment of the business?
 - a. What are the policy surrender charges?
 - b. If the cash value is insufficient, how long until it will be, and on what assumptions? Can the arrangement be left intact until the insured's death?
4. **Policy Equity.** Does the policy currently have any equity? In other words, is the cash value in excess of the amount due as repayment for premium advances, and if so, by how much?

⁹⁸ See Brody and Ratner, "What To Do With Those Existing Split-Dollar Plans," *supra* note 35. See also Skeletons in the Closet: What to Do With "Grandfathered" Split-Dollar Arrangements by David Houston & Maggie Mitchell, *The AALU Quarterly*, Spring 2012.

5. **Disposition of Policy Equity.** Is the grandfathered arrangement an equity arrangement (equity goes to the insured) or a non-equity arrangement (equity goes to the business)?
6. **Investment in Contract.** Does the insured (or his or her ILIT) have any basis in the policy (see **Question C.15**)?
7. **Modification to Product/Arrangement.** What type of product is involved? Can the premium payments or death benefits be adjusted or the product exchanged? Can the terms of the arrangement be modified, subject to the material modification issues (see **Question C.24**)?
 - a. If the changes to the policy or any terms for the split-dollar arrangement constitute a material modification, what will the tax consequences be under the final regulations?
 - b. Do the benefits of the modification outweigh these consequences?
8. **Planned Exit.** Was an exit strategy reviewed at inception? If so, which party assumed the risk that the policy would not perform sufficiently to support repayment to the business from policy cash value?
 - a. Does the business have the desire or flexibility to forgive part or all of its repayment right?
9. **Bonus Options.** Can or will the business and/or insured agree to switch to a bonus arrangement to support the policy?
 - a. Does the insured understand that the bonus will be taxable as income and that there also will be a corresponding taxable gift of an equivalent amount if the policy is owned by an ILIT, which may raise GST tax and exemption allocation issues if the insured intends for the ILIT to be fully GST tax exempt?
10. **ILIT Issues.** Are there fiduciary or other considerations the ILIT trustee must address in considering a modification or termination of the arrangement or the underlying policy?

C.36. What Are Potential Exit Strategies for a Grandfathered Arrangement?

Based on the information collected in response to the questions in **Question C.35**, the following options may work for the typical types of grandfathered arrangements:⁹⁹

Endorsement (Non-Equity) Arrangements. Typically, grandfathered endorsement arrangements are non-equity arrangements. Accordingly, there are no concerns related to the potential taxation of any policy equity to the insured (as discussed at **Question C.17**). In these cases, the timeframe for the duration of the arrangement and the performance of the policy will determine how to proceed. For example:

- **Maintain Arrangement.** If the arrangement will terminate at the insured's retirement (with the business, perhaps, retaining the policy and using the policy cash value to fund a SERP for the insured), the parties may want to keep the arrangement in place. If the grandfathered arrangement was entered into before Jan. 28, 2002, the parties can continue to measure the annual economic benefit using the lower Insurer Term Rates without complying with the additional restrictions imposed by Notice 2002-8 (see **Question C.8**).
- **Rollout Policy.** If the arrangement was intended to remain in place until the insured's death and to provide the insured with substantial death benefits (usually payable to the insured's ILIT), the annual economic benefit may eventually become too great, even with application of the Insurer Term Rates. In addition, if the ILIT holds the rights to the death benefit, the imputed annual gift made each year to the ILIT will also grow. In these cases, the business may want to transfer the

⁹⁹ See discussions of these options at Brody and Ratner, "What To Do With Those Existing Split-Dollar Plans," *supra* note 35; Ratner and Leimberg, "A Planner's Guide to Split-Dollar After the Final Regulations," *supra* note 45.

policy to the insured (or his or her ILIT) via a distribution or a sale of the policy to the insured (or his or her ILIT).

- A distribution of the policy will be taxed to the insured based on the relationship of the policies, with a corresponding gift to the insured's ILIT. Whether a distribution is feasible from the insured's tax perspective is highly dependent on the insured's financial circumstance and the tax environment. Some insureds may prefer to time a rollout to occur after retirement, when they anticipate less income.
- If properly structured, a sale of the policy should avoid compensation income on distribution of the policy to the insured and a gift of the policy to the ILIT, but the insured will need to fund the ILIT with the cash needed to purchase the policy, which may require a gift. Also, if the sale is to an ILIT, the parties will want to confirm that it is a wholly owned grantor trust with regard to the insured for federal income tax purposes; otherwise, the transfer could run afoul of the transfer for value rules under IRC § 101(a)(2), resulting in taxation of the policy death benefit in excess of the consideration paid for the transfer. In addition, the ILIT trustee must ensure purchase of the policy complies with his or her fiduciary duties.
- **Practice Notes:** Obtaining a fair market value of the policy for purposes of a distribution and/or sale may be difficult, as different valuation standards apply for income and gift tax purposes (i.e., premiums plus earnings less reasonable charges (PERC) or interpolated terminal reserve values for income tax, the adjusted interpolated terminal reserve value under the gift tax regulations).¹⁰⁰ Query whether the insured could report different values for income and gift tax purposes, if the applicable valuation standards produce significantly different results. In addition, if the policy is held by an ILIT with a professional or institutional trustee, they may be reluctant to engage in a sale transaction due to the concerns over proper valuation and their fiduciary duties to the ILIT and beneficiaries.
- **Cash-out Policy.** If the policy has a sufficient cash surrender value, the business may want to surrender the policy using the cash surrender value to repay itself, and terminate the arrangement. The business may recognize income to the extent the policy cash value exceeds its investment in the contract.

Collateral Assignment Equity Arrangements

- Rollout of Policy with or Without Bonus. The business is either repaid or forgives its reimbursement right under the arrangement and releases the collateral assignment of the policy.
 - *Considerations.*
 - The business must decide if it will waive or forgive any part of the reimbursement amount due (e.g., as a bonus). The business may need to address accounting issues related to forgiving the obligation.
 - Otherwise, the insured (and ILIT, if it holds the policy) must determine how to fund the business' repayment right. Assuming an ILIT holds the policy:
 - If the policy has cash value, it may be possible to access that value to repay the business (an "internal rollout"), subject to review of any income-tax consequences from such actions based on whether the policy is a modified endowment contract (MEC), is in a gain position with regard to accessing cash value, etc.¹⁰¹ Withdrawals from or loans against

¹⁰⁰ See Rev. Proc. 2005-25 for PERC valuation for income tax purposes and Reg. §25.2512-6 for valuation for gift tax purposes.

¹⁰¹ See Brody, "Cutting Edge Split-Dollar – After the Notices and Proposed Regulations," *supra* note 46 at page 47 ("The possible effects of [IRC] Section 7702(f)(7) limitation of tax-free withdrawals up to the owner's basis in the policy, and of the MEC provisions of TAMRA 88 (for affected policies), are concerns in planning a policy rollout, to the extent policy values are intended to be used to

policy cash value also could limit the policy's ability to sustain itself or to provide a source of income going forward.

- The use of non-policy assets may be preferable to exit the strategy (an “external rollout”) based on the policy economics but requires the insured to fund the ILIT with assets other than the policy or external borrowing. This could be accomplished with taxable gifts, or, if the ILIT is a grantor trust, on a leveraged basis through the use of loans from the insured to the ILIT (or an installment sale of assets to the ILIT). The insured, however, may not have sufficient assets to fund the repayment or may not wish to use them.
- If the policy has equity at rollout, the business must determine how to report and treat that equity (as compensation if the insured is an employee, a distribution to an owner, etc.) and whether it wishes to take a position that the equity is not taxable, relying on the “no-inference” language in Notice 2002-8 (see **Question C.18**).
- The insured will be subject to tax on the forgiven amount and any equity reported by the business, based on the relationship of the parties (as compensation, a distribution, etc.), less any basis in the policy.¹⁰² If an ILIT owns the policy, there will be an imputed gift of a corresponding amount from the insured to the ILIT.
 - **Practice Note:** The insured could take a position that the equity is not taxable, relying on the “no-inference” language; however, this may be a difficult position to support if the business has reported the amount as income. Alternatively, the insured could try to negotiate a “gross-up” in compensation for the tax liability.
- Although the business should receive a deduction for any amount treated as compensation to an insured employee, it may face IRC §162(m) deduction limitations if the imputed compensation from any forgiven repayment obligation or equity is not “reasonable.”

effect the rollout on an income-tax-free (and, in the case of MECs, penalty-free) basis...); Brody, Richey, and Baier, 386-4th T.M., *Insurance-Related Compensation*, Art.VI.C.1, *supra* note 32, (“The possible effects of the [IRC] §7702(f)(7) limitation on tax-free withdrawals up to the owner's basis in the policy, and of the modified endowment contract (MEC) provisions of TAMRA (for affected policies), are concerns in planning a policy rollout to the extent policy values are intended to be used to effect the rollout on an income-tax-free (and, in the case of MECs, penalty-free) basis; in all of these cases, external rollouts may make the most sense. Many of the potential problems that can occur on rollout are solvable by not using the policy values to accomplish the corporate repayment incident to the rollout. For example, using other sources of cash (or borrowings) would avoid the equity taxation issues . . . and any tax consequences of using policy values to effect the rollout.”).

MEC stands for a modified endowment contract, a life insurance contract as defined under IRC §7702A that is entered into or materially modified after June 21, 1988, in which the cumulative premiums paid in the first seven years of the policy exceed the amount needed to provide for a paid-up policy based on statutorily set level annual premiums (the “seven-pay test”). In effect, this test requires the policy to provide a minimum level of insurance coverage for each dollar amount of premium over the policy's first seven years. If the policy is a MEC, withdrawals, surrenders and policy loans (including pledges of the MEC as collateral for a loan) are taxed as ordinary income until they exceed any gain in the contract (essentially cash value over premiums paid). IRC §72(e)(10). An additional 10-percent penalty tax may apply to the amount included in gross income, unless certain limited exceptions apply (i.e., no penalty for distributions (a) made on or after the date on which the taxpayer attains age 59½, (b) which is attributable to the taxpayer's becoming disabled, or (c) which is part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his beneficiary). IRC § 72(v). If a policy is a MEC, it remains a MEC. The status cannot be changed, even upon an exchange of the policy.

Partial surrender or withdrawals from the cash value of a non-MEC policy will be subject to income tax to the extent they exceed “investment in the contract.” IRC § 72(e)(2). For this purpose, “investment in the contract” means the aggregate amount of premiums or other consideration paid for the contract, less the aggregate amount received to date under the contract, to the extent that such amount was excludable from gross income. IRC § 72(e)(6).

¹⁰² See **Question C.15** for a discussion of basis in the policy.

- Depending on the entity, if the insured is a shareholder or partner, the business may need to make equalizing distributions to the other owners.
- The business' release of its security interest under a collateral assignment arrangement should not constitute a transfer for value under IRC § 101(a)(2), since the initial collateral assignment is not a transfer for value.¹⁰³
- Often, the policy will need additional premiums to remain in force, particularly if policy cash value was used to fund the rollout, which will now be the insured's responsibility. Possible options to assist the insured in meeting these premiums include:
 - A decrease in the policy death benefit or an exchange of the policy to reduce premiums needs.
As the split-dollar arrangement is terminated, a material modification is no longer a concern, although the insured will want to make sure such changes do not adversely affect policy guarantees or other terms.
 - A possible private split-dollar arrangement between the insured and his or her ILIT, subject to the final regulations.
 - A bonus plan arrangement, if the business still wants an insured employee to have coverage and is willing to increase his or her compensation, or possibly additional split-dollar loans for future premium payments (see Question **D.35** for a discussion of split-dollar loans under the final regulations).
- **Switch to a Loan (Collateral Assignment Equity Arrangements Prior to Equity Buildup).**¹⁰⁴
Prior to any equity buildup in the policy,¹⁰⁵ the business and insured convert all prior premium payments, less any repayments made to the business, to a loan on the first day of the year in which the election to switch to loan treatment is made. The business and insured determine the loan terms, such as length or term, interest rate, payment schedule, etc.

The insured (or, more typically, his or her ILIT) continues as the owner of the policy. The business retains a security interest in the policy, evidenced by a collateral assignment reflecting its revised interest.

- *Considerations.*¹⁰⁶
 - This approach will not be available for arrangements between public companies and directors and covered executives under SOX, due to the prohibition against personal loans to such individuals and may not be an option for organizations, like nonprofits, that have chosen to adopt or are otherwise subject to SOX-like policies (see **Question E.16**).
 - If the underlying policy has not yet produced equity and the Insurer Term Rates, if they apply, remain low for purposes of calculating the annual economic benefit to the insured, the parties could delay the switch to a loan until the year before policy equity will appear, and continue reporting under the rules available for grandfathered arrangements. The parties need to consider the performance of the policy, the applicable Insurer Term Rates for determining the annual

¹⁰³ See Regs. § 1.101-1(b)(4).

¹⁰⁴ See safe harbor provided under Section VI.3 of Notice 2002-8. See also Brody and Ratner, "What To Do With Those Existing Split-Dollar Plans," *supra* note 35.

¹⁰⁵ See note 44 for a discussion of when policy equity develops.

¹⁰⁶ See discussion in Ratner and Leimberg, "A Planner's Guide to Split-Dollar After the Final Regulations," *supra* note 45.

economic benefit to the insured, the current interest rates that would apply to a loan, and the possibility of a rise in those rates if the loan were delayed.

- If the switch to a loan occurs when the policy has equity, it will likely trigger current taxation of that equity to the insured, with an imputed gift to the ILIT, as discussed in **Questions C.17 and C.19**.
- Once converted, the conversion likely constitutes a material modification, and thus application of the loan regime under the final regulations.¹⁰⁷ Specific taxation under those rules will depend on several factors, primarily the term of the loan, the interest rate charged and the relationship between the parties. See discussion beginning at **Question D.35** regarding the application of the loan regime under the final regulations.
- Where an ILIT holds the policy, the final regulations may divide the loan into two separate loans: one made by the business to the insured with a corresponding loan from the insured to the ILIT (see **Question D.60**). In this case, the loan approach generally will work best if the ILIT is a grantor trust with respect to the insured, in order to avoid treating the imputed interest on the loan to the ILIT as taxable income to the insured.
 - Grantor trust status may also facilitate the insured engaging in an installment sale or other loan transactions with the ILIT. This could provide funding for the ILIT to repay the loan to the borrower and/or future premium payments on the policy, avoiding the need for future loans from the business to subsidize the premiums.
- If required, future premiums on the policy can be paid by the insured (and his or her ILIT), via bonus compensation from the business, subject to the same policy review and payment options as discussed in the rollout option above, or funded through additional split-dollar loans under the final regulations (see discussion beginning at **Question D.35**).
- **Policy Roll-in.** The insured (or his or her ILIT) transfers the policy to the business, which terminates the arrangement. If ongoing life insurance coverage is desired, the business could implement a non-equity endorsement arrangement taxed under the economic benefit regime under the final regulations (see discussion of the economic benefit regime beginning at **Question D.10**). The business would endorse the desired amount of death benefit to the insured's designated beneficiary (e.g., his or her ILIT).
 - *Considerations.*
 - The approach may appeal in cases where a policy has not developed equity. Since, in an equity split-dollar arrangement, the business' reimbursement right equals the lesser of the premiums it paid or the policy's cash value, the transfer of the policy to the business should satisfy its reimbursement right.
 - A transfer of the policy to the business in exchange for a release of the insured's obligation under the split-dollar agreement likely constitutes a transfer for value under IRC §101(a)(2), which would result in taxation of the policy death benefit in excess of the consideration paid for the transfer (e.g., the amount of the

¹⁰⁷ See Lawrence Brody, Michael D. Weinberg, and Myron Kove, "Practice Alert: Experts' Critical Analysis of Final Split-Dollar Regulations," Estate Planners Alert Newsletter (RIA) (Dec. 2, 2003), stating that "Prudence may suggest assuming that the new rules do apply to the switch, notwithstanding that the plan was a pre-final regs. plan." See also Ratner and Leimberg, "A Planner's Guide to Split-Dollar After the Final Regulations," *supra* note 45 (stating that "the IRS is likely to consider a post-9/17/03 switch from economic benefit regime to loan regime as a material modification of the contract. It's therefore likely that the final Regs. would apply from that point.").

obligation released). If the business will not surrender the policy, it should be reviewed whether an exception to the transfer for value rule applies (e.g., transfer of the policy to a partnership or corporation in which the insured is a partner or shareholder).¹⁰⁸

- If a non-equity endorsement arrangement is implemented after the roll-in, the employee will have no access to policy equity. This may not be critical if the transferred policy was underperforming or only death benefit protection is now desired, somewhat like a death-benefit-only plan.
- The employee will have imputed income for the cost of current life insurance protection provided under the new arrangement for the duration of the plan.
 - This cost will be determined similarly to the annual economic benefit under the grandfathered arrangement, except that the parties can use the Insurer's Term Rates only if they meet the more stringent requirements imposed by Notice 2002-8 (see **Question C.8**). Otherwise, the Table 2001 rates must be used, which can substantially increase the annual economic benefit (See **Question C.10**).
- If the policy is owned by an ILIT (as is likely), use of this strategy should consider any potential estate or gift tax issues resulting from a new endorsement, economic benefit arrangement if implemented after the policy roll-in. For example, will the insured's assignment to the ILIT of the endorsed interest in the death benefit constitute a gift, potentially subject to gift tax? If so, that gift likely will subject the endorsed death benefits to the estate inclusion rule applicable to gifts of life insurance policies within three years of death (see IRC § 2035).
- The ILIT trustee must review whether a transfer of a policy to the business will comply with its fiduciary duties to the ILIT and its beneficiaries, factoring in the change in the economic benefits, if any, provided to the ILIT under a new arrangement and the potential estate tax consequences noted above.
- **Leave Plan Intact.** Although not really an "exit," the parties can leave the arrangement in place until the death of the insured, with continued taxation on the annual economic benefit as provided under the grandfathered rules.
 - *Considerations.*
 - Under Notice 2002-8, there should be no current tax on any policy equity as long as the insured reports or contributes the annual economic benefit, which will be required even if no further premiums are due on the policy (see **Questions C.13** and **C.14**). It also seems that the policy equity may not be taxed if the arrangement continues until the insured's death.¹⁰⁹
 - Depending on the policy, if the business will defer its reimbursement right until the death of the insured, the policy cash value will not be used to repay the business and thus could be applied to support the death benefit.
 - The business, however, will need to account for the discounted value of its receivable over the insured's life expectancy.

¹⁰⁸ See note 85 for a review of IRC §101(a)(2).

¹⁰⁹ See Joshua E. Husbands and J. Alan Jensen, "Split-Dollar Life Insurance Funding: You Mean People Still Do That?" *Probate & Property Magazine*, May/June 2008, p. 3 (the parties to the grandfathered split-dollar arrangement "can ignore the equity if they are certain that the policy will be held until the death of the insured(s) and the proceeds paid. Because of the exclusion from income under Code § 101, the entire proceeds should be exempt from income tax and no equity in the policy should be recognized on the payment of the proceeds.").

- In addition, if the insured or the ILIT accesses the policy equity through loans or withdrawals, it will likely result in immediate taxation to the extent those amounts exceed the insured's or ILIT's basis in the policy.
- Also, if terms of the split-dollar arrangement require termination of the agreement at the insured's retirement, it is possible that an extension of the arrangement until death will constitute a material modification, resulting in taxation of the annual economic benefit and the policy equity under the final regulations.

CASE STUDIES

The following case studies review the potential tax issues associated with various grandfathered split-dollar arrangements upon termination of the plan. Note that the results of any particular case are highly sensitive to the case's unique facts and the federal and state tax rates and laws then applicable. These case studies are for illustration only and cannot be relied upon or used as the basis for any tax advice.

C.37. Rollout from a Grandfathered Collateral Assignment Split-dollar (with Equity)

Facts. A collateral assignment, contributory split-dollar agreement was established between X. Co. and executive E's ILIT over 15 years ago (and prior to Jan. 28, 2002). There have been no material modifications to the arrangement or the underlying policy that would result in application of the final regulations. ILIT owns the policy and is a grantor trust with respect to E for federal income tax purposes. The agreement calls for the ILIT, as policy owner, to contribute an amount equal to the annual economic benefit provided under the arrangement to X Co. X Co. paid the annual premiums to the insurance carrier, and its reimbursement right, which is for the lesser of cumulative premiums advanced or the policy's cash surrender value, was secured from policy cash value by a collateral assignment filed with the life insurance carrier. The agreement now requires termination of the split-dollar arrangement. It was anticipated that X Co. would be repaid upon termination using policy cash values. The policy is currently in an equity position, since the policy cash value exceeds the amounts owed to X Co.

Termination. The policy cash value will be used to repay the cumulative premiums advanced by X Co.,¹¹⁰ who will release its collateral assignment and terminate the split-dollar agreement.

Economics:

• Cumulative Premiums Advanced by X Co.	\$1,420,000
• Cumulative Premium Contributions by ILIT	\$80,000
• Total Premiums Paid for Policy	\$1,500,000
• Total Policy Cash Value	\$2,250,000
• Policy Equity	\$750,000
• X Co. Tax Bracket	40%
• Executive E's Tax Bracket	40%
• Gift Tax Rate	40%

Potential Tax Outcomes. Based on the above:

- X Co.:

¹¹⁰ See **Question C.36** and related notes for a discussion of considerations and issues associated with a rollout of policy with or without bonus involving the use of policy cash value.

- Receives \$1,420,000 as repayment of the total premiums it has advanced, which should not be subject to tax.
- Must decide whether it will report \$750,000 of policy equity as compensation income to E and take a corresponding income tax deduction, subject to limitations under IRC §162(m) regarding reasonableness of the compensation.
 - Arguably, X Co. could choose not to report the policy equity as compensation to E, relying on the “no-inference” language under Notice 2002-8 to take the position that the policy equity is not taxable under the pre-regulation guidance applicable to grandfathered equity arrangements.
 - The conservative course, due to the penalties associated with an employer's underreporting of compensation income, would be to report the equity as compensation.
- *Executive E:*
 - Has compensation income of \$750,000, less any basis in the policy,¹¹¹ unless E seeks to take a position that the policy equity is not subject to tax, relying on the “no-inference” language of Notice 2002-8. E's willingness/success in taking this position may be impacted by whether X Co. takes a similar stance.
 - Assuming tax at a maximum income tax rate of 40 percent, the termination of the arrangement could result in a top federal income tax liability of \$300,000.
 - The equity is essentially phantom income to E. Unless X Co. agrees to bonus the tax liability to E as additional compensation, which, may not qualify for a corresponding compensation deduction due to reasonableness requirements, or E has access to the ILIT to help pay the income tax liability, E will need to come up with cash to pay the liability.
 - Makes a corresponding, imputed gift of the taxable equity (e.g., \$750,000) to the ILIT.
 - Depending on the terms of the ILIT, including the number of beneficiaries who hold Crummey withdrawal powers, if any, E may be able to fully shelter the imputed gift through the use of annual exclusion gifts.
 - Otherwise, assuming annual exclusion gifts are not available, E could incur federal gift tax of up to \$300,000, assuming application of a top-40-percent gift tax rate or must use \$750,000 of his federal gift tax exemption (if he has any remaining) to shelter the gift.
 - In addition, if E intends for the ILIT to be fully exempt from GST tax, he likely will need to allocate up to \$750,000 of his federal GST tax exemption (if he has any remaining) to preserve the ILIT's GST tax-exempt status.
 - Termination of the arrangement could result in a combined federal income and gift tax liability to E of up to \$600,000.

C.38. Rollout from a Grandfathered Equity Collateral Assignment Split-dollar (No Policy Equity)

Facts. A collateral assignment, contributory split-dollar agreement was established between X. Co. and executive E's ILIT over 15 years ago (and prior to Jan. 28, 2002). There have been no material

¹¹¹ See **Question C.15** and related notes for a discussion of an insured's/ILIT's contributions to annual economic benefit costs and the development of basis in the policy.

modifications to the arrangement or the underlying policy that would result in application of the final regulations. ILIT owns the policy and is a grantor trust with regard to E for federal income tax purposes. The agreement calls for the ILIT, as policy owner, to contribute an amount equal to the annual economic benefit provided under the arrangement to X Co. X Co. paid the annual premiums to the insurance carrier, and its reimbursement right, which is for the lesser of cumulative premiums advanced or the policy's cash surrender value, was secured from policy cash value by a collateral assignment filed with the life insurance carrier. The agreement now requires termination of the split-dollar arrangement.

Termination. It was anticipated that policy cash values would be used to repay X Co. upon termination of the arrangement. The policy owned by the ILIT has not performed well, such that the cash surrender value is less than the total premiums paid by X Co. Either the policy will be assigned to X Co. or policy cash values will be used to pay X Co. in satisfaction of its reimbursement right under the split-dollar arrangement,¹¹² and the agreement will terminate.

Economics:

• Cumulative Premiums Advanced by X Co.	\$1,420,000
• Cumulative Premium Contributions by ILIT	\$80,000
• Total Premiums Paid for Policy	\$1,500,000
• Total Policy Cash Value	\$1,150,000
• Difference in Policy Cash Surrender Value and Premium Advances by X Co.	(\$270,000)
• X Co. Tax Bracket	40%
• Executive E's Tax Bracket	40%

Potential Tax Outcomes. Based on the above:

- X Co.: Receives repayment of its reimbursement right under the split-dollar arrangement (i.e., the lesser of policy's cash surrender value or total premiums paid by X Co.).
- Executive E: With no policy equity, the termination of the arrangement should not produce a realized gain to E.¹¹³

C.39. Termination of a Grandfathered Collateral Assignment Split-dollar (with Equity) and 162 Bonus of the Corporate Interest in the Policy

Facts. A collateral assignment, contributory split-dollar agreement was established between X. Co. and executive E's ILIT over 15 years ago (and prior to Jan. 28, 2002). There have been no material modifications to the arrangement or the underlying policy that would result in application of the final regulations. ILIT owns the policy and is a grantor trust with respect to E for federal income tax purposes. The agreement calls for the ILIT, as policy owner, to contribute an amount equal to the annual economic benefit provided under the arrangement to X Co. Under the terms of the agreement, X Co.'s reimbursement right is for the lesser of cumulative premiums advanced or the policy cash surrender value, and this reimbursement is secured from the policy's cash value by a collateral assignment filed with

¹¹² See **Question C.36** and related notes for a discussion of considerations and issues associated with a rollout of policy with or without bonus and a roll-in of a policy.

¹¹³ See Husbands and Jensen, "Split-Dollar Life Insurance Funding: You Mean People Still Do That?" *supra* note 108, at p. 4 ("If there is no equity, a termination should not or cannot produce realized gain."); Lawrence Brody and Mary Ann Mancini, "Sophisticated Life Insurance Techniques," ABA Section of Taxation Meeting, May 2011, Sec. II.E.1(d)(i) ("Planning going forward . . . What can and should be done about existing pre-final regulation arrangements that did not qualify for or did not take advantage of the safe harbors of [Notice 2002-8] before Jan. 1, 2004? . . . Many arrangements will be planned to rollout after January 1, 2004. . . If there is no equity at that point, there will be no tax consequences.").

the life insurance carrier. The agreement now requires termination of the split-dollar arrangement. The policy is currently in an equity position, since the policy cash value exceeds the amounts owed to X Co.

Termination. X Co. has decided to release its collateral assignment interest in the policy as a 162 bonus to E and terminate the split-dollar agreement.

Economics:

• Cumulative Premiums Advanced by X Co.	\$1,420,000
• Cumulative Premium Contributions by ILIT	\$80,000
• Total Premiums Paid for Policy	\$1,500,000
• Total Policy Cash Value	\$2,250,000
• Policy Equity	\$750,000
• X Co. Tax Bracket	40%
• Executive E's Tax Bracket	40%
• Gift Tax Rate	40%

Potential Tax Outcomes. Based on the above:

- X Co.:
 - Receives \$0 as repayment of the total premiums it has advanced.
 - Reports \$1,420,000 as compensation income to E and receives a corresponding income tax deduction (subject to limitations under IRC § 162(m) regarding reasonableness of the compensation).
 - Must decide whether it will report the \$750,000 of policy equity as compensation income to E and take a corresponding income tax deduction (again subject to limitations under IRC § 162(m) regarding reasonableness of the compensation).
 - Arguably, X Co. could choose not to report the policy equity as compensation to E, relying on the “no-inference” language under Notice 2002-8 to take the position that the policy equity is not taxable under the pre-regulation guidance applicable to grandfathered equity arrangements.
 - The conservative course, due to the penalties associated with an employer's underreporting of compensation income, would be to report the equity as compensation.
- Executive E:
 - Has compensation income of \$2,170,000, less any basis in the policy,¹¹⁴ unless E seeks to take a position that the \$750,000 attributable to the policy equity is not subject to tax, relying on the “no-inference” language of Notice 2002-8 (E's willingness/success in taking this position may be impacted by whether X Co. takes a similar stance).
 - Assuming tax at a maximum income tax rate of 40 percent, the termination of the arrangement could result in a top federal income tax liability of \$868,000.

¹¹⁴ See **Question C.15** and related notes for a discussion of an insured's/ILIT's contributions to annual economic benefit costs and the development of basis in the policy.

- The equity is essentially phantom income to E. Unless X Co. agrees to also bonus the tax liability to E as additional compensation, which may not qualify for a corresponding compensation deduction due to reasonableness requirements, or E can access the ILIT to help pay the income tax liability. E will need to come up with cash to pay the liability.
- Makes a corresponding, imputed gift of the taxable amount (e.g., \$2,170,000) to the ILIT.
 - Depending on the terms of the ILIT, including the number of beneficiaries who hold Crummey withdrawal powers, if any, E may be able to fully shelter the imputed gift through the use of annual exclusion gifts.
 - Otherwise, assuming annual exclusion gifts are not available, E could incur federal gift tax of up to \$868,000, assuming application of a top-40-percent gift tax rate, or must use \$2,170,000 of his federal gift tax exemption (if he has any remaining) to shelter the gift.
 - In addition, if E intends for the ILIT to be fully exempt from GST tax, he likely will need to allocate up to \$2,170,000 of his federal GST tax exemption (if he has any remaining) to preserve the ILIT's GST tax-exempt status.
 - Termination of the arrangement could result in a combined federal income and gift tax liability to E of up to \$1,736,000.

Section D: Post-regulation Split-dollar Arrangements

DEFINITIONS

D.1. What Is a “Post-regulation” Split-dollar Arrangement?

A post-regulation split-dollar arrangement is an arrangement entered into after Sept. 17, 2003 (or on or before that date and materially modified thereafter), the effective date of the final split-dollar Treasury Regulations (“**final regulations**”).¹¹⁵

D.2. What Do the Terms “Entered into” and “Materially Modified” Mean for Purposes of the Final Regulations?

See **Questions C.2 and C.3** for the definitions of “entered into” and “materially modified” for purposes of determining whether the final regulations apply to a split-dollar arrangement, as well as the discussion beginning at C.26 regarding the impact of material modifications to a grandfathered split-dollar arrangement.

Practice Note: As noted in **Question C.2**, the first step in dealing with any existing split-dollar arrangement is to confirm whether you are dealing with a grandfathered or post-regulation split-dollar arrangement, as the administration, potential taxation, and recommendations for maintaining, modifying or terminating the arrangement will vary significantly depending on this initial classification.

For simplicity and to maintain consistency with references in the final regulations, for the remainder of this Section D, post-regulation split-dollar arrangements will be referred to as “split-dollar arrangements” (as compared to “grandfathered split-dollar arrangements”).

D.3. What Is a “Split-dollar Arrangement” Under the Final Regulations?

Generally. The final regulations generally define a split-dollar arrangement as any arrangement between an “owner” and a “non-owner” of a life insurance contract that satisfies the following criteria:

- Either party to the arrangement pays, directly or indirectly, all or any portion of the premiums on the life insurance contract, including payment by means of a loan to the other party that is secured by the life insurance contract.
- At least one of the parties is entitled to recover, conditionally or unconditionally, any part of the premiums it pays, and the recovery will be made from, or is secured by, the proceeds of the life insurance contract.
- The arrangement is *not* part of a group-term life insurance plan under IRC §79 unless such plan provides permanent benefits to employees.¹¹⁶

Practice Note: This very broad definition means that most premium-splitting or lending arrangements between related parties (e.g., employer-employee, business-owner) will qualify as split-dollar arrangements, regardless of the documentation or structure used. Thus, advisors should always consider the potential application and impact of the final regulations when reviewing or recommending life insurance premium funding strategies in business planning situations.

Practice Note: Despite the changes in split-dollar tax rules, businesses and insured owners and/or employees can still find planning benefits in split-dollar arrangements. For example, the sharing of premiums can often provide additional compensation benefits and life insurance coverage for employees at a relatively low tax cost to both the business and the insured. It can also provide insurance funding for insureds who currently have limited or unpredictable cash flow.

¹¹⁵ See Reg. § 1.61-22(j)(1) and (2).

¹¹⁶ Reg. § 1.61-22(b)(1).

Specific Arrangements. Compensatory split-dollar arrangements (between an employer and an employee)¹¹⁷ and shareholder arrangements (between a corporation and a shareholder)¹¹⁸ also constitute split-dollar arrangements for purposes of the final regulations, whether or not they fall under the general definition, if:

- The employer or corporation (as applicable) pays, directly or indirectly, any part of the premiums.
- Either 1) the beneficiary of any part of the death benefit is designated by the employee or shareholder (as applicable) or is a person whom he or she would reasonably be expected to designate or 2) the employee or shareholder has any interest in the policy's cash value.

D.4. What Arrangements Are *Not* Split-dollar Arrangements?

The following arrangements are excluded from the definition of split-dollar arrangements:

- **Key Man Insurance.** “Key man” life insurance, where a business purchases life insurance coverage on a key employee or owner while retaining all the rights and benefits under the policy, including all death benefits and cash value.¹¹⁹
- **Bonus Plans.** Any plan where the party advancing the premiums does not expect reimbursement and has no interest in the policy (e.g., IRC §162 bonus plans). In these cases, the premium payments will be taxed based on the relationship of the parties (i.e., as compensation, a dividend, a gift, etc.).
- **True Co-ownership Arrangements.** Arrangements where each party has an undivided and identical fractional or percentage interest in each right, benefit, and obligation under the policy.¹²⁰ In this case, each party will be treated as the owner of a separate contract not subject to a split-dollar arrangement (see **Question D.5** below discussing policies with two or more owners).¹²¹
- **Group Term Insurance.** Group term life insurance plans under IRC §79, apart from those providing permanent protection to the employee.¹²²

D.5. Who Is the “Owner” of a Policy Under a Split-dollar Arrangement?

Generally the “owner” of a life insurance contract subject to a split-dollar arrangement is the **person named as the policy owner on the contract**.¹²³

Two or More Owners. If a policy names two or more owners, each will be treated as an owner of a separate contract to the extent of such person's interest.¹²⁴ The IRS, however, “will use existing authority to challenge” a transaction that substantively results in any sharing of the policy rights, benefits, or obligations among the policy owners. In such a case, the person who is the first-named policy owner is treated as the owner of the entire contract.¹²⁵

¹¹⁷ Or other service recipient and service provider. See Reg. § 1.61-22(b)(2)(i).

¹¹⁸ Reg. § 1.61-22(b)(2)(ii).

¹¹⁹ TD 9092, 68 Fed. Reg. 54,336, 54,337 (Sept. 17, 2003).

¹²⁰ Reg. § 1.61-22(c)(4).

¹²¹ Reg. § 1.61-22(c)(1)(i); TD 9092, 68 Fed. Reg. 54,336, 54,338 (Sept. 17, 2003).

¹²² See Lawrence Brody, Michael D. Weinberg, and Myron Kove, “Practice Alert: Experts' Critical Analysis of Final Split-Dollar Regulations,” *Estate Planners Alert Newsletter (RIA)* (Dec. 2, 2003).

¹²³ Reg. § 1.61-22(c)(1)(i).

¹²⁴ See **Question D.4**.

¹²⁵ The preamble to the final regulations states that the IRS has concerns that “certain arrangements may be inappropriately structured to avoid the application of these regulations (for example, by using separate life insurance contracts that are, in substance, one life insurance contract).” The IRS “will consider all of the facts and circumstances of an arrangement to determine whether the parties have appropriately characterized the arrangement as one involving undivided interests and, therefore, not subject to these regulations”. See TD 9092, 68 Fed. Reg. 54,336, 54,338 (Sept. 17, 2003). See also Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, §63.12 “Split-Dollar Life Insurance” (Thomson Reuters/Tax & Accounting, 2d/3d ed. 1993-2013, updated June 2013 and visited on September 2013).

Compensatory and Private Non-equity Arrangements. The final regulations treat an employer/service recipient as owner of the policy under a non-equity split-dollar arrangement¹²⁶ entered into in connection with the performance of services,¹²⁷ and the donor as the policy owner under a non-equity split-dollar arrangement entered into between the donor and a donee (e.g., an irrevocable life insurance trust “ILIT”),¹²⁸ regardless of who the policy actually names as the owner.

D.6. Who Is a “Non-owner”?

A “non-owner” is defined as any person other than the owner “that has any direct or indirect interest in such contract.”¹²⁹

Example: X Co. and ILIT, an irrevocable, non-grantor trust, enter into a split-dollar arrangement in connection with the performance of services by executive, E. X Co. will pay all premiums on a life insurance policy insuring E’s life until termination of the arrangement or E’s death. E’s child, C, is the ILIT beneficiary. X Co. is the owner of the contract. At termination of the arrangement or E’s death, X Co. will receive the lesser of the total premiums it paid or the policy’s cash value, and ILIT will receive any balance. The policy cash value is fully accessible by X Co. and its creditors, but ILIT has the right to borrow or withdraw the portion of the policy cash value exceeding the amount payable to X Co.

E and ILIT each receive economic benefits under the split-dollar arrangement -- from X Co. to E as compensation, and separately from E to ILIT as a gift. Thus, because E and ILIT each have an indirect interest in the policy, each is a non-owner.¹³⁰

D.7. Why Does Policy Ownership Matter?

As discussed at **Question D.8**, the final regulations provide two regimes to determine the income, gift, and/or employment tax treatment of split-dollar arrangements: 1) the economic benefit regime and 2) the loan regime.

Whether the economic benefit regime or the loan regime applies to tax a split-dollar arrangement depends solely on which party is the deemed owner of the underlying life insurance policy for purposes of the final regulations (i.e., the business or insured).

TAXATION

D.8. How Are Split-dollar Arrangements Taxed Under the Final Regulations?

The final regulations provide two mutually exclusive regimes to tax split-dollar arrangements for purposes of federal income tax, gift tax, and employment taxes (e.g., FICA, FUTA, etc.): 1) the economic benefit regime¹³¹ and 2) the loan regime.¹³²

¹²⁶ I.e., the only economic benefit provided under the arrangement is current life insurance protection. See **Questions B.10-B.12** for a general discussion of equity and non-equity arrangements.

¹²⁷ Reg. § 1.61-22(c)(1)(ii)(A)(1). Note that for compensatory split-dollar arrangements, whether equity or non-equity arrangements, ownership of the policy is attributed to the employer/service recipient if the policy is owned by 1) a “secular trust,” as defined at IRC § 402(b) (i.e., an irrevocable trust in which the employee’s interest in and right to the trust’s assets are vested from the trust’s inception, and the trust’s assets are not subject to claims of the employer’s creditors), 2) a trust that is treated as a grantor trust for federal income tax purpose with regard to the employer/service recipient (e.g., a “rabbi trust” — an irrevocable grantor trust which holds deferred compensation payable to an employee but is subject to the claims of the employer’s creditors), 3) welfare benefit funds (as defined under IRC §419(e)(1)) or 4) a person under the employer/service recipient’s common control (as defined in IRC §414(c)) or a member of its controlled group (as defined at IRC §414(b)).

¹²⁸ Reg. § 1.61-22(c)(1)(ii)(A)(2).

¹²⁹ Reg. § 1.61-22(c)(2)(i).

¹³⁰ Reg. § 1.61-22(c)(2)(ii) Ex.

¹³¹ Reg. § 1.61-22.

¹³² Reg. § 1.7872-15.

The deemed “owner” of the policy for purposes of the final regulations (see **Question D.5**) determines which regime applies, as follows:

- ***Business Is Owner (or Deemed Owner) – Insured Is Non-owner: Economic Benefit***

The economic benefit regime will apply to:

- Split-dollar arrangements entered into in connection with the performance of services (“**compensatory split-dollar arrangements**”) where the employer or service-recipient is the named policy owner (e.g., the endorsement method);¹³³
- A compensatory, non-equity split-dollar arrangement where the employee is the named policyowner (e.g., the collateral assignment method);¹³⁴
- A split-dollar arrangement between a donor and donee (a “**private split-dollar arrangement**”) where the donor is the policy owner;¹³⁵ or
- A private *non-equity* split-dollar arrangement, where the donee is the named policy owner.¹³⁶

- ***Insured (or ILIT) Is Owner – Business Is Non-owner: Loan Regime (Generally)***

The loan regime will apply to any collateral assignment arrangement not subject to the economic benefit regime (generally those involving an equity component).

D.9. How Are Split-dollar Arrangements Taxed for Estate Tax Purposes?

Note that the final regulations do not address the estate taxation of split-dollar arrangements. Thus, for the insured under the split-dollar arrangement, general estate tax principles apply to determine the potential estate taxation of the split-dollar arrangement and the underlying policy (including whether the insured had any “incidents of ownership” in the policy for estate tax purposes).¹³⁷ Thus, for example, if a properly formed and administered ILIT owns the underlying policy or the insured’s interest in the policy, and the insured does not possess any incidents of ownership in the policy (i.e., no rights to surrender the policy, to name the beneficiary etc.), any death benefit proceeds payable at the insured’s death should be excluded from the insured’s estate.

ECONOMIC BENEFIT REGIME

D.10. How Does the Economic Benefit Regime Tax Split-dollar Arrangements?

For economic benefit split-dollar arrangements, the non-owner (i.e., the insured) annually receives and must recognize the “full value of all economic benefits” provided under the arrangement, less any consideration paid by the non-owner directly or indirectly to the owner.¹³⁸

D.11. What Are Recognizable Economic Benefits Under the Economic Benefit Regime?

The value of the economic benefits that a non-owner must recognize equals the total of¹³⁹:

1. ***Current Insurance Protection***: The cost of current life insurance protection provided to the non-owner¹⁴⁰

¹³³ Reg. § 1.61-22(b)(3)(ii)(A).

¹³⁴ Reg. § 1.61-22(c)(1)(ii)(A)(1).

¹³⁵ Reg. § 1.61-22(b)(3)(ii)(B).

¹³⁶ Reg. § 1.61-22(c)(1)(ii)(A)(2).

¹³⁷ See, e.g., IRC § 2042 and underlying regulations.

¹³⁸ Reg. § 1.61-22(d)(1).

¹³⁹ Reg. § 1.61-22(d)(2).

2. **Current Access to Policy Equity:** The amount of policy cash value to which the non-owner has current access (including annual increases in cash value)¹⁴¹
3. **Any Other Benefits:** The value of any other economic benefits provided under the arrangement¹⁴²

D.12. What Is the Cost of Current Life Insurance Protection Under the Economic Benefit Regime?

The cost of current life insurance protection represents the economic value of *the term life insurance coverage provided to the non-owner, less any amounts contributed by the non-owner*.¹⁴³

Practice Note: In non-equity split-dollar arrangements, current life insurance protection should be the only benefit provided to the non-owner.

D.13. How Is the Cost of Current Life Insurance Protection Calculated Under a Split-dollar Arrangement?

To determine the cost of current life insurance protection,¹⁴⁴ the parties to the split-dollar arrangement may apply the *lower* of the following term rates (assuming both are available) to the amount of current life insurance protection provided to the non-owner (see **Question D.14** for determining the amount of protection provided)¹⁴⁵:

- **Table 2001.** The term insurance rates as set forth in Table 2001. Table 2001 does not provide for survivorship rates, although Notice 2002-8 instructs taxpayers to make “appropriate adjustments” to these premium rates if the life insurance protection covers more than one life.¹⁴⁶
 - **Practice Note:** Many practitioners believe the “Greenberg to Greenberg” formula should be used to determine survivorship rates, as updated with Table 2001 rates.¹⁴⁷
- **Insurer’s Alternative Published Term Rates (“Insurer Term Rates”).** Insurer Term Rates, if they represent the issuing insurer’s current published premium rates available to all **standard risks** for

¹⁴⁰ As defined in Reg. §1.61-22(d)(3). See discussion beginning at **Question D.12**.

¹⁴¹ As defined in Reg. §1.61-22(d)(4)(ii). See discussion beginning at **Question D.20**.

¹⁴² Reg. § 1.61-22(d)(2)(iii).

¹⁴³ See Zaritsky & Leimberg, *Tax Planning With Life Insurance: Analysis With Forms*, § 6.05[2][c][ii] (Thomson Reuters/WG&L, 2d Ed. 1998, with updates through May 2013)(online version accessed on Checkpoint (www.checkpoint.riag.com) Sept. 2013).

¹⁴⁴ Determined as of the last day of the non-owner’s taxable year, unless the owner and non-owner agree to instead use the policy anniversary date. If the split-dollar arrangement terminates during the taxable year of the non-owner, then the cost is determined on the termination date. (Reg. §1.61-22(d)(5)). The owner and non-owner of the split-dollar arrangement must use the same valuation date, and that valuation date must be used for all years prior to termination of the split-dollar arrangement unless the parties receive consent of the IRS commissioner to make a change. (Reg. § 1.61-22(d)(5)(ii)). Similar rules apply for determining the date of the provision of benefit from the owner to the non-owner for employment and self-employment tax purposes. (Reg. § 1.61-22(d)(5)(iv)).

¹⁴⁵ Reg. § 1.61-22(d)(3)(ii). Technically, the regulations provide that the cost of current life insurance protection is determined by multiplying 1) the full amount of current life insurance protection provided to a non-owner under a split-dollar arrangement by 2), a “life insurance premium factor” designated in guidance published in the Internal Revenue Bulletin. To date, however, the IRS has not published any “life insurance premium factor.” Since the final regulations do not contain updated factors and the IRS has not issued additional guidance, Notice 2002-8, which republished Table 2001, is left as the only outstanding guidance for this purpose.

¹⁴⁶ See Notice 2002-8, Sec. III.2, which provides that “for arrangements entered into before the effective date of future guidance, taxpayers may use the premium rate table set forth at the end of this notice to determine the value of current life insurance protection on a single life that is provided under a split-dollar life insurance arrangement, in a qualified retirement plan, or under employee annuity contracts. (This table is captioned as Table 2001 and was originally published in Notice 2001-10.) Taxpayers should make appropriate adjustments to these premium rates if the life insurance protection covers more than one life.”

¹⁴⁷ Based on the letter dated Aug. 10, 1983, from IRS actuary Norman Greenberg (in response to a request from Morton Greenberg, Counsel and Director of Advanced Underwriting, Manufacturer’s Life), in converting individual PS 58 rates to PS 38 survivorship rates. See Michael F. Amoia, Kristen E. Simmons, and Robert C. Slane, “Private Split-dollar – What’s New about an Old Opportunity,” *NAEPC Journal of Estate & Tax Planning* (June 2009); Lawrence Brody, Michael D. Weinberg, and Myron Kove, “Practice Alert: Experts’ Critical Analysis of Final Split-Dollar Regulations,” *Estate Planners Alert Newsletter* (RIA) (Dec. 2, 2003).

\$1,000 of initial issue one-year term life insurance, and, after Dec. 31, 2003, meet the following additional requirements¹⁴⁸:

- The insurer generally makes the availability of such rates known to persons who apply for term coverage from the insurer.
- The insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels.¹⁴⁹

See **Question D.15** for an example of calculating the cost of current life insurance protection using both Table 2001 rates and Insurer Term Rates.

D.14. What Is the Amount of Current Life Insurance Protection Provided Under a Split-dollar Arrangement?

The amount of current life insurance protection provided to a non-owner each year equals the total death benefit under the policy (including paid-up additions), **less**:

- Death benefits payable to the owner as reimbursement¹⁵⁰
- The amount of any policy cash value (i.e., equity) taxed to, or paid for by, the non-owner¹⁵¹

See **Question D.22** for an example of calculating both the cost of current life insurance protection and the value of current access to policy equity.

Since the final regulations tax the non-owner's access to policy equity on a current basis (see **Question D.20**), that amount must be removed from the calculation of current life insurance protection to avoid double taxation.¹⁵² For non-equity split-dollar arrangements, the access to policy equity should have a \$0 value.

D.15. What Is the Impact of Using Table 2001 Rates Versus Insurer Term Rates to Calculate the Cost of Current Life Insurance Protection?

As noted with grandfathered arrangements (discussed at **Question C.10**), Insurer Term Rates are generally much lower than the Table 2001 rates and will result in a lower cost of current life insurance protection. Thus, parties to a split-dollar arrangement typically will prefer the use of Insurer Term Rates to determine the taxable economic benefit to the non-owner.

Example: Under Table 2001, the term rate for an insured, age 65, is \$11.90 per \$1,000 of death protection. Assume an insurer who issues a policy underlying a split-dollar arrangement has published one-year term rates for the same age of \$2.03 per \$1,000. On an amount of \$1 million of current life insurance protection, the difference in the taxable cost of current life insurance protection under the two rates would equal almost \$10,000.

¹⁴⁸ Notice 2002-8, Sec. III.3, referencing Rev. Rul. 66-110, as amplified by Rev. Rul. 67-154. This Notice provides that split-dollar arrangements entered into prior to the date of "future guidance" may continue to use the Insurer's Term Rates, subject to the requirements noted. Although not entirely clear, since the final regulations do not provide any guidance on the use of Insurer Term Rates and no other "future guidance" has been issued, it appears that compliant Insurer Term Rates can be used even for post-regulation split-dollar arrangements, at least until a table of premium factors is published in the Internal Revenue Bulletin. See Zaritsky & Leimberg, *Tax Planning With Life Insurance: Analysis With Forms*, § 6.05[2][c][iii], *supra* note 142, stating that "The IRS did not state in Notice 2002-8 that the insurer's published premium can be used to value the term coverage after Dec. 31, 2003, with respect to a life insurance contract (or individual certificate) issued after March 1, 2001. Nonetheless, it seems likely that this interpretation will be adopted by the IRS for all subsequent transactions."

¹⁴⁹ Notice 2002-8, Sec. III.3 specifically states that the IRS "will not consider an insurer's published premium rates to be available to all standard risks who apply for term insurance unless" these requirements are met.

¹⁵⁰ Including any outstanding policy loans that offset amounts otherwise payable to the owner.

¹⁵¹ Reg. § 1.61-22(d)(3)(i).

¹⁵² See Brody, Richey, and Baier, 386-4th T.M., *Insurance-Related Compensation*, Art. VI.F.3.a.

Presumably, if the IRS challenges the use of Insurer Term Rates, the cost of current life insurance protection would be re-determined based on the higher Table 2001 rate, with any corresponding federal income and gift tax liability adjusted accordingly.¹⁵³

Practice Note: If the insured is deemed to make a gift of the annual economic benefit to a third party, as when the insured's ILIT owns the policy, (see **Question D.33**), the insured may want to consider adequately disclosing on a Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return," the use of the Insurer Term Rates to determine the annual economic benefit and corresponding gift to start the running of the return's statute of limitations, particularly if there is any allocation of federal GST tax exemption to the gift.¹⁵⁴

D.16. Will Insurance Carriers Certify Their Insurer Term Rates for IRS Compliance?

As discussed in **Question C.9** for grandfathered arrangements, insurance carriers generally will not opine as to whether their Insurer Term Rates comply with the requirements for the use of such rates for split-dollar arrangements after Dec. 31, 2003.¹⁵⁵

Practice Note: While, in practice, advisors and clients may continue to use the lower Insurer Term Rates, the client bears the risk of whether the IRS will accept these rates as the basis for determining the cost of current life insurance protection under an economic benefit split-dollar arrangement.

D.17. Will the Cost of Current Life Insurance Protection Increase Each Year?

Yes, as with the annual economic benefit under grandfathered arrangements (see **Question C.11**), the cost of current life insurance protection increases each year with the age of the insured, and, in the case of a survivorship policy, will rise steeply at the death of the first insured, assuming the amount of current life insurance protection remains the same.

Example: Under Table 2001, the term rate for an insured, age 45, is \$1.53 per \$1,000 of death protection but rises to \$11.90 for an insured at age 65. If a split-dollar arrangement provides \$1 million of current life insurance protection, the cost of current life insurance protection is \$1,530 for the 45-year-old and \$11,900 for the 65-year-old, a difference of over \$10,000.

D.18. What Is the Impact of the Increasing Cost of Current Life Insurance Protection?

The continual increase in the cost of current life insurance protection as the insured ages means most economic benefit split-dollar arrangements need "exit" strategies to terminate the arrangement before the cost becomes overly burdensome, such as before the insured reaches an age with significant annual term rates or at the death of the first insured in a survivorship policy.

See the discussion of possible exit (also referred to as "rollout") strategies and related issues for split-dollar arrangements beginning at **Question D.76**.

¹⁵³ See Lawrence Brody and Charles Ratner, "What To Do With Those Existing Split-Dollar Plans," *Trusts & Estates*, March 2007, stating "In practice today, some carriers use 'old' rates; others do not. While carriers using old term rates might tell planners they're confident those rates qualify under Notice 2002-8, they generally don't provide a guarantee. Some carriers let the planner decide which rate, old or new, to use."

¹⁵⁴ See IRC § 6501(c)(9); Reg. § 301.6501(c)-1(f).

¹⁵⁵ *Id.* See also Lawrence Brody and Mary Ann Mancini, "Memorandum to Advanced Underwriting Subscription Service Clients, Re: Recent Split-Dollar Issues: The Section 409A Deadline For Compensatory Split-Dollar Arrangements; The Availability of Alternative Term Rates For Split-Dollar Arrangements; and Employer Reporting of Equity on Termination of Pre-Final Regulation Arrangements," Aug. 15, 2008.

D.19. What Happens When the Policy Is Paid up or the Business No Longer Needs to Advance Premiums?

Even if the business is no longer advancing premiums to the insurance carrier, the non-owner must continue to take into account the annual cost of current life insurance protection provided under the split-dollar arrangement, to the extent the non-owner does not pay or reimburse that cost.¹⁵⁶

D.20. What Is Current Access to Policy Cash Value (Equity Arrangements)?

A non-owner in a split-dollar arrangement has current access to policy cash value if the non-owner has a current or future right to any portion of the policy's cash value, and the policy's cash value is¹⁵⁷:

- Current accessible, directly or indirectly, by the non-owner,
- Inaccessible to the owner, or
- Inaccessible to the owner's general creditors (whether by agreement or operation of state law). Policy cash value is inaccessible 1) to the owner if the owner does not have the full rights to policy cash value normally held by an owner of a life insurance contract and 2) to the owner's general creditors if the creditors cannot, for any reason (including by operation of applicable state law), effectively reach the policy cash value in the event of the owner's insolvency.¹⁵⁸

Practice Note: If an economic benefit split-dollar arrangement includes an equity component (e.g., a non-owner's right to any remaining cash value after repayment of the owner upon termination of the arrangement), the owner's or owner's creditors' non-access to policy cash value equals access for the non-owner.¹⁵⁹

Example: X Co. and its executive, E, enter into an economic benefit split-dollar arrangement under which X Co. is the policy owner for purposes of the final regulations and E is the insured and non-owner. X Co. pays all premiums on the life insurance policy until termination of the arrangement or E's death with no contributions. At that time, X Co. is entitled to receive the lesser of the total premiums paid or the policy's cash value, with E entitled to receive any remaining amounts (i.e., an equity arrangement). Otherwise, E has no rights to borrow, withdraw or access, directly or indirectly, the policy cash value. State law makes the policy's equity component inaccessible to X Co.'s general creditors. Although E cannot withdraw the policy's equity, under these circumstances, E is deemed to have current access to policy cash value.¹⁶⁰

¹⁵⁶ See Henkel, *Estate Planning and Wealth Preservation: Strategies and Solutions*, §12.06[4][a][i][A] (Thomson Reuters/WG&L 1997, with updates through June 2013) (online version accessed on Checkpoint (www.riacheckpoint.com) Oct. 2013).

¹⁵⁷ See Reg. §1.61-22(d)(4)(ii).

¹⁵⁸ See Regs. §1.61-22(d)(4). See Brody, Richey, and Baier, *Insurance-Related Compensation*, Art. VI.F.3.b, *supra* note 151, noting that, assuming the arrangement is an equity arrangement, "the preamble to the regulations makes it clear that state creditor protection laws insulating life insurance policies from the claims of the owner's creditors cause the policy cash values to be treated as currently accessible to the non-owner on the theory that the constructive receipt rules applicable to deferred compensation should apply, assuming the arrangement is an equity arrangement." See also TD 9092, 68 Fed. Reg. 54,336 (Sept. 17, 2003).

¹⁵⁹ The preamble to the final regulations states that "The final regulations clarify that the non-owner has current access to policy cash value only if, under the arrangement, the non-owner has a current or future right to policy cash value; the non-owner will not have any such right in a true non-equity arrangement. If the non-owner does have such a right, any restriction on the owner's creditors to reach policy cash value, whether established by contract or by local law, results in an economic benefit to the non-owner. Several commentators objected to the rule in the 2003 proposed regulations that the non-owner has current access to any portion of the policy cash value that cannot be accessed by the owner. These commentators argued that as long as policy cash value can be accessed by the owner's creditors in the event of insolvency, the owner should not be viewed as providing any economic benefit to the non-owner. That objection, however, overlooks the economic reality of an equity split-dollar life insurance arrangement. If the owner commits funds to a life insurance contract and undertakes that it will not withdraw those funds from the insurance contract, the amounts so committed do not remain a general asset of the owner. The owner of the life insurance contract in such an arrangement has parted with the ownership and use of the funds for the benefit of the non-owner. This contrasts with an irrevocable rabbi trust, where the employer effectively remains the tax owner of the assets held by the trustee and the rabbi trust assets may still be (and very often are) invested in the employer's business." See TD 9092, 68 Fed. Reg. 54,336 (Sept. 17, 2003).

¹⁶⁰ See Treas. Reg. §1.61-22(d)(6), Ex. 2. See also TD 9092, 68 Fed. Reg. 54,336 (Sept. 17, 2003).

D.21. When Does the Non-owner Have Direct or Indirect Access to Policy Cash Value?

The IRS will broadly construe the concept of "access" to include any direct or indirect right under the arrangement allowing the non-owner to obtain, use, or realize potential economic value from the policy cash value.¹⁶¹ For instance, a non-owner has access to policy cash value if the non-owner can:

- Directly or indirectly make policy withdrawals
- Borrow from the policy
- Effect a total or partial surrender of the policy, and/or
- Anticipate, assign, alienate, pledge, or encumber the policy cash value, or the cash value is available to the non-owner's creditors

Example: X Co. and its executive, E, enter into an economic benefit split-dollar arrangement under which X Co. is the policy owner for purposes of the final regulations and E is the insured and non-owner. X Co. pays all premiums on the life insurance policy until termination of the arrangement or E's death. At that time, X Co. is entitled to receive the lesser of the total premiums paid or the policy's cash value, with E entitled to receive any remaining amounts (i.e., an equity arrangement). The policy cash value is fully accessible by X Co. and its creditors, but E also has the right to borrow or withdraw at any time the policy equity. Because the split-dollar arrangement is an equity arrangement and E can access a portion of the policy cash value, E must include in gross income the amount of the policy cash value to which he has current access (less any amount previously taxed to him).¹⁶²

D.22. How Is the Value of Current Access to Policy Cash Value Calculated?

The portion of the policy cash value taxable to the non-owner is the amount to which the non-owner has current access, reduced by any amount the non-owner included in gross income in prior years of the arrangement. The policy cash value includes any cash value attributable to paid-up additions and is determined without regard to surrender or similar charges.¹⁶³

The following example illustrates the calculation of value for both the cost of current life insurance protection and current access to policy cash value for a non-owner under an equity split-dollar arrangement taxed under the economic benefit regime.

Example: On Jan. 1 of Year 1, X Co. and executive E enter into an economic benefit split-dollar arrangement under which X Co. is the policyowner for purposes of the final regulations, and E is the insured and non-owner. X Co. pays all premiums on the policy until termination of the arrangement or E's death. At that time, X Co. is entitled to the lesser of the total premiums paid or the policy's cash value, with E entitled to receive any remaining amounts (i.e., an equity arrangement). Under the agreement, the policy cash value is fully accessible by X Co. and its creditors, and E has the right to borrow or withdraw from cash value in excess of amounts owed to X Co. (i.e., the policy equity). Thus, *E receives both current life insurance protection and access to policy cash value under the arrangement and must include the value of both in gross income.*

X Co. buys a policy with a death benefit of \$1,500,000, insuring E, who is age 50. X Co. pays annual premiums of \$60,000. At the end of Year 1, the policy cash value equals \$55,000, at the end of Year 2, \$140,000, and at the end of Year 3, \$240,000. E must include the following in gross income:

¹⁶¹ TD 9092, 68 Fed. Reg. 54,336 (Sept. 17, 2003).

¹⁶² Reg. §1.61-22(h), Ex. 2.

¹⁶³ Reg. §1.61-22(d)(4)(i).

- **Year 1: \$3,324**
 - Current Access to Policy Cash Value: \$0
(\$55,000 of policy cash value – \$60,000 payable to X Co. for premiums)
 - Cost of Current Life Insurance Protection: \$3,324
((\$1,445,000 (\$1,500,000 – \$55,000 payable to X Co.) /\$1000) x \$2.30 Table 2001 rate)

- **Year 2: \$23,427**
 - Current Access to Policy Cash Value: \$20,000
(\$140,000 of policy cash value – \$120,000 payable to X Co. for premiums)
 - Cost of Current Life Insurance Protection: \$3,427
((\$1,360,000 (\$1,500,000 – \$120,000 payable to X Co. – \$20,000 of cash value included in E's gross income)/\$1,000) x \$2.52 Table 2001 rate)

- **Year 3: \$43,541**
 - Current Access to Policy Cash Value: \$40,000
(\$240,000 of policy cash value – \$180,000 payable to X Co. for premium – \$20,000 of cash value included in E's gross income in Year 2)
 - Cost of Current Life Insurance Protection: \$3,541
((\$1,260,000 (\$1,500,000 – \$180,000 payable to X Co. – \$60,000 of cash value included in E's gross income for Years 2 and 3)/\$1,000) x \$2.81 Table 2001 rate)

D.23. Can the Policy Cash Value or the Valuation Date Be Adjusted to Limit or Reduce the Value of the Non-owner's Current Access to Policy Cash Value?

No. The final regulations include an anti-abuse rule designed to prevent parties to a split-dollar arrangement from manipulating the policy cash value in order to understate the value of the economic benefit that the non-owner must take into account.¹⁶⁴ In such a case, the valuation date will be the date on which the amount of the economic benefit was greatest during that taxable year.¹⁶⁵

D.24. How Are Economic Benefits Taxed Under a Contributory Arrangement?

As discussed in **Question B.8**, in a “contributory plan,” the insured contributes a part of the premium payment, while the business pays the balance. As with grandfathered arrangements (see **Question C.14**), the non-owner's contribution under an economic benefit split-dollar arrangement offsets the otherwise taxable economic benefit to the non-owner.¹⁶⁶

Compared to grandfathered arrangements, however, the final regulations unfavorably modify the tax treatment of contributory economic benefit arrangements by *requiring the owner of the policy (the*

¹⁶⁴ TD 9092, 68 Fed. Reg. 54,336 (Sept. 17, 2003).

¹⁶⁵ Reg. § 1.61-22(d)(5)(ii).

¹⁶⁶ Reg. § 1.61-22(d)(1).

business) to include in gross income any amounts paid by a non-owner, directly or indirectly, for any economic benefits provided under the arrangement.¹⁶⁷

Example: Assuming the same facts from the example in **Question D.22**, if, in Year 1, E contributed \$3,324 to the payment of premiums, it would cover the cost of his current life insurance protection, leaving him with \$0 of reportable income from the arrangement. X Co., however, would have to recognize the \$3,324 as gross income.

D.25. Does the Non-owner Receive Basis in the Policy Under a Contributory Arrangement?

No. Prior to the transfer of the contract to the non-owner (see **Question D.29**), the “investment in the contract,” or basis, (IRC § 72(e)(6))¹⁶⁸ only accrues to the owner (the business) under the split-dollar arrangement, regardless of whether the non-owner (insured) reports as income or makes any contributions for any economic benefit provided under the arrangement.¹⁶⁹ A non-owner insured does not receive basis in the policy for amounts he or she reports as income under the arrangement.

Note, however, that upon a transfer of the contract to the non-owner (the insured), the non-owner’s investment in the contract after the transfer will include the value of economic benefits previously taken into account and taxed to the non-owner, but excluding those attributable to the cost of current life insurance protection (see **Question D.29**).

Practice Note: Contributions by the insured (or other third-party policyowner, like an ILIT) likely will not be as income tax-efficient in post-regulation economic benefit split-dollar arrangements, particularly since the owner (the business) must include the contributions in gross income. Such contributions would offset the imputed gift to an ILIT if it is the party to the split-dollar arrangement, but the ILIT must have funds to make the contributions, which may require a gift from the insured if the ILIT has no other assets except the policy.

D.26. How Are Distributions, Loans or Other Non-death-benefit Proceeds Received Under the Policy Taxed in the Economic Benefit Regime?

Non-death-benefit proceeds received under a split-dollar policy (e.g., policy withdrawals, dividends, and specified policy loans) and provided to the non-owner are treated as first provided to the owner (the business), and then transferred to the non-owner. A specified policy loan is one where 1) the loan proceeds are distributed directly from the insurance company to the non-owner, 2) a reasonable person would not expect the non-owner to repay the loan or 3) the non-owner’s obligation to repay the loan to the owner is satisfied or is capable of being satisfied upon repayment by either party to the insurer.¹⁷⁰ These amounts are taxed:

¹⁶⁷ Reg. § 1.61-22(f)(2)(ii). See Zaritsky, Aghdami & Mancini, *Structuring Buy-Sell Agreements: Analysis With Forms* (Thomson Reuters/Tax & Accounting, 2d Ed. 2000, with updates through Sept. 2013) (online version accessed on Checkpoint (www.checkpoint.riag.com) Oct. 2013) at § 8.02, stating that “the rationale is that the owner is “renting” out part of the benefit of the life insurance contract to the non-owner for consideration, and that consideration constitutes income to the owner.”

¹⁶⁸ IRC § 72(e)(6) defines “investment in the contract” for purposes of amounts not received as an annuity under a life insurance contract (including policy surrenders, cash value withdrawals and dividends), as the aggregate amount of premiums or other consideration paid for the contract before such date, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws. Generally, under IRC § 72, for life insurance policies that are not modified endowment contracts (see discussion at note 56): 1) the owner may withdraw from policy cash value, income-tax-free, up to its investment in the contract, 2) withdrawals and complete surrenders of policies will generate ordinary income to the extent the amount received exceeds the owner’s investment in the contract and 3) the owner may take policy loans, income-tax-free.

¹⁶⁹ See Reg. § 1.61-22(f)(2)(i) and Reg. § 1.61-22(f)(2)(ii). The preamble to the final regulations explains that: The regulations generally treat only one person as the owner of the life insurance contract. Because only the owner of a life insurance contract can have an investment in that contract, a non-owner employee cannot have basis in the contract for any of the costs of current life insurance protection. In addition, such costs should not be included in the non-owner’s basis or investment in the contract if and when the non-owner becomes the owner of the contract because those payments were made for annual life insurance protection, which protection was exhausted prior to the non-owner’s acquisition of the contract. TD 9092, 68 Fed. Reg. 54,336 (Sept. 17, 2003).

¹⁷⁰ See Reg. § 1.61-22(e)(2). The IRS and Treasury believed that this rule was necessary to ensure that parties to a split-dollar arrangement do not avoid current taxation of the non-owner with respect to amounts provided to the non-owner through the contract. TD 9092, 68 Fed. Reg. 54,336 (Sept. 17, 2003).

- First to the owner, in accordance with IRC § 72 (e.g., a withdrawal of policy cash value generally is subject to income tax only if it exceeds the owner's investment in the contract, assuming the policy is not a MEC).¹⁷¹
- To the non-owner (the insured), based on the relationship between the parties (e.g., as compensation).¹⁷² This amount also applies for purposes of employment and gift taxes, for example, if the policy is held by the insured's ILIT, the insured will recognize compensation and will be deemed to have made a corresponding gift of the deemed amount received, which likely will be subject to gift tax (see **Question D.33**).

The non-owner may deduct any consideration paid and the value of any economic benefits (*other than* the cost of current life insurance protection) that the non-owner actually has taken into account.

Example: On Jan. 1 of Year 1, X Co. and executive E enter into an economic benefit split-dollar arrangement under which X Co. is the policyowner for purposes of the final regulations and E is the insured and non-owner. X Co. pays all premiums on the policy until termination of the arrangement or E's death. At that time, X Co. is entitled to the *greater* of the total premiums paid or the policy's cash value. The policy is not a MEC. X Co. is required to make annual premium payments of \$10,000, and E is required to make annual premium payments of \$500. In Year 5, a \$500 policyowner dividend payable to E is declared by the insurer. E directs the insurer to apply the \$500 as E's premium payment for Year 5.

X Co. is treated as receiving a \$500 distribution under the contract taxable under IRC § 72 (e.g., subject to tax if the dividend exceeds X Co.'s investment in the contract). E must include the \$500 in gross income as compensation. X Co. then must include E's \$500 contribution to the arrangement in income (but will receive a corresponding increase in its investment in the contract).¹⁷³

D.27. Can the Business Take a Deduction for Premiums Paid Under an Economic Benefit Split-dollar Arrangement?

No, the business cannot take an income tax deduction for any premiums it pays under the split-dollar arrangement, even the portion allocated to amounts reported by and taxed to the insured as income.¹⁷⁴ The premium payments, however, will be included in the owner's investment in the contract for purposes of IRC § 72(e)(6).¹⁷⁵

Note that, in "bonus plans," (see **Question B.9**) where the business bonuses the amount of the insured's tax liability with respect to the benefits under the split-dollar arrangement, the bonus amount may be deductible as compensation, assuming the insured's overall compensation, including the bonus, is ordinary, necessary, and reasonable.¹⁷⁶ The bonus may not be deductible, however, if it mirrors too

¹⁷¹ A MEC is a "modified endowment contract," as defined by IRC § 7702A. Generally, non-MECs involve premiums paid for four or more years. If the policy is a MEC, withdrawals, surrenders and loans (including pledges of the MEC as loan collateral) are taxed as ordinary income until they exceed any gain in the MEC (see IRC 72(e)(10)), and an additional 10-percent penalty tax may apply to the amount included in gross income (see IRC § 72(v)). See **Question D.74** for a discussion regarding the potential use of MECs in split-dollar arrangements.

¹⁷² Reg. § 1.61-22(e)(1). See **Question D.33** for a discussion of imputed gifts.

¹⁷³ Reg. § 1.61-22(h), Ex. 6.

¹⁷⁴ Except as provided in Treas. Reg. § 1.83-6(a)(5) or in the case of the owner's transfer of the policy to the non-owner, where the non-owner includes the policy cash value in income (see **Question D.29**). See Treas. Reg. § 1.61-22(f)(2)(ii). See also IRC § 264(a)(1), which generally prohibits a business deduction for the premiums paid on life insurance where the business, either directly or indirectly, benefits from the policy.

¹⁷⁵ Treas. Reg. § 1.61-22(f)(2)(ii).

¹⁷⁶ IRC § 162(a).

closely the employee's contribution amount or is otherwise deemed to be an insurance premium payment.¹⁷⁷

D.28. How Are Policy Death Benefits Taxed Under the Economic Benefit Regime?

Death benefits paid to a non-owner qualify for the general exclusion of life insurance death benefits from gross income under IRC § 101(a), but only to the extent that the insured paid or reported the annual cost of current life insurance protection as an economic benefit.¹⁷⁸ Otherwise, the final regulations treat the owner as receiving the full death benefit, income tax-free under IRC §101(a) (assuming compliance with IRC § 101(j) for certain employer-owned contracts, if applicable — see **Questions E.8-E.15**), and then paying the applicable amount to the non-owner's beneficiary, subject to tax based on the relationship of the parties (e.g., as compensation in an employer/employee relationship).¹⁷⁹

In other words, if the non-owner fails to report or contribute the cost of the current life insurance protection under a split-dollar arrangement, the death benefits allocated to the non-owner will lose their exclusion from income tax.

D.29. What Are the Tax Consequences upon a Transfer of the Policy to the Non-owner?

A transfer of the policy underlying a split-dollar arrangement occurs when a non-owner (the insured or his or her ILIT) becomes the policy owner for purposes of the final regulations.¹⁸⁰ After the transfer, any premiums paid by the former owner/transferee (i.e., the business) are includable in the transferee's gross income, unless they are taxed as split-dollar loans.¹⁸¹

When the transfer occurs,¹⁸² the non-owner/transferee (and the owner/transferee for employment or gift tax purposes) must recognize the then fair market value of the policy (see **Question D.30**), *less any*:

- Consideration paid by the non-owner for the transfer
- Any economic benefits the non-owner previously paid for or recognized *other than* the cost of current life insurance protection¹⁸³

If the policy is transferred in connection with the performance of services, taxation will not apply until the policy or interest therein becomes taxable under IRC § 83 (i.e., when any substantial risk of forfeiture lapses).

*The business can take a deduction for transferring ownership of the policy to the non-owner equal to the amount included in the non-owner's gross income as a result of the transfer plus all amounts previously included in the non-owner's gross income as economic benefits received under the arrangement (other than for the cost of current life insurance protection).*¹⁸⁴

Example: X Co. and executive E enter into an economic benefit split-dollar arrangement under which X Co. is the policyowner for purposes of the final regulations, and E is the insured and non-owner. X Co. pays all premiums on the policy until termination of the arrangement or E's death. At that time, X Co. is entitled to the *lesser* of the total

¹⁷⁷ See Streng & Davis, *Retirement Planning: Tax and Financial Strategies*, § 17.02[2][c][iv], (ThomsonReuters/WG&L, 2012 ed., updated Sept. 2012 and visited on June 2013); Brody, Richey, and Baier, *Insurance-Related Compensation*, Art.VI.C.1, *supra* note 151.

¹⁷⁸ Reg. § 1.61-22(f)(3).

¹⁷⁹ See, Brody, Richey, and Baier, 386-4th T.M., *Insurance-Related Compensation*, VI.F.3.f.

¹⁸⁰ Reg. § 1.61-22(c)(3). Also applies to a transfer of an undivided interest in a policy, which, after the transfer, will result in two separate policies under the final regulations.

¹⁸¹ Reg. § 1.61-22(g)(4). See Zaritsky & Leimberg, *Tax Planning With Life Insurance: Analysis With Forms*, § 6.05[2][c][viii], *supra* note 142.

¹⁸² Reg. § 1.61-22(g)(3).

¹⁸³ Reg. § 1.61-22(g)(1).

¹⁸⁴ See Reg. § 1.83-6(a)(5)(i).

premiums paid or the policy's cash value, with E entitled to receive any remaining amounts (i.e., an equity arrangement). E has the right to borrow or withdraw from any cash value in excess of the amount owed to X Co. under the arrangement (i.e., the policy equity).

X Co. buys a policy with a death benefit of \$1,500,000. X Co. transfers the policy to E after it has paid \$180,000 in premiums. The policy cash value (and the policy's fair market value for purpose of the transfer) is \$240,000. E has taxable current access to policy equity of \$60,000 (\$240,000 – \$180,000 of reimbursement due to X Co.). E pays no consideration for the transfer. E must include \$180,000 as compensation income upon transfer of the contract, as follows¹⁸⁵:

○ Policy Value:	\$240,000
○ Amount E pays for transfer	(\$0)
○ Amount E previously included in income as current access to policy cash value	(\$60,000)
○ Amount E must include as compensation income	\$180,000

X Co. may take a deduction for \$240,000 (\$180,000 + \$60,000 included in E's income as compensation), assuming the compensation would otherwise be deductible.

Practice Note: In effect, these transfer rules give the non-owner "basis" in the policy equity for benefits previously included in income based on current access to policy cash value, and let the owner recoup deductions for prior amounts treated as paid to the non-owner that were non-deductible when the owner had an interest in the policy.

D.30. What Is the Policy's Fair Market Value for Purposes of a Transfer from an Owner to the Non-owner?

The fair market value of the life insurance policy equals the policy cash value as of the date of the transfer, plus the value of all other rights under the policy, whether or not guaranteed, but excluding the value of current life insurance protection. For gift tax purposes, however, the value of the policy will be determined in accordance with the gift tax regulations, which is the interpolated terminal reserve value plus unapplied premiums for a contract that has been in place for some time and on which future premiums are due.¹⁸⁶ If the policy transfer is connected with the performance of services, however, the policy's fair market value is determined when the transfer of the policy become taxable under IRC § 83 (i.e., when any substantial risk of forfeiture lapses), without regard to any lapsed restrictions.¹⁸⁷

D.31. What Is the Non-owner's Investment in the Contract After a Transfer of the Policy to the Non-owner?

After a transfer of the policy to the non-owner/transferee, the "new" owner will have investment in the contract (basis) for purposes IRC § 72(e) equal to the *greater of*.

¹⁸⁵ Reg. § 1.61-22(h), Ex. 5.

¹⁸⁶ See Reg. § 25.2512-6 and Reg. § 1.61-22(g)(2). Presumably the reference to "policy cash value" means without reference to surrender charges. See Brody, Richey, and Baier, *Insurance-Related Compensation*, Art.VI.G.5, Art. VI.F.3,g and Art. VI.F.5, *supra* note 151; Lawrence Brody and Michael D. Weinberg, "How an Innovative New Technique for Split-Dollar Life Insurance Works," *Estate Planning Journal* (WG&L), Feb. 2006 (stating that "In determining whether there is policy equity, cash value – prior to surrender charges – is the relevant value.").

¹⁸⁷ Reg. § 1.61-22(g)(3).

- The fair market value of the policy, *or*
- The total consideration paid by the non-owner for the transfer, plus any amounts the non-owner previously paid or included in income for economic benefits under the arrangement, *excluding* the cost of current life insurance protection.¹⁸⁸

Example: X Co. and executive E enter into an economic benefit split-dollar arrangement under which X Co. is the policy owner for purposes of the final regulations, and E is the insured and non-owner. X Co. pays all premiums on the policy until termination of the arrangement or E's death. At that time, X Co. is entitled to the lesser of the total premiums paid or the policy's cash value, with E entitled to receive any remaining amounts (i.e., an equity arrangement). E has the right to borrow or withdraw from any cash value in excess of the amount owed to X Co. under the arrangement (i.e., the policy equity).

In Year 5, X Co. transfers the policy to E for no consideration. The policy's fair market value is \$200,000. X Co. has paid \$50,000 in premiums, and E has reported \$12,000 of economic benefits attributable to the annual cost of current life insurance protection under the arrangement. In addition, E has current access to \$150,000 of policy cash value, which was previously reported by E as an economic benefit.

E's investment in the contract after the transfer is \$200,000, representing the greater of the \$200,000 fair market value of the policy and the \$150,000 of access to cash value previously reported by E as an economic benefit. E does not receive any basis for the \$12,000 reported as the cost of current life insurance protection.¹⁸⁹

D.32. How Is the Income from the Split-dollar Arrangement Taxed to the Insured?

The taxation of economic benefits or other imputed income provided to the insured under the split-dollar arrangement, whether from the value of current life insurance protection or current access to policy cash value (see **Question D.58**)¹⁹⁰, depends on the relationship between the insured and the business and in what capacity the insured receives the benefits under the arrangements (e.g., as an employee or business owner).¹⁹¹

Employee. If the insured receives the benefits as an employee, those benefits will be taxable to the insured as compensation income, at ordinary income tax rates. The imputed compensation should also constitute wages for employment tax (e.g., FICA and FUTA) purposes.¹⁹²

Note that, depending on the structure of the economic benefit arrangement, it may need to comply with the nonqualified deferred compensation provisions under IRC § 409A or be subject to taxation under those provisions as well. See **Questions E.1-E.7** for a discussion the types of economic benefit arrangements to which § 409A may apply.

Business Owner. If the insured receives the benefits in his or her capacity as an owner of the business, the benefits will be treated as a distribution, which may be taxable as a dividend, a return of

¹⁸⁸ Reg. § 1.61-22(g)(4)(ii)(A); Reg. § 1.61-22(g)(4)(ii)(D)(iii). Note that, for gratuitous transfers of a policy between a donor and a donee (i.e., in a private split-dollar arrangement), the "new" owner's investment in the contract immediately after the transfer equals the sum of:

- Any consideration paid by the transferee to acquire the policy
- The total premiums or other consideration paid or deemed paid by the transferor (prior "owner"), and
- Any amounts the non-owner previously paid or included in income for economic benefits under the arrangement (i.e., amounts not included in income (e.g., because received or deemed received as a gift) will not count toward determining the new owner's investment in the contract). Reg. § 1.61-22(g)(4)(ii)(B).

¹⁸⁹ Reg. § 1.61-22(g)(4)(ii)(D), Ex. (i) and (ii).

¹⁹⁰ Similar treatment applies for imputed income under a split-dollar loan arrangement, as noted at **Question D.58**.

¹⁹¹ Reg. § 1.61-22(d)(1).

¹⁹² See discussion of employment taxes in Zaritsky & Leimberg, *Tax Planning With Life Insurance: Analysis With Forms*, § 6.05[2][g], *supra* note 142.

capital, a guaranteed payment, etc., depending on the type of business entity and the nature of the distribution.¹⁹³ For example:

- *C corporations*: The benefits provided under the grandfathered split-dollar arrangement to a non-employee shareholder likely are taxable as dividends, to the extent the corporation has earnings and profits.¹⁹⁴ If there are no earnings and profits, the basis on which the shareholder will be taxed is unclear, because not having earnings and profits may not sustain dividend taxation, in which case, another theory may apply.
- *S corporations*: A distribution to a non-employee shareholder of an S corporation will be treated similarly to a C corporation shareholder, to the extent the S corporation has accumulated C corporation profits or earnings. If there are no such accumulated profits or earnings, then, as with C corporations, the basis for taxation is unclear, although another theory may apply.¹⁹⁵ As a side note, due to the pass-through income tax treatment of S corporations, unlike C corporations, the insured shareholder under the split-dollar arrangement will report income on the amounts used by the S corporation to pay the insurance premiums (which are non-deductible, see **Question C.22**) and also will receive a taxable economic benefit from the arrangement (unless a contributory plan is used). Due to this effective “double taxation,” the perception of some advisors is that business split-dollar arrangements work only for S corporation employees, not shareholders. Since significant personal wealth transfer planning could be achieved through grandfathered split-dollar arrangements, particularly arrangements that attempted to transfer policy equity, advisors may still discover existing grandfathered split-dollar arrangements with S corporations and non-employee shareholders.
 - Several PLRs involving primarily contributory split-dollar arrangements between a shareholder and an S corporation have found that the benefits provided under the arrangement did not create an impermissible second class of stock. Those PLRs generally espouse the theory that the split-dollar arrangements are fringe benefits, similar to the payment of health insurance premiums, not a vehicle to circumvent the one class of stock requirement.¹⁹⁶
- *Partnerships/LLCs*: The final regulations do not yet include specific provisions applicable to partnerships but have reserved a separate section for future guidance.¹⁹⁷ However, the tax treatment of benefits provided to a partner under a split-dollar arrangement with a partnership (or LLC taxed as a partnership¹⁹⁸) should be based on principles similar to

¹⁹³ Reg. § 1.61-22(b)(2)(iii).

¹⁹⁴ Rev. Rul. 79-50; IRC § 301(c). Any policy equity in a grandfathered arrangement, if and when taxable under Notice 2002-8, would be treated and taxed similarly to the economic benefit (e.g., as a dividend).

¹⁹⁵ Again, if the S corporation does not have accumulated C corporation earnings or profits to support dividend taxation, it is unclear on what basis the economic benefit will be taxed to the shareholder (*id.*).

As a side note, due to the pass-through income tax treatment of S corporations, unlike C corporations, the insured shareholder under the split-dollar arrangement will report income on the amounts used by the S corporation to pay the insurance premiums (which are non-deductible, see **Question D.27**) and also will receive a taxable economic benefit from the arrangement. Due to this effective “double taxation,” the perception of some advisors is that business split-dollar arrangements work only for S corporation employees, not shareholders.

¹⁹⁶ See e.g., PLRs 200914019, 200441023, 9803008, 9735006, 9709027, 9651017, 9331009 (replacing PLR 9309046), 9318007, and 9248019, all involving contributory arrangements, and PLR 9413023, involving a non-contributory arrangement. See also Zaritsky & Leimberg, *Tax Planning with Life Insurance: Analysis with Forms*, §6.05[5][e], *supra* note 142. Most of these PLRs espouse the theory that the split-dollar arrangements are fringe benefits (similar to the payment of health insurance premiums), not a vehicle to circumvent the one class of stock requirement. Many of the PLRs addressing contributory plans specifically note that, since the corporation was to be reimbursed for the annual cost of the insurance protection, the split-dollar insurance agreements did not alter rights to distribution and liquidation proceeds that would cause the business to have more than one class of stock. But see Eustice & Kuntz, *Federal Income Taxation of S Corporations*, § 3.08[3][c], Thomson Reuters/WG&L (4th Ed. 2001, with updates through April 2013; online version accessed on www.checkpoint.thomsonreuters.com on June 2013), which notes a concern that an S corporation could encounter issues regarding a second class of stock if a non-contributory plan is used.

¹⁹⁷ Reg. § 1.61-22(c)(1)(iv).

¹⁹⁸ See PLR 9625013.

those for arrangements between corporations and shareholders.¹⁹⁹ The classification of the distribution, however, may affect the taxation. For example, if the distribution is considered as payment to a partner for services, without regard to the income of the partnership, it may be treated and taxed as a guaranteed payment to the insured partner.²⁰⁰

Practice Note: Depending on the entity type and the relationship between the entity and the insured, benefits under a split-dollar arrangement that are treated as a distribution (e.g., from an S corporation to a shareholder) may require *pro rata* distributions to the other non-insured shareholders/owners.

D.33. What Are the Tax Consequences if an ILIT Owns or Has an Interest in the Policy Under the Economic Benefit Split-dollar Arrangement?

An ILIT created by the insured may own the entire policy, as in a non-equity collateral assignment arrangement between an employer and employee, or hold an interest in the policy, which is the right to the death benefits and/or access to policy cash value in excess of amounts owed to the owner, in order to keep the policy proceeds out of the insured's estate.²⁰¹ In such a case, the ILIT will be considered a non-owner and the total economic benefits provided under the arrangement (i.e., the cost of current life insurance protection, the value of any current access to policy equity, and any other benefits), will not only constitute taxable income to the insured, but will be an imputed gift by the insured to the ILIT, subject to gift tax.²⁰²

Example: X Co. and Trust, an irrevocable, non-grantor trust, enter into a split-dollar arrangement in connection with the performance of services by executive E. X Co. will pay all premiums on a life insurance policy insuring E's life until termination of the arrangement or E's death. X Co. is the named owner of the contract. At termination of the arrangement or E's death, X Co. will receive the lesser of the total premiums it paid or the policy's cash value, and Trust will receive any balance. The policy cash value is fully accessible by X Co. and its creditors, but Trust has the right to borrow or withdraw the portion of the policy cash value exceeding the amount payable to X Co.

E and T each receive economic benefits under the split-dollar arrangement — from X Co. to E as compensation, and separately from E to Trust as a gift. If the ILIT makes contributions to the premium payments, as with a contributory plan, the contributions will offset the otherwise taxable economic benefits to the insured, and thus any deemed gift by the insured to the ILIT for gift tax purposes. Of course, the impact of these tax benefits will be reduced if the insured must make gifts to the ILIT to provide it with funds to make its premium contributions under the split-dollar arrangement. In addition, as discussed in **Question D.24**, the owner under the split-dollar agreement (the business) will be taxed on those contributions.

These imputed gifts also will constitute GSTs for GST tax purposes and potentially subject to an immediate GST tax if they are made to a "skip" person. A skip person is an individual more than one generation removed from the insured or to a trust solely benefiting such individuals.²⁰³

¹⁹⁹ See Louis A. Mezzullo, "Life Insurance Planning," dated April 9, 2012, in materials for The American Law Institute Continuing Legal Education and American College of Trust and Estate Counsel Telephone Seminar/Webcast: "How to Handle the Toughest Issues in the Operation and Succession of a Family Business," Sept. 11, 2012.

²⁰⁰ See Rev. Rul. 91-26, treating a partnership's health care premium payments on behalf of a partner as guaranteed payments for purposes of IRC § 707. See also Brody, Harris, and Shenkman, "Split-Dollar Insurance and the Closely Held Business," *RPTe Report*, American Bar Association Section of Real Property, Trust and Estate Law, Oct. 2009.

²⁰¹ As an effort to avoid the application of IRC §§ 2042 (which includes the death benefits payable under a policy in the insured's estate if he or she retained any incidents of ownership in the policy at death) and 2035 (which includes the death benefits payable under a policy in the insured's estate if he or she relinquishes, within three years of death, all such incidents of ownership in the policy).

²⁰² Regs. §§ 1.61-22(c)(2)(ii), Ex.

²⁰³ For 2014, the federal GST tax exemption amount is \$5,340,000, which is indexed annually for inflation. See Rev. Proc. 2014-18.

Practice Note: If the imputed gifts are made to skip persons, or to an ILIT that the insured intends to be GST-tax-exempt, the insured should consider allocating his or her GST tax exemption to such transfers by filing a Form 709, “United States Gift (and Generation-Skipping Transfer) Tax Return,” reporting the transfer and the commensurate GST allocation. This allocation of GST tax exemption may be required even if the imputed gift to the ILIT qualifies for the annual exclusion from gift tax (as discussed below in **Question D.34**). Annual exclusion gifts to most ILITs do not automatically qualify for the annual exclusion from GST tax, since those requirements are far more restrictive.²⁰⁴

D.34. Do Imputed Gifts of Economic Benefits to an ILIT Qualify for the Annual Exclusion from Gift Tax?

See the discussion at **Question C.20** regarding the availability of annual exclusion gifts for imputed gifts of economic benefits to an ILIT, as similar rules apply to economic benefit split-dollar arrangements as to grandfathered arrangements.²⁰⁵

In a non-contributory split-dollar arrangement involving an insured’s ILIT, the insured does not make any contributions to the ILIT. Rather, the business pays the premiums directly to the insurance carrier. Income is imputed to the insured in the amount of the economic benefit provided under the agreement, with a corresponding imputed gift by the insured of those economic benefits to the ILIT. Often, the ILIT will only hold the policy and have no other assets from which to pay any potential withdrawal demand.²⁰⁶

In cases where the ILIT holds the policy and no other assets, the availability of the annual exclusion to shelter the imputed gift to the ILIT most likely depends on 1) whether the beneficiaries received notice of their withdrawal rights,²⁰⁷ 2) the availability of the policy or its cash value for use in satisfying exercised Crummey powers and 3) the flexibility provided by the terms of the ILIT.

This issue is more straightforward under a contributory plan, since the insured typically makes an annual contribution to the ILIT so the trustee can apply it to the ILIT’s portion of the premium. Thus, there is a direct contribution of cash to the ILIT from which to satisfy any exercised Crummey powers, which should facilitate qualification of the gift as a present interest gift.²⁰⁸

Practice Note: In reviewing an ILIT in connection with a non-contributory split-dollar arrangement, consider whether the ILIT:

- Provides the Crummey power holders with an absolute right of withdrawal with regard to a transfer to the ILIT (with or without receiving notice)
- Broadly defines what constitutes a “contribution” to the trust for Crummey power purposes (ideally, the definition of “transfer” would include any direct or indirect transfer that is deemed a gift, including any premium payment made, directly or indirectly, by any person other than the trustee to the insurer)

²⁰⁴ Specifically, the trust can only benefit one individual and if the trust does not terminate before such individual dies, the assets of such trust must be includible in the individual’s gross estate. See IRC § 2642(c).

²⁰⁵ Generally, a person’s first \$14,000 of annual gifts to a donee is exempt from federal gift tax (“annual exclusion gifts”). This is the amount of the annual exclusion gift set for 2014 and is indexed for inflation. See Rev. Proc. 2013-35. A gift only qualifies as an annual exclusion gift if the donee has a “present interest” in the gift (as with an outright gift). IRC §2503(b)(1).

²⁰⁶ Many trusts give beneficiaries the power to withdraw all or part of the gift, up to the gift tax annual exclusion amount (a “Crummey power”) in order to qualify gifts made to the trust as annual exclusion gifts. When a donor does not make a direct gift to the trust, however, and the trust otherwise holds no or only limited assets, there may not be sufficient assets available to satisfy exercised Crummey powers, which raises concerns whether the beneficiary really has a present interest in the gift to the trust. See discussion *infra* at note 94.

²⁰⁷ Note that courts considering this issue have not mandated a notice requirement, and the Tax Court has specifically rejected the requirement in two instances (see *Turner v. Comm’r*, TC Memo 2011-209 and *Est. of Cristofani v. Comm’r*, 97 TC 74, 80 (1991)). The IRS, however, has consistently taken the position that a trustee must give notice to all adult Crummey power holders informing them of their withdrawal rights and of the gift upon which they can exercise such rights (see e.g., Rev. Rul. 81-7, TAM 9532001). Thus, ideally, notice would be provided to a trust’s Crummey power holders of any imputed gifts made by the employee to a trust under a split-dollar arrangement for which annual exclusion treatment is sought.

²⁰⁸ See e.g., PLR 8051128. Again, ideally, Crummey power holders would receive notice when the employee makes the contribution to the ILIT (or will have received advanced notice of anticipated, scheduled contributions).

- Allows the trustee to satisfy (or at least does not prohibit the trustee from satisfying) exercised Crummey powers by distributing any asset of the ILIT (including a fractional interest in a policy) or by borrowing²⁰⁹

If the ILIT that is part of a non-contributory split-dollar arrangement satisfies the above, the greater the likelihood that the imputed gifts to the ILIT will qualify for the annual exclusion.

LOAN REGIME

D.35. When Does the Loan Regime Apply to Split-dollar Arrangements?

The loan regime applies to any split-dollar arrangement not taxed under the economic benefit regime. If the loan regime applies, the insured or a person chosen by the insured (e.g., his or her ILIT) is the owner of the policy (hereafter, the “owner”) and the business is the non-owner (hereafter, the “non-owner/business”). The premium payments made by the non-owner/business to the owner are taxed as split-dollar loans.²¹⁰

D.36. How Does the Loan Regime Tax Split-dollar Arrangements?

Taxation under the loan regime is based on the adequacy of the interest charged on the split-dollar loans. If the loan provides for adequate interest,²¹¹ it is governed by the general tax rules for debt instruments, except as modified in the final regulations.²¹² If the interest rate stated under the split-dollar loan is inadequate, it will be classified as, and governed by the rules applicable to, below-market loans,²¹³ with certain exceptions.

For example, the *de minimis* exceptions for below-market gift, corporate-shareholder and compensation-related loans (where the aggregate outstanding amount of the loan does not exceed \$10,000) do not apply to split-dollar loans. In addition, below-market split-dollar loans payable on death are considered hybrid loans, with any foregone interest thereunder recognized annually, like a split-dollar demand loan (see **Questions D.47 and D.50**), as opposed to straight term loans (where all the foregone interest over the term is fully recognized in the year the loan is made (see **Question D.49**)).

D.37. What Payments Create Split-dollar Loans Under Loan Regime Split-dollar Arrangements?

Each payment under a split-dollar arrangement constitutes a separate loan for general federal tax and split-dollar purposes, with the non-owner/business and the owner treated, respectively, as the lender and borrower, if:

- The non-owner/business makes the payment, directly or indirectly, to the owner, including a premium payment made by the business directly or indirectly to the carrier issuing the policy held by the insured/owner

²⁰⁹ Crummey powers may not be sufficient to provide a present interest for annual exclusion purposes if the ILIT trustee cannot satisfy potential withdrawal demands from trust assets other than cash contributions (see e.g., PLR 8126047 and PLR 8103074). The trust agreement may avoid this issue if it allows the trustee to satisfy withdrawal rights through distributions of cash, other property (including a fractional interest in a life insurance policy), or even borrowing against an insurance policy's cash value (see e.g., PLR 8021058 and PLR 8006109). Older private letter rulings have ruled that Crummey powers over the gifts made to a trust created gifts of present interests even though the trusts held only term or group term life insurance policies lacking cash value (see e.g., PLRs 8118051, 8006109, 8006048, 7947066, 7935091, and 7826050).

²¹⁰ Reg. §§ 1.61-22(b)(3)(i) and 1.7872-15(a)(2). See Henkel, *Estate Planning and Wealth Preservation: Strategies and Solutions*, § 12.06[3][d][ii][B] (Thomson Reuters/WG&L 1997, with updates through June 2013) (online version accessed on Checkpoint (www.checkpoint.riag.com) Oct. 2013).

²¹¹ See Code § 7872.

²¹² Reg. § 1.7872-15(a)(1). Note that, with regard to the non-owner/business, if the split-dollar loan provides for stated interest or original issue discount (“OID”), then it is subject to Reg. § 1.7872-15(f), regardless of whether the interest is sufficient. See Reg. § 1.7872-15(f)(1) (providing that a split-dollar loan is subject to the same Internal Revenue Code and regulatory provisions for stated interest and OID as other loans).

²¹³ Reg. § 1.7872-15(a)(1).

- The payment qualifies as a loan under general federal tax principles or, if not (because the loan is nonrecourse), *a reasonable person would expect full repayment of the amount* to the business/non-owner, with or without interest
- The repayment is to be made from, or is secured by, the policy's death benefit proceeds, the policy's cash surrender value, or both, as with a collateral assignment of the policy²¹⁴

Example: Assume 1) executive E owns a life insurance policy under a split-dollar arrangement, 2) X Co., pays premiums on the policy, 3) there is a reasonable expectation that X Co. will be repaid and 4) the repayments are secured by collateral assignment of the policy. *Each* premium payment made by X Co. is a separate loan for federal tax purposes.²¹⁵

Practice Note: The preamble to the final regulations specifically states that the IRS recognizes that, even in the earlier years of a split-dollar loan arrangement, when policy surrender and load charges may significantly reduce the policy's cash surrender value, thus under-collateralizing the non-owner's/business' loans, so long as a reasonable person would expect the payments to be repaid in full, the payments will be taxed as split-dollar loans.²¹⁶

Note that the *de minimis* exceptions for below-market gift, corporate-shareholder and compensation related loans, where the aggregate outstanding amount of the loan does not exceed \$10,000²¹⁷, do not apply to exempt payments from treatment as split-dollar loans.²¹⁸

D.38. What Is a “Reasonable Expectation” of Repayment for a Split-dollar Loan?

The final regulations do not define the phrase “reasonable expectation” or clarify when a “reasonable person” would expect a payment to be repaid, and thus, the IRS could look to existing case law²¹⁹ and apply a facts and circumstances test to make a determination of whether the arrangement produces a reasonable expectation of payment. For nonrecourse split-dollar loans, however, the non-owner/business and owner can address the reasonable representation requirements by filing a written representation with the IRS that states that a reasonable person would expect that all payments under the loan to be made (see **Question D.42** for the representation's requirements).

D.39. What if There Is No Reasonable Expectation of Repayment?

If there is no reasonable expectation of repayment, for example, where the non-owner and owner enter into a separate agreement providing that the non-owner will make a transfer to the owner in an amount sufficient to repay the purported split-dollar loan, the payment will not qualify as a split-dollar loan²²⁰ and will be taxed under general federal tax principles (e.g., as taxable compensation to the insured employee and/or a gift to an ILIT).²²¹

If only part of the payment is reasonably expected to be repaid, the final regulations treat the business/non-owner as making two payments: one that is repayable and one that is not. The portion not

²¹⁴ Regs. §§ 1.7872-15(a)(2)(i) and (b)(1).

²¹⁵ Reg. § 1.7872-15(a)(2)(iv), Ex. 1.

²¹⁶ See 68 Fed. Reg. 54,342 (Sept. 17, 2003); Brody, Richey, and Baier, 386-4th T.M., *Insurance-Related Compensation*, Art. VI.F.4.

²¹⁷ See IRC 7872(c)(2) and (c)(3).

²¹⁸ Reg. § 1.7872-15(a)(3).

²¹⁹ See e.g., *Gibson Prods. Co v. U.S.*, 637 F.2d 1041 (5th Cir.) (holding that, in a true lending transaction, the borrower normally possesses assets nearly equal or greater in value than the amount of indebtedness, whether or not those assets are hypothecated to secure the debt. In addition, the lender usually expects the borrower to maintain those assets at such a level until the obligation is satisfied. Moreover, in a true lending transaction, there exists the reasonable likelihood that the lender will be repaid in light of all reasonably foreseeable risks.); *Graf v. Comm'r*, 80 T.C. 944 (1983) (holding that that a loan will not be recognized for tax purposes simply because it is payable solely out of profits, but, by its nature such a loan necessarily takes on the flavor of an investment. Only when, in an objective sense, there is a reasonable certainty that full repayment will occur will such a loan be recognized.).

²²⁰ See Zaritsky & Leimberg, *Tax Planning With Life Insurance: Analysis With Forms*, §6.05[2][d][i], *supra* note 142 (Thomson Reuters/WG&L, 2d Ed. 1998, with updates through May 2013)(online version accessed on Checkpoint (www.checkpoint.riag.com) Sept. 2013).

²²¹ See 68 Fed. Reg. 54,342 (Sept. 17, 2003).

repayable is subject to tax based on general federal tax principles, based on the relationship of the parties (e.g., employee/employer).²²² However, if less than 80 percent of a premium payment is reasonably expected to be repaid, the final regulations provide that no part of the payment will be considered a loan (making the entire payment taxable under general federal tax principles.²²³ The operation of this provision, however, is unclear, because if it is reasonably expected that a clearly specified portion of a payment will be re-paid, even if less than 80 percent, it would seem that loan treatment should still apply to this portion.

D.40. Are Most Split-dollar Loans Considered Nonrecourse for Purposes of the Final Regulations?

Yes, almost all collateral assignment split-dollar arrangements are nonrecourse to the owner/insured, as they are typically secured only by the policy and/or its cash value.

D.41. What Is the Impact of Having a Nonrecourse Split-dollar Loan?

If a split-dollar loan is nonrecourse, the regulations treat the loan as providing for contingent payments, unless the parties to the arrangement provide the written representation discussed at **Question D.42**.

The final regulations provide a special set of rules to test contingent payments for adequacy of interest, which increases the testing complexity and the potential for tax exposure.²²⁴ Effectively all scheduled payments under a split-dollar loan that are treated as contingent payments are ignored for purposes of testing the adequacy of interest under the loan, regardless of whether the loan provides for the current payment or accrual of interest.²²⁵ *Thus, a split-dollar loan deemed to have contingent payments may be treated as a below-market loan (subject to tax on the forgone interest), even if an adequate interest rate is otherwise charged under the arrangement.*²²⁶

D.42. Can Parties to a Nonrecourse Split-dollar Loan Avoid Contingent Payment Treatment?

Yes, an otherwise non-contingent, nonrecourse payment on a split-dollar loan will not be considered a contingent payment if **both** parties to the split-dollar loan represent, in writing, that a reasonable person would expect that all payments under the loan will be made (a “**nonrecourse representation**”).²²⁷

The nonrecourse representation must:

- Be in writing and signed by both the non-owner/business, as lender, and the owner, as borrower, no later than the last day (including extensions) for filing the non-owner/business' or the owner's federal income tax return (whichever is earlier) for the taxable year when the first split-dollar loan is made
- Include the names, addresses and tax identification numbers of the non-owner/business, the owner and any indirect participants to the split-dollar loan (e.g., if the policy owner/borrower under the arrangement is the insured's ILIT, the insured will be an indirect participant — see **Questions D.59 and D.60**)

Unless otherwise stated therein, the nonrecourse representation applies to all subsequent split-dollar loans made pursuant to the arrangement. *Each party should attach a copy of the nonrecourse representation to its federal income tax return for each taxable year in which the non-owner/business*

²²² Reg. § 1.7872-15(a)(2)(ii); Reg. 1.61-22(b)(5).

²²³ Reg. § 1.7872-15(a)(2)(iv), Ex. 2(ii).

²²⁴ Reg. §§ 1.7872-15(d)(1) and (2). See Brody, Richey, and Baier, *Insurance-Related Compensation*, Art. VI.F.4, *supra* note 151.

²²⁵ See Marla Aspinwall, “No Way Out! Split-Dollar Loans May Be Traps for the Unwary.”

²²⁶ Reg. § 1.7872-15(j); Richard L. Harris, “Is Stranger-Owned Life Insurance (SOLI) a Split-Dollar Arrangement?” *Steve Leimberg's Estate Planning Newsletter* #1051, Nov. 16, 2006, www.leimbergservices.com.

²²⁷ Reg. § 1.7872-15(d)(2)(i).

makes a loan to which the representation applies.²²⁸ See **Appendix AP.9** for a sample nonrecourse representation.

The phrase “nonrecourse” is not defined in the applicable regulations, and it is unclear if a recourse loan made to an ILIT that holds no assets other than the policy would be treated as nonrecourse for this purpose.²²⁹ Further, most collateral assignment split-dollar arrangements are structured as nonrecourse to the owner. Thus, a conservative approach would be to have the non-owner/business and the owner file a nonrecourse representation with their federal income tax returns as provided in the final regulations for each year that a split-dollar loan is made, particularly since correcting a failure to file can be difficult, as discussed in the note below.

Practice Note: The IRS has not specified a correction method for parties who fail to file nonrecourse representations, but did issue a series of private letter rulings granting extensions to file nonrecourse representations to a nonprofit organization and the insured executives who were parties to a split-dollar loan arrangement.²³⁰ The parties each filed private ruling requests based on the procedure specified for requesting an extension of time to make an election under Reg. §301.9100-1. However, as the process for complying with Reg. §301.9100-1 and filing private ruling request is difficult, time-consuming and expensive, parties to split-dollar loans likely will want to err on the side of caution and file the nonrecourse representation (assuming the representation is truthful).

D.43. What Is Adequate Interest for Purposes of Testing a Split-dollar Loan?

Interest on the split-dollar loan is adequate if it equals the AFR set for the specified type of loan (term or demand) in the month the loan was made.²³¹ The AFRs are adjusted each month and published by the IRS in a Revenue Ruling issued 10–13 days before the start of the month to which they apply.²³² Thus, to determine the AFR for testing the adequacy of interest for a split-dollar loan, the parties to the arrangement must determine the loan term and date.

D.44. What if a Split-dollar Loan Does Not Charge Adequate Interest?

If the split-dollar loan does not charge adequate interest, it is a below-market loan governed by IRC § 7872 and the underlying regulations. In general, the loan is re-characterized as a loan with interest at the appropriate AFR, coupled with imputed transfers and retransfers of the forgone interest between the non-owner/business and the policy owner. The tax treatment and consequences of the imputed transfers resulting from below-market loan status depend upon the relationship between the parties (e.g., employee-employer) and upon whether the split-dollar loan is a demand loan, term loan or hybrid loan,²³³ but *generally will result in the insured being taxed on the “phantom income” attributable to the foregone interest.*

D.45. What Is a Split-dollar Demand Versus a Term Versus a Hybrid Loan?

A split-dollar demand loan is any split-dollar loan that is payable in full at any time on the demand of the lender (or within a reasonable time thereafter).²³⁴

A split-dollar term loan is any split-dollar loan other than a split-dollar demand loan.²³⁵

²²⁸ Reg. § 1.7872-15(d)(2)(ii). Each party should retain an original of the representation as part of its books and records.

²²⁹ See Brody, Richey, and Baier, 386-4th T.M., *Insurance-Related Compensation*, Art. VI.F.4, footnote 681.

²³⁰ See PLRs 201041006 through 201041024. The parties indicated in their private ruling request that they had relied on the erroneous advice of a tax return preparer who had advised that the loans were recourse to the insured.

²³¹ Reg. § 1.7872-15(a). Reg. §1.7872-15(g) provides special rules to adjust testing for split-dollar loans with variable interest rates.

²³² See e.g., Rev. Rul. 2014-8, specifying AFRs for March 2014, issued on Feb. 20, 2014.

²³³ Reg. § 1.7872-15(a)(1). Note that an imputed transfer of compensation under the split-dollar loan rules represents wages for employment tax purposes (e.g., FICA and FUTA).

²³⁴ Reg. § 1.7872-15(b)(2).

²³⁵ Reg. 1.7872-15(b)(3).

Split-dollar hybrid loans are types of split-dollar term loans that are 1) payable on the death of an individual (a “**POD split-dollar loan**”) or 2) conditioned on the future performance of substantial services, such as loans payable upon termination of employment or upon the later of an employee’s death or termination of employment, a “**performance-based split-dollar loan**.”²³⁶

The main difference between each type of loan is how it is tested for the adequacy of the loan interest charged and the resulting taxation if the interest is inadequate. Generally, a *below-market split-dollar term loan results in an acceleration of income recognition by requiring the policy owner, as borrower, to recognize all the forgone interest in the year the loan is made*. Below-market demand and hybrid loans, however, result in recognition of the forgone interest on an annual basis. See the questions below for a more detailed discussion, as well as a summary comparison of the various loan types attached at **Appendix AP.4**.

D.46. How Is a Split-dollar Demand Loan Tested for Adequacy of Interest?

A split-dollar demand loan is *tested each year it remains outstanding* to determine if the loan provides for adequate interest. For testing purposes, the appropriate AFR is based on the blended annual short-term AFR published by the IRS in July of each year (e.g., 0.22 percent for 2013).²³⁷

D.47. How Is a Below-market Split-dollar Demand Loan Taxed?

For each year the loan does not provide for adequate interest, the loan is a below-market split-dollar demand loan for that calendar year and will be re-characterized as a loan bearing interest at the appropriate AFR. Each year, the amount by which the interest under the appropriate AFR exceeds the loan’s specified interest rate (the “**forgone interest**”) is deemed transferred from the non-owner/business (as lender) to the owner/insured (as borrower) and then paid back by the owner/insured to the non-owner/business as interest income.²³⁸

The annual imputed transfers of the forgone interest will be taxable based on the relationship of the parties (e.g., as compensation, a distribution, a gift, etc.). An imputed transfer of compensation under the split-dollar loan rules represents wages for employment tax purposes (e.g., FICA and FUTA). See **Question D.60** for treatment of interest under a split-dollar loan made to an ILIT.

Example: In Year 1, X Co. and executive E enter into a split-dollar arrangement. E is the owner of a life insurance policy on his life. X Co. makes a \$100,000 premium payment, repayable upon demand without interest. The payment is a below-market split-dollar demand loan that is nonrecourse to E (assume X Co. and E make the required nonrecourse representations). Assume the applicable blended AFR for demand loans in Year 1 is 0.22 percent. On the Year 1 loan anniversary date in Year 2, X Co. makes another \$100,000 premium payment, subject to the same loan terms. The applicable blended AFR in Year 2 is 0.35 percent.

Year 1: The amount of forgone interest deemed transferred from X. Co. to E and then from E to X. Co. is \$220 (\$100,000 x .0022). E will be taxed on the \$220 as compensation. X Co. can take a compensation deduction for this amount (assuming it is reasonable) but also must include it in gross income as interest income, which effectively offsets the deduction. E cannot deduct the interest he is deemed to have paid on the split-dollar demand loan.²³⁹

²³⁶ See Treas. Reg. 1.7872(e)(5) for special rules applicable to these hybrid loans. See also Marla Aspinwall, “No Way Out! Split-Dollar Loans May Be Traps for the Unwary,” Brody, Richey, and Baier, *Insurance-Related Compensation*, Art. VI.F.4, *supra* note 151.

²³⁷ Reg. § 1.7872-15(e)(3)(ii); Revenue Ruling 2013-15 (publishing the blended annual rate for 2013).

²³⁸ Reg. § 1.7872-15(e)(3)(iii).

²³⁹ See Reg. § 1.7872-15(c), which limits the interest deduction under IRC §§ 163(h) and 264(a), but provides that, in certain circumstances, an “indirect participant” may be allowed to deduct qualified stated interest, OID or imputed interest on a deemed loan. See Reg. § 1.7872-15(e)(2)(iii) and **Questions D.59 and D.60** for a discussion of split-dollar loans involving indirect

Year 2: Both the Year 1 loan of \$100,000 and the Year 2 loan of \$100,000 are tested based on the blended AFR of 0.35 percent. The amount of forgone interest under each loan is \$350, for total forgone interest of \$700. Again, E will be taxed on \$700 of compensation but cannot take a corresponding deduction for the interest he is deemed to have paid to X Co. X Co. may take a compensation deduction for the \$700 but must include a similar amount of interest income in its gross income.

Note that split-dollar demand loans generally should *not* be used in split-dollar arrangements involving a corporation, a majority shareholder and the shareholder's ILIT, if the shareholder's intention is to keep the policy death benefit outside of his or her taxable estate. The corporation's ability to demand repayment of the split-dollar loan at any time may be considered an "incident of ownership" in the policy for estate tax purposes, which would be attributable to the majority shareholder, thus potentially resulting in estate tax inclusion of the policy death benefit in his or her estate.

Practice Note: Apart from corporate-majority shareholder split-dollar loans, no-interest demand loans may be preferred in business split-dollar loan arrangements due to the ease of administration in calculating the annual forgone interest. The total outstanding amount of all loans (e.g., the total premiums paid by the business) is simply multiplied each year by the applicable blended short-term AFR for that year. Of course, the interest rate will fluctuate year to year, which causes some unpredictability with regard to the insured's annual tax exposure.

D.48. How Are Split-dollar Term Loans Tested for Adequacy of Interest?

The term of a split-dollar term loan is based on the period from the date the loan is made until the loan's stated maturity date.²⁴⁰ Note that if there are options exercisable under the loan that could affect the yield or the term, the parties to the split-dollar loan will be deemed to exercise, or not exercise, the options in a manner that produces the smallest yield or, if unaffected, the longest term.

The rate used for purposes of testing the adequacy of interest under a split-dollar term loan is the AFR specified for the loan term and compounding period (e.g., annually, semi-annually, etc.) as of the date of the loan. The short-term AFR applies for loan terms of three years or less, the mid-term AFR for loan terms of over three years to nine years and the long-term AFR for loan terms of over nine years.²⁴¹

A split-dollar term loan provides for adequate interest if the present value of all payments due under the loan (the "**imputed loan amount**") as of the loan date at least equals the face amount of the loan. The AFR is the discount rate used to determine the imputed loan amount.

Example: X Co. and shareholder S enter into a split-dollar arrangement under which S is named as the policyowner. X Co. makes a \$100,000 premium payment, repayable without interest in 15 years. The premium payment is a split-dollar term loan. X Co. and S both file nonrecourse representations with regard to the payment. Assume the long-term AFR (based on annual compounding) at the time the loan is made is 3.5 percent.

Based on a 15-year term and a discount rate of 3.5 percent, the present value of the payments under the loan is \$59,689. This loan is a below-market split-dollar term loan because the imputed loan amount of \$59,689 (the present value of the loan amount required to be repaid to X Co.) is less than the face amount of the loan (\$100,000).

D.49. How Is a Below-market Split-dollar Term Loan Taxed?

If the split-dollar term loan does not provide for adequate interest, the loan is a below-market split-dollar term loan. Unless the below-market term loan qualifies as a hybrid loan (see **Question D.50**) or a gift

participants (i.e., the insured is the indirect participant when a third party, such as the insured's ILIT, owns the policy and is the actual borrower under the split-dollar loan).

²⁴⁰ Reg. § 1.7872-15(e)(4)(iii). Regs. § 1.7872-15(e)(3)(iii)(B) and (4)(iii).

²⁴¹ Generally, short-term notes have lower AFRs than mid-term notes, and mid-term notes have lower AFRs than long-term notes.

term loan between a donor and donee,²⁴² it is re-characterized as consisting of two parts as of the date of the loan (i.e., the date the premium is paid):

1. The imputed loan amount (as defined in **Question D.48**)
2. An imputed transfer from the non-owner/business to the owner of the remaining loan amount (the “**imputed transfer amount**”)

Note that gift split-dollar term loans are treated somewhat differently for income tax purposes, and there is a distinction between the income and gift tax consequences of gift split-dollar term loans. First, gift split-dollar term loans are tested under the same rules for non-gift split-dollar term loans to determine whether the gift loan is below-market for both gift and income tax purposes. After testing, however, if the gift split-dollar loan is below-market, then:

- For gift tax purposes, there is a deemed gift of the imputed transfer amount (i.e., the excess of the face amount of the loan over the present value of the borrower's repayment obligation), based on the AFR in effect when the loan is made.
- For income tax purposes, however, there is no transfer of the entire imputed transfer amount. Rather, there is a deemed transfer of the foregone interest on an annual basis, just as under a split-dollar demand loan, but calculated each year by applying the AFR in effect as of the date of the loan (e.g., if the initial AFR was 2.5 percent, that AFR will be applied each year to determine the amount of foregone interest for income tax purposes).

If the gift split-dollar loan is between a grantor and a wholly owned grantor trust, there will be no income tax consequences from the gift loan.²⁴³

The owner is taxed on the imputed transfer amount based on the relationship of the parties. Generally, a below-market split-dollar term loan is treated as having original issue discount (“**OID**”) equal to the imputed transfer amount, which the non-owner/business must take into account in accordance with the OID rules.²⁴⁴

Example: Based on the same facts as the example in **Question D.48** involving the \$100,000 loan from X Co. to shareholder S, the imputed transfer amount to S is \$40,311 (\$100,000 – \$59,689 imputed loan amount). X. Co. is treated as making a corporate distribution taxable under IRC § 301 to S of \$40,311 in the year of the loan, and X Co. must take the same amount into account as OID.²⁴⁵

Practice Note: As noted, the rules applicable to below-market split-dollar term loans cause an acceleration of the recognition of all the forgone interest into the year the loan was made, which may result in substantial phantom income to the insured (and a gift to his or her ILIT, if it is a party to the arrangement). That, combined with the typically higher interest rates associated with fixed term loans (as compared to demand loans) can make them less attractive for business split-dollar planning, unless the business and insured structure the arrangement as a hybrid loan, which is taxed similarly to a split-dollar demand loan, but with the benefit of fixing the interest rate for the specified term. In the case of arrangements between corporation and majority shareholders, hybrid loans can provide a workable alternative to the estate inclusion issues associated with demand loans (see **Questions D.50 and D.72**).

D.50. How Are the Term and Adequacy of Interest Determined for Split-dollar Hybrid Loans?

²⁴² Reg. § 1.7872-15(e)(5).

²⁴³ Reg. § 1.7872-15(e)(4)(iv). See Reg. § 1.7872-15(e)(5)(iv).

²⁴⁴ Reg. § 1.7872-15(e)(4)(v). See Reg. § 1.1272-1 for the treatment of OID.

²⁴⁵ Reg. § 1.7872-15(e)(4)(vi), Ex.

Hybrid Loan Terms. For hybrid loans, the loan term used for testing a POD split-dollar loan or one payable on the earlier of the death of an individual and another term *is the shorter of* 1) the individual's life expectancy, determined under IRC §72 actuarial tables as of the day the loan is made or 2) any other specified term (e.g., a terms of years).²⁴⁶

The loan term used for testing a performance-based split-dollar loan depends on the loan's stated maturity date; if there is no stated maturity date, then it is based on a term of seven years.²⁴⁷

Interest Testing. Hybrid split-dollar loans (both POD and performance based) are tested for adequacy of interest in the same manner as split-dollar term loans (discussed at **Question D.48**).²⁴⁸

If a hybrid split-dollar loan does not provide for adequate interest, then it is treated as a below-market demand loan, and the forgone interest is taxed annually in the same manner as split-dollar demand loans (see **Question D.47**). *Unlike split-dollar demand loans, the AFR used to determine the forgone interest under a below market hybrid loan stays fixed for the entire loan term, based on the annually compounding AFR applicable to the loan as of the initial loan date.*²⁴⁹

Example: Using similar facts as in the example at **Question D.49**, X Co. and shareholder S, a 68-year-old male, enter into a split-dollar arrangement under which S is the policy owner. X Co. makes a \$100,000 premium payment, repayable, without interest, this time from the death benefits of the policy upon S's death. S's life expectancy is 15 years. The payment is a split-dollar term loan, to which the long-term, annually compounding AFR of 3.5 percent applies, based on S's life expectancy.

As with the split-dollar term loan in the example at **Question D.49**, based on a 15-year term and a discount rate of 3.5 percent, the present value of the payments under the loan is \$59,689. This loan is a below-market split-dollar hybrid loan because the imputed loan amount of \$59,689 (the present value of the loan amount required to be repaid to X Co.) is less than the face amount of the loan (\$100,000).

Unlike the split-dollar term loan at **Question D. 49**, S will not be immediately taxed on the remaining loan balance of \$40,311. Rather, S will be taxed annually on \$3,500, which will be the amount of forgone interest for each year the loan remains outstanding, assuming the interest accrued on the loan's adjusted issue price (\$100,000) at the applicable long-term AFR (3.5 percent). Thus, each year, X Co. will be treated as making a corporate distribution under IRC § 301 to S of \$3,500. In addition, X Co will have \$3,500 of imputed interest income in each year of the loan arrangement.²⁵⁰

D.51. What Happens if a Split-dollar Hybrid Loan Exceeds Its Original Term?

If a split-dollar hybrid loan exceeds its original term, because the individual lived longer than his or her life expectancy or continues to perform services, the split-dollar loan is treated as retired and reissued on that date as a split-dollar demand loan for cash equal to the loan's then adjusted issue price.²⁵¹ The deemed retirement and reissuance have no immediate tax consequence.²⁵²

²⁴⁶ Reg. § 1.7872-15(e)(5)(ii)(C).

²⁴⁷ Reg. § 1.7872-15(e)(5)(iii)(C).

²⁴⁸ Reg. §§ 1.7572-15(e)(5)(ii)(B) and (e)(5)(iii)(B).

²⁴⁹ Reg. §§ 1.7872-15(e)(5)(ii)(C) and (e)(5)(iii)(C). See also Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, § 63.12.3 "Split-Dollar Life Insurance" (Thomson Reuters/Tax & Accounting, 2d/3d ed. 1993-2013, updated June 2013 and visited on Sept. 2013).

²⁵⁰ Reg. § 1.7872-15(e)(5)(iv).

²⁵¹ Reg. §§ 1.7872-15(e)(5)(ii)(D) and (e)(5)(iii)(D).

²⁵² See Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, §63.12.3 "Split-Dollar Life Insurance" (Thomson Reuters/Tax & Accounting, 2d/3d ed. 1993–2013, updated June 2013 and visited on Sept. 2013).

For reissued POD split-dollar loans, the loan is *not* retested for adequacy of interest as of the date of reissuance. Any forgone interest continues to be determined annually under the AFR used to test the loan when originally issued.²⁵³

Example: Assuming the same facts as from the example in **Question D.50**, if shareholder S lives more than 15 years after the X Co.'s premium payment, the split-dollar loan is deemed repaid and reissued for cash payments of \$100,000 on the 15th anniversary of the original payment, and the long-term, annually compounding AFR of 3.5 percent will continue to apply for purposes of determining the annual forgone interest under the loan. The deemed payment and reissuance have no tax consequence to S and X. Co. S and X Co. will continue to recognize deemed § 301 distributions and interest payments of \$3,500 annually until S's death.²⁵⁴

For reissued performance based split-dollar loans, however, the loan is retested to determine whether it is below-market, and if so, the applicable AFR as of the reissue date of the loan, based on the term of the reissued loan, will be used to determine the annual forgone interest for the remainder of the reissued term.²⁵⁵

D.52. What if the Non-owner/Business Forgives, Cancels, Waives or Otherwise Pays the Outstanding Interest on a Split-dollar Loan?

If the non-owner/business forgives, cancels or waives interest due under a split-dollar loan, that interest amount,²⁵⁶ *plus a deferral charge on the waived interest based on the underpayment of tax penalty rate*, is deemed transferred to the non-owner/business as interest income and then retransferred to the owner.²⁵⁷ The imputed re-transfer of the interest amount to the owner is subject to tax based on the relationship between the parties (e.g., as compensation if the owner is an employee).²⁵⁸

Note, however, that for nonrecourse split-dollar loans for which the parties file nonrecourse representations (see **Question D.42**), if the interest actually paid on the split-dollar loan is less than the interest required to be accrued, the unpaid interest is still treated as forgiven by the non-owner/business and retransferred to the owner but is *not* increased by the deferral charge.²⁵⁹

The stated interest on a split-dollar loan also may be disregarded (even when adequate) if the non-owner/business or a related person pays, directly or indirectly, all or part of the interest.²⁶⁰ A facts and circumstances test applies to determine if the interest is “to be paid” by the non-owner/business.²⁶¹ For example, a bonus plan to pay an amount directly equal to the loan interest to the owner/employee would fall under this provision.²⁶² In addition, in compensatory, equity split-dollar loan arrangements, waiving or

²⁵³ Reg. § 1.7872-15(e)(5)(ii)(D).

²⁵⁴ See Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, § 63.12.3 “Split-Dollar Life Insurance” (Thomson Reuters/Tax & Accounting, 2d/3d ed. 1993–2013, updated June 2013 and visited on Sept. 2013).

²⁵⁵ Reg. § 1.7872-15(e)(5)(iii)(D).

²⁵⁶ Determined as provided in Reg. § 1.7872-15(h)(2) for a split-dollar term loan and Reg. § 1.7872-15(h)(3) for a split-dollar demand loan.

²⁵⁷ Reg. § 1.7871-15(h)(1)(i).

²⁵⁸ Reg. § 1.7872-15(h)(1)(i); Reg. § 7872-15(e)(1)(i).

²⁵⁹ Reg. § 1.7872-15(h)(1)(iv).

²⁶⁰ Reg. § 1.7872-15(h)(1)(iii); Reg. § 1.7872-15(a)(4)(i).

²⁶¹ Reg. § 1.7872-15(a)(4)(i).

²⁶² See Brody, Richey, and Baier, 386-4th T.M., *Insurance-Related Compensation*, Art. VI.F.4, also recognizing that the issue also could arise in a donor/donee private split-dollar loan if the donor makes a circular gift of cash to the ILIT and the ILIT trustee immediately pays the donor for the interest due, stating that “it is unclear how a less formal arrangement might be treated, such as one in which an employer makes a decision, on an annual basis, to provide a bonus to the employee in an amount equal to the employee’s interest obligation, or increases the employee’s compensation occasionally, or a donor makes occasional gifts to the donee of the interest due or one or more larger gifts that are unrelated to the interest due.” The authors further note that “The most troublesome aspect of this rule is that there is no apparent provision that would exclude the [non-owner/business] payment of the [owner’s] interest obligation from the [owner’s] income, so that the [owner] appears to be taxed on both the imputed income under IRC § 7872 and the actual income from the bonus arrangement. This seems to be an implausible result.”

forgiving interest may subject the loan to the tax provisions applicable to nonqualified deferred compensation arrangements under IRC § 409A issues, potentially resulting in immediate taxation of any amount deemed deferred under the arrangement for purposes of that Code section. See **Questions E.1 – E.7** for a discussion of the potential impact of IRC § 409A on compensatory split-dollar arrangements.

D.53. What if the Non-owner/Business Waives or Forgives Repayment of Loan Principal?

If the non-owner/business waives or forgives any portion of the loan principal, the parties must take into account the amount forgiven in accordance with the relationships between the parties (e.g., as compensation between an employer and employee, as a gift from a donor to an ILIT).²⁶³

Note, however, that waiver or forgiveness of the loan should not be part of the understanding or agreement from inception of the arrangement. The final regulations take the position that for the loan arrangement to be bona fide, the parties must at all times intend that the loan will be repaid.²⁶⁴ If the split-dollar loan is not respected, the IRS may seek to tax any equity in the policy under an economic benefit regime. Again, as noted in **Question D.52**, for compensatory, equity split-dollar loan arrangements, waiving or forgiving principal may subject the loan to the tax provisions applicable to nonqualified deferred compensation arrangements under IRC § 409A, with potentially adverse tax consequences. See **Questions E.1 – E.7** for a discussion of the potential impact of IRC § 409A on compensatory split-dollar arrangements.

D.54. How Is the Non-owner/Business Taxed on Interest and Other Payments Under a Split-dollar Loan?

Payments made by the owner to the non-owner/business under the split-dollar loan are applied first to any accrued and unpaid interest (including OID) in the order accrued, and then to principal, in the order the outstanding loans were made. Any amount received above outstanding interest and principal obligation will then be applied to the repayment of any other payments made by the non-owner/business that were not reasonably expected to be repaid by the owner, and then to payment of any other owner obligations under the split-dollar arrangement.²⁶⁵

The non-owner/business will treat interest under a split-dollar loan, whether stated, imputed, or OID, in the same manner as on other loans, even if the split-dollar loan is below-market.²⁶⁶ For example, a non-owner/business who makes a split-dollar loan with stated interest must account for qualified stated interest under its regular method of accounting.²⁶⁷ Typically, the non-owner/business will include interest under a split-dollar loan in gross income as it accrues, although the owner may be able to take a compensation deduction for any imputed or forgone interest deemed transferred to an insured under the arrangement who is an employee. Based on this current inclusion of income, the non-owner/business generally excludes subsequent interest payments from gross income and excludes principal payments as a return of loan principal.²⁶⁸

*No payment received by the non-owner/business with respect to a split-dollar loan is considered received by reason of the death of the insured,²⁶⁹ so IRC § 101(a)'s exclusion of life insurance death benefits from taxable income does **not** apply, even if the insurance carrier directly distributes the benefits to the non-owner/business. Any such distribution should be treated as received by the owner and then transferred to the non-owner/business, to be applied as provided above.*

²⁶³ Reg. § 1.61-22(b)(6).

²⁶⁴ Reg. § 1.7872-15(a)(2)(B). Also required for a loan to be respected under general federal tax principles. See *Prof'l Serv. v. Comm'r*, 79 T.C. 888 (1982); *Delta Plastics Corp. v. Comm'r*, 54 T.C. 1287 (1970); *Reed v. Comm'r*, 68 T.C.M. (CCH) 1429; *Roet v. Comm'r*, 52 T.C.M. (CCH) 778 (1986); *Reed v. Comm'r*, 68 T.C.M. (CCH) 1429 (1994). See also *Sutter v. Comm'r*, T.C. Memo 1998-250 (1998).

²⁶⁵ Reg. § 1.7872-15(k).

²⁶⁶ Reg. § 1.7872-15(f)(1).

²⁶⁷ See Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, §63.12.3 "Split-Dollar Life Insurance" (Thomson Reuters/Tax & Accounting, 2d/3d ed. 1993-2013, updated June 2013 and visited on Sept. 2013).

²⁶⁸ *Id.*

²⁶⁹ Reg. § 1.7872-15(m).

D.55. Who Accrues Policy Basis/Investment in the Contract for Premiums Paid Under Split-dollar Loans?

Investment in the contract for purposes of IRC § 72(e)(6) (i.e., basis) accrues solely for the benefit of the owner, which, under the loan regime, is the insured or other third-party (e.g., his or her ILIT).

D.56. How Is the Owner Taxed on Distributions, Withdrawals, Death Benefits or Other Proceeds Received from the Policy Underlying the Split-dollar Loan?

Policy proceeds received by the owner are taxed pursuant to the other Code sections applicable to amounts received from life insurance contracts, including IRC §72 and §101(a). For example:

- Assuming the policy is not a MEC, the owner will not incur income tax on policy loans or policy withdrawals, up to the owner's investment in the contract.
- The death benefits payable to the policy beneficiary upon the insured's death are excludable from gross income under IRC §101(a), assuming there has been no transfer of the policy for valuable consideration.²⁷⁰

D.57. Can the Non-owner/Business Deduct Premium Payments?

No, the non-owner/business is not allowed a deduction for any portion of the premium paid through a split-dollar loan, since the non-owner/business is either a direct or indirect beneficiary of the policy.²⁷¹

D.58. How Is Imputed Income Under a Split-dollar Loan Taxed to the Insured?

The taxation of imputed income to an insured under a split-dollar loan will depend on the relationship of the insured to the non-owner/business, such as compensation if the insured is an employee, as a distribution if the insured is a shareholder, etc. See **Question D.32**.

D.59. Can the Policy Owner, as Borrower, Deduct Interest on the Split-dollar Loan?

Generally, no, the policy owner cannot deduct interest on a split-dollar loan, regardless of whether it's qualified stated interest, OID or imputed interest.²⁷² However, interest may be deductible if the loan is deemed made by the insured as an "indirect participant" to the split-dollar loan, such as where there is an imputed loan from the non-owner business to the insured, and then from the insured to his or her ILIT. The insured, as the indirect participant, may be able to deduct interest paid on the deemed loan from the non-owner/business, and the ILIT may be able to deduct interest on the imputed loan from the insured, although this would be unnecessary if the ILIT is a grantor trust for federal income tax purposes with respect to the insured. See **Question D.60** for a more detailed discussion of the treatment of split-dollar loans with indirect participants.

D.60. What if a Below-market Split-dollar Loan Is Made to a Third-party Owner (e.g., the Insured's Trust)?

If a split-dollar loan is a below-market loan between a business and a third party other than the insured (such as the insured's ILIT or family member), the original, below-market split-dollar loan is split into two successive loans, with the same terms as the original²⁷³.

²⁷⁰ A transfer for value rule under IRC § 101(a) will include in gross income otherwise excludable death benefits if the policy is transferred for valuable consideration (which can include the satisfaction and release of obligations under a split-dollar agreement). The transfer of a policy to the insured, an ILIT that is a wholly owned grantor trust with regard to the insured, a partner of the insured, a partnership in which the insured is a partner or a corporation in which the insured is a shareholder or officer will be exempt from the inclusion rule. A transfer of the policy to anyone else (e.g., to the insured's child or spouse) could inadvertently run afoul of these rules, resulting in taxation of the death benefit in excess of any consideration paid by the new owner for the transfer.

²⁷¹ IRC § 264.

²⁷² Reg. § 1-7872-15(c). The regulations cite IRC §163(h) (which denies deductions for "personal interest") and IRC §264(a) (which denies deductions for life insurance premiums and certain interest on policy loans.).

²⁷³ Reg. § 1.7872-15(e)(2).

1. A loan from the non-owner/business to the insured (the indirect participant)
2. A loan from the insured to the policy owner (e.g., ILIT, family member, etc.)

Any resulting transfers of forgone interest or other benefits between the non-owner/business and the insured and between the insured and the policy owner from these deemed loans will be taxed depending on the relationship of the parties, as compensation, a gift, or a distribution.²⁷⁴

Example: In Year 1, X Co. and ILIT, an irrevocable, non-grantor trust created by executive E, enter into a split-dollar arrangement under which ILIT is named as the policy owner. E is an employee of X Co. X Co. makes a \$100,000 premium payment, repayable upon demand without interest. The payment is a below-market split-dollar demand loan that is nonrecourse to E and the ILIT (assume X Co., E and ILIT make the required nonrecourse representations). Assume the applicable blended AFR for demand loans in Year 1 is 0.22 percent.

The below-market split-dollar loan from X to ILIT is restructured as two deemed below-market split-dollar demand loans: 1) a compensatory below-market split-dollar loan between X Co. and E, as the indirect participant, and 2) a gift below-market split-dollar loan between E and ILIT. Each deemed loan has the same terms and conditions as the original loan.

Under the compensatory split-dollar loan, the amount of forgone interest deemed transferred from X Co. to E, as the indirect participant is \$220 ($\$100,000 \times .0022$), and, for the gift split-dollar loan, the amount of forgone interest deemed paid by ILIT to E is \$220 ($\$100,000 \times 0.022$).

E will have interest income in the amount of \$220 received from the ILIT. In addition, E will be taxed on the \$220 deemed received from X Co. as compensation. However, unlike when the split-dollar loan is made directly to E (see example at **Question D.47**) E, as an indirect participant, may be able to deduct under IRC §163(d) the \$220 interest he is deemed to retransfer to X Co. as a payment of interest on the compensatory loan. If ILIT is a grantor trust, none of the above should apply, since the ILIT would be disregarded for income tax purposes.

X Co. can take a compensation deduction for the \$220 of interest deemed transferred to E (assuming it is reasonable) but X Co. must include in its gross income the \$220 of interest it is deemed to receive back from E, which effectively nullifies the deduction.²⁷⁵

Regardless of whether the ILIT is a grantor or non-grantor trust, for gift tax purposes, E will be deemed to have made a gift to the ILIT equal to the amount of the annual forgone interest (\$220).

FORMATION AND ADMINISTRATION

D.61. What Is the Typical Structure for Economic Benefit Split-dollar Arrangements?

Economic benefit split-dollar arrangements may be structured as endorsement arrangements, where the business owns the underlying policy, or non-equity collateral assignment arrangements, with the insured or a third party (typically, the insured's ILIT), owning the policy. See **Questions B.3** and **B.4** for a discussion of endorsement arrangements and collateral assignment arrangements.

²⁷⁴ *Id.*

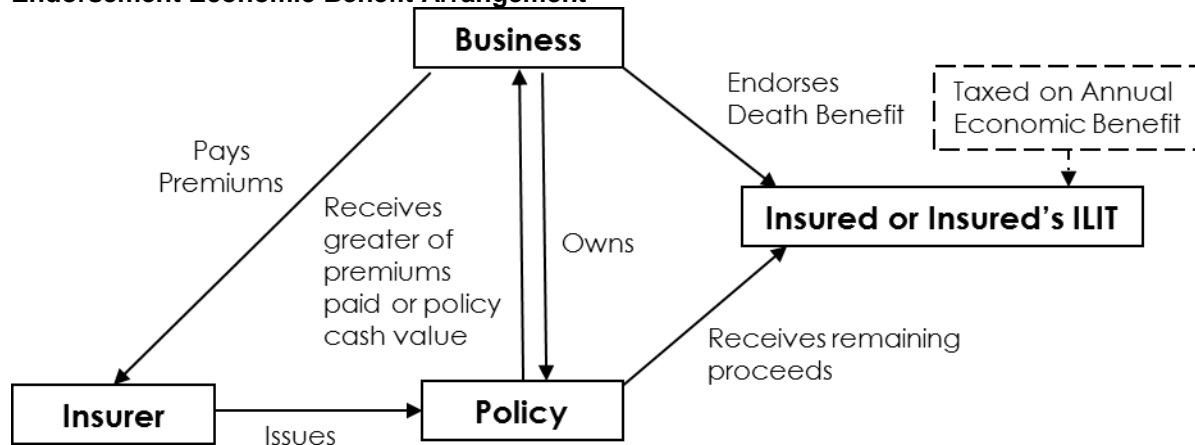
²⁷⁵ Treas. Reg. § 1.7872-15(e)(2)(ii).

Practice Note: Under the economic benefit regime, endorsement arrangements almost always will be structured as non-equity arrangements due to the adverse income tax consequences imposed by the final regulations, as well as the potential application of IRC § 409A (see discussion at **Questions E.1-E.7**).

D.62. Why Use an Endorsement Arrangement Versus a Non-equity Collateral Assignment Arrangement?

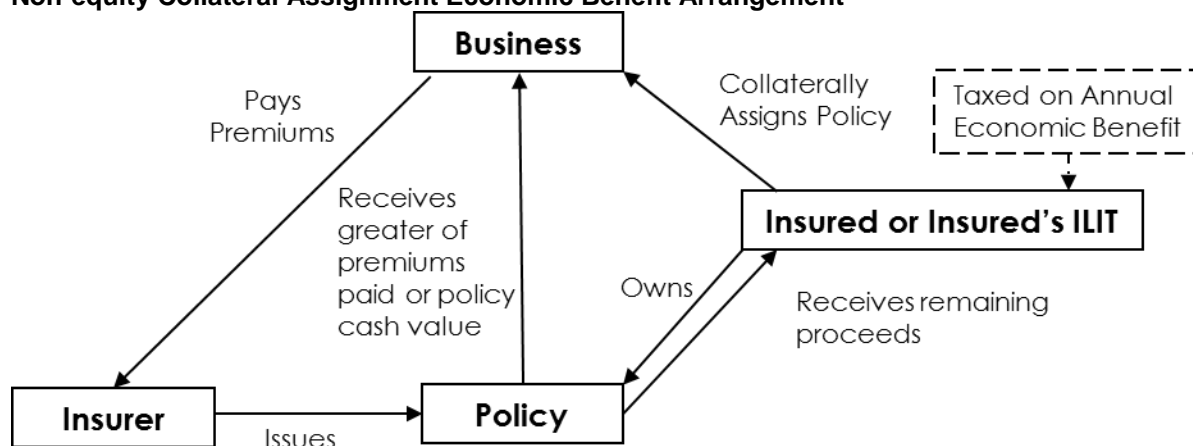
Endorsement. An endorsement arrangement is often used to provide death benefit coverage as an added benefit for a key employee or if the business wants to maintain control of the policy as a form of “golden handcuffs.” A business may also incorporate endorsement split-dollar into a nonqualified deferred compensation arrangement, in which the business has purchased life insurance to fund future compensation payments on a tax-efficient basis. See **Question B.3** for a discussion of endorsement arrangements.

Endorsement Economic Benefit Arrangement



Non-equity Collateral Assignment. Non-equity collateral assignment arrangements are common in private split-dollar arrangements and in business arrangements where the insured will retain control and ownership of the policy (but no equity), and he or she is likely to have a taxable estate large enough to require the payment of federal estate taxes. The non-equity collateral assignment approach facilitates the ownership of the policy by the insured's ILIT, which, if property formed, should keep the death benefit payable under the arrangement out of the insured's estate. This structure also allows flexibility to “switch” to loan regime treatment if the economic benefit costs become too high or the policy will eventually develop equity (see **Question D.79** for a discussion of switching from an economic benefit to a loan regime). See **Question B.4** for a discussion of collateral assignment arrangements.

Non-equity Collateral Assignment Economic Benefit Arrangement



D.63. What Are the Formation Requirements for Economic Benefit Arrangements?

To form and document the arrangement, the business and insured should execute a written split-dollar agreement that addresses the following issues:

- Who will purchase and own the policy? The business in an endorsement arrangement or the insured (or typically his or her ILIT) in a collateral assignment arrangement.
 - How will policy dividends be applied? For example, to buy one-year term insurance.
 - How will the premiums be paid? Will the insured make any contributions for the cost of current life insurance protection? Who will be the party responsible for actually paying the premiums to the carrier (typically the business)?
 - Who will calculate the value of the annual economic benefits due to the insured (typically the business)?
 - What is the repayment amount due to the business? Generally the greater of the total premiums advanced by the business or the policy's cash surrender value.
 - Where will the repayment come from? Policy cash value, policy death benefits, other assets?
 - Who will hold the rights and various incidents of ownership in the policy, such as the right to name beneficiaries, to surrender the policy, to borrow or pledge the policy?
 - How and when will the death benefits be distributed?
 - When will the agreement terminate? Upon the insured's death, retirement or departure? At the insured's or ILIT trustee's discretion, or upon mutual agreement?
- As the policy likely will constitute an "employer-owned life insurance" contract for purposes of IRC § 101(j), *prior to purchase of the policy*, the business should provide the insured with notice of the life insurance purchase and obtain the insured's consent in compliance with the requirements of IRC § 101(j). Otherwise, the death benefits payable to the business may not be excluded from gross income under § 101(a). See a discussion of the provisions and requirements of § 101(j) for employer-owned life insurance beginning at **Question E.8** and a sample notice and consent form at **Appendix AP.10**.

- For endorsement arrangements, the business should complete an endorsement to the insured or the insured's ILIT, using an endorsement form provided by the carrier issuing the policy. The endorsement form gives the insured or the insured's ILIT the right to designate the beneficiary of the policy death benefits in excess of the amounts owed to the business.
- For collateral assignment arrangements, the insured (or the insured's ILIT, if it holds the policy) should file a collateral assignment with the issuing carrier, assigning a security interest in the policy to the business, typically equal to the greater of the total premiums paid by the business or the policy cash value (i.e., a non-equity arrangement).

D.64. What Are the Maintenance Requirements for Economic Benefit Arrangements?

To maintain an economic benefit arrangement:

- Each year the business must calculate the value of the economic benefit provided to the insured under the arrangement. This is the cost of current life insurance protection and, far less commonly, the value of any current access to policy cash value and any other economic benefits.
- The business and insured must report this same value for employment and income taxes, as applicable. In addition, this value will be used by the insured to determine any imputed gifts to an ILIT that holds the policy for purposes of gift and GST tax reporting requirements.
- If the insured is contributing the cost of current life insurance protection, he or she will make the contribution based on that value. The business must include the same value for the contribution in its gross income.

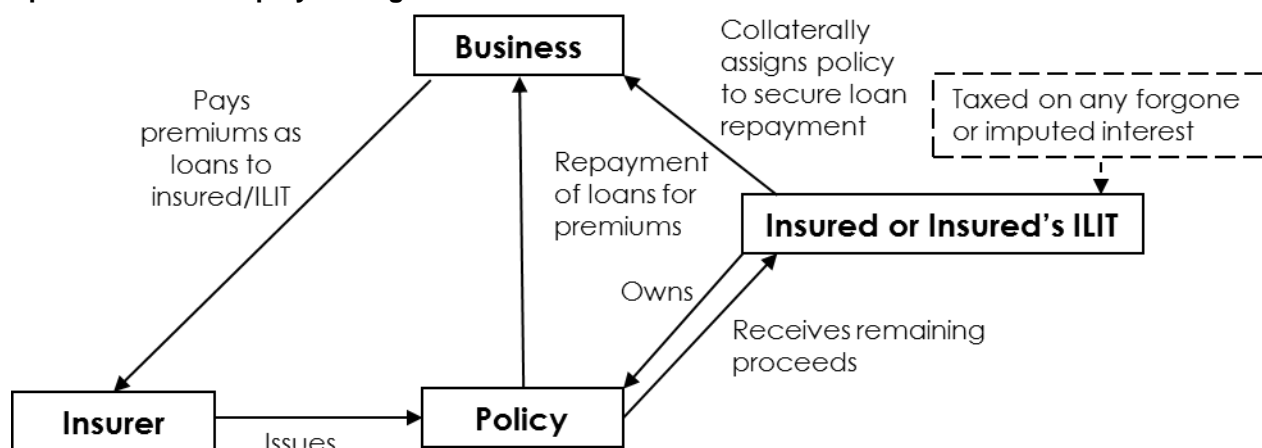
The final regulations provide that death benefits payable to or for the insured from a policy subject to an economic benefit split-dollar arrangement will only be excludable from gross income if the insured has paid for or properly recognized and reported the cost of current life insurance protection each year. Thus, it is critical that this annual cost be properly calculated and reported or paid for each year to preserve the death benefit exclusion.

Practice Note: The business and insured should periodically review the arrangement, the performance of the policy and the projected growth of the policy cash value and the projected increases in the cost of current life insurance protection to determine whether the arrangement is working as intended and/or whether modifications or an exit should be implemented sooner rather than later.

D.65. How Are Split-dollar Loans Typically Structured?

Split-dollar loan arrangements, whether demand, term or hybrid loans, are documented using the collateral assignment method, with the insured, or, in most cases, the insured's ILIT, owning the policy. See **Question B.4**.

Split-dollar Loan Equity Arrangement



D.66. Why Use a Demand Versus a Term Versus a Hybrid Split-dollar Loan?

Numerous factors impact the decision of how to structure the split-dollar loan, including the following (see also the chart with a summary comparison of the loan structuring options at **Appendix AP.4**):

Demand Loans. Split-dollar demand loans will be attractive:

- For ease of administration in determining the annual interest due. If a series of demand loans are made, assuming all are no-interest (as is common), the annually compounded blended AFR is simply multiplied against the outstanding loan balance to determine the total interest due or forgone under all the outstanding loans.
- To take advantage of low rates. The applicable blended AFR for demand loans is usually one of the lowest AFRs available, particularly in a low interest rate environment.

Demand loans, however, are subject to annual interest rate fluctuations, making it potentially difficult to accurately predict future interest costs. Also, as discussed at **Question D.47**, a demand structure may not be recommended for split-dollar loans between corporations and majority shareholders due to potential estate tax inclusion issues.

Term Loans. Term loans may be used in situations where:

- The parties intend to charge and pay stated interest at least equal to the appropriate AFR for the loan. Otherwise, the loan will be treated as a below-market split-dollar term loan, resulting in the acceleration of all forgone interest over the loan term into the year the loan is made.
- A corporation is entering into a split-dollar arrangement with a majority shareholder. As noted below, a hybrid loan may be a better option if the parties are going to establish a below-market loan arrangement.
- When the parties want to loan an amount sufficient to cover multiple past or future premiums in order to lock in a stated interest rate over the entire term.

Split-dollar term loans, however, can be difficult to administer, since each premium payment is a new, separate loan made under a different AFR, meaning a separate interest calculation for each loan made under the arrangement. In addition, the acceleration of the recognition of forgone interest into the initial year of the loan generally makes them less tax and cost efficient than demand and hybrid loans. Finally, if the parties intend to have the borrower pay the interest currently in order to avoid below market loan

treatment, but the borrower does not make a payment, the provisions applicable to the taxation of the forgiven interest, plus application of the deferral penalty, could apply (see **Question D.52**).

Hybrid Loans. Hybrid loans may work well in situations where:

- The parties want to lock in an interest rate for a specified term, but do not want to require the current payment of interest at the applicable AFR.
- The parties want to avoid the acceleration of interest recognition into the year the loan is made.
- The term of the arrangement will be tied to the performance of services.
- The arrangement is between a corporation and a majority shareholder.

D.67. What Are the Formation and Administrative Requirements for a Split-dollar Loan?

To form and document the loan:

- The insured (or the insured's ILIT) and the business should execute an agreement or note stating the sum of the loan, the specified interest rate and compounding period (or none if the loan will be interest-free), the note term (demand, term, at insured's death or retirement, etc.), whether interest will be paid or accrued, and the payment schedule for interest and principal.
 - As each premium paid constitutes a separate loan, the agreement should provide the terms for all subsequent loans expected to be made under the agreement.
- If the business is a corporation, a corporate resolution should be passed authorizing the transaction and the disbursement of loan proceeds.
- The insured (or the insured's ILIT, if it holds the policy) should file a collateral assignment with the issuing carrier, assigning a security interest in the policy to the business equal to the amounts due to it under the note.

D.68. What Are the Maintenance Requirements for a Split-dollar Loan?

To maintain and administer split-dollar loans:

- Each loan made must be tested for adequacy of interest as required by its structure. Every outstanding demand loan tested when initially made and annually thereafter; each term and hybrid loan tested when initially made (see **Questions D.45-D.51**).
- If the loan provides for adequate interest and the insured (or third-party owner) is making current interest payments, those payments must be made to the business on schedule and reported by the business as income. If the interest accrues, payments will not be required from the insured or third-party owner, but the business likely will currently report the accrued interest on an annual basis.
- If the loan does not provide for adequate interest, the forgone interest (for demand loans and hybrid loans) or imputed transfer amount (for terms loans) must be calculated and reported and recognized for tax purposes in accordance with the final regulations (see **Questions D.45-D.51**).
- If the split-dollar loan is nonrecourse, each of the business and the policyowner/borrower (e.g., the insured or his or her ILIT) should complete and attach a copy of a nonrecourse representation to its federal income tax return for each taxable year in which the business makes a loan to which the representation applies (see **Question D.42** and sample nonrecourse representation at **Appendix AP.9**).

To preserve the non-contingent treatment of the split-dollar loan payments (and avoid the complexity and adverse tax consequences associated with contingent payments), it is crucial that both the business and

the insured file the nonrecourse representation with their respective federal income tax returns for each year of the arrangement.

Practice Note: As with economic benefit split-dollar arrangements, the business and insured should periodically review all split-dollar loans under the loan arrangement, the performance of the policy, the projected increases in the policy cash value (particularly if that value is expected to be used to repay the loans and rollout of the arrangement), and the outstanding and projected interest and loan amounts to determine whether the arrangement is working as intended and/or whether modifications or an exit should be implemented.

SELECTING REGIMES

D.69. What Are the Main Factors in Selecting a Split-dollar Regime?

The choice to have a split-dollar arrangement fall under the economic benefit regime or the loan regime will depend primarily on whether:

1. It is more economical to have the insured contribute or report and pay tax on the annual term insurance cost under the economic benefit regime versus the interest (or forgone interest) under a split-dollar loan.
2. The arrangement intends for any equity build-up in the policy to benefit the insured.

The issues and considerations associated with each regime are discussed in below **Questions D.70 and D.71**. See the chart with a summary comparison of the regimes at **Appendix AP.3**.

D.70. When Should the Business and Insured Consider the Economic Benefit Regime?

In general, the business and insured may prefer taxation of the split-dollar arrangement under the economic benefit regime when:

- There is a young insured or a survivorship arrangement.
 - The annual term insurance rates for measuring the cost of current life insurance protection will be low (at least initially or until the first death). For example, the Table 2001 term insurance rate per \$1,000 of coverage for an individual age 40 is only \$1.10.
- The arrangement is intended to be a non-equity arrangement, or the parties do not expect equity in the policy to appear for some time.
 - The current taxation of equity under the economic benefit regime plus, for compensatory arrangements, the potential application of the IRC §409A tax provisions for nonqualified deferred compensation arrangements (see discussion beginning at **Question E.1**) generally make economic benefit equity arrangements undesirable.
 - If the development of policy equity will be delayed, the parties may consider implementing a non-equity economic benefit arrangement and then switching to a split-dollar loan just prior to the appearance of policy equity (see **Question D.79** for further discussion of this switch option).
- The insured wants predictability regarding the maximum amounts that will be subject to tax or that must be contributed.
 - The Table 2001 rates are fixed so that the parties can calculate the annual cost of current life insurance for years to come. Under the loan regime, however, the business generally makes a new loan with each premium payment, subject to a new interest rate, and the cumulative interest on all outstanding loans determines the potentially taxable benefit to the insured each year.

- The business wants to own or control the policy.
 - Under the final regulations, the economic benefit regime will automatically apply if the business is the named policy owner.

D.71. When Should the Business and Insured Consider a Split-dollar Loan?

The business and insured may prefer taxation as a split-dollar loan if:

- The insured is older or after the first death in a survivorship arrangement, particularly if applicable interest rates are low.
 - The annual term insurance rates may be prohibitively high for older insureds and could spike upon the death of the first insured under a survivorship policy.
- The parties want to provide the insured (or more typically, his or her ILIT) with tax-free access to policy equity.
 - Only the loan regime allows the insured or ILIT to have current or future access to policy cash values without current taxation.
 - In addition, for compensatory equity arrangements, a split-dollar loan should not be subject to tax as a nonqualified deferred compensation arrangement under IRC §409A, unless the business forgives any portion of the loan (see the discussion beginning at **Question E.1**).

D.72. Are There Special Considerations for Split-dollar Arrangements Between Corporations and Majority Shareholders?

Yes. If a corporation owns the policy subject to a split-dollar arrangement or otherwise holds any incidents of policy ownership for estate tax purposes,²⁷⁶ those powers will be attributed to the majority shareholder who is insured under the policy, likely pulling any policy death benefits payable for the benefit of the shareholder (such as to a family member or an ILIT) into his or her estate.²⁷⁷ *If the majority shareholder wants to avoid this estate inclusion, an endorsement structure likely will not work.*

Thus, a corporation and majority shareholder likely will want to structure the split-dollar arrangement as a collateral assignment with third-party ownership of the policy (such as through an ILIT). To avoid attribution of any incidents of policy ownership to the insured majority shareholder, the collateral assignment arrangement should use a restricted or “bare-bones” collateral assignment form under which the shareholder’s ILIT retains all incidents of policy ownership apart from the pure security interest assigned to the corporation.

The arrangement, either with or without an equity component, generally will be taxed as a split-dollar loan under the loan regime. Again, to avoid giving any incidents of policy ownership to the majority shareholder, the parties should not structure the loan as a demand loan (see **Question D.47**). A split-dollar hybrid loan based on the shorter of a specified term or shareholder’s life expectancy may be a suitable alternative (see **Questions D.50-D.51**).

Practice Note: Advisors and clients should use caution if using a collateral assignment form provided by the insurance carrier, as most carrier forms are not designed or intended for use with a split-dollar arrangement. Thus, the terms of the form may not be as restrictive as required to avoid creating incidents of policy ownership. Typically, a unique collateral assignment form should be drafted (by an experienced advisor or attorney) to address the specific issues and requirements associated with a split-dollar loan. If

²⁷⁶ For the insured under a split-dollar arrangement, general estate tax principles apply to determine the potential estate taxation of the split-dollar arrangement and the underlying policy (including whether the insured had any incidents of ownership in the policy for estate tax purposes, including the rights to surrender the policy, to name the beneficiary etc.). See, e.g., IRC § 2042 and underlying regulations.

²⁷⁷ See Reg. § 20.2042-1(c)(6).

the parties suggest or consider using a carrier's collateral assignment form, it should be carefully reviewed to determine what rights it gives to the lender and whether they may qualify as incidents of ownership for estate tax purposes.

PRODUCT CONSIDERATIONS

D.73. Why Are Cash Value Products Often Used in Split-dollar Arrangements?

Generally, the business in a split-dollar arrangement will want a product that protects its right to repayment prior to the death of the insured. Otherwise, the business may have no recourse to obtain full reimbursement. Thus, a product with cash value and/or a return of premium rider may be preferred. Cash value products also provide more flexibility in terms of premium design, exchange options and exit strategy alternatives, since the cash value can be applied to premiums or used to repay the business upon exit.

For universal or variable cash value products, the split-dollar arrangement should specifically address who has the right to modify premiums payment timing or amounts and to choose death benefit options. For variable policies, the parties will also need to decide who has authority to make investment choices with regard to the policy's separate account.²⁷⁸

D.74. Should a MEC Be Used in a Split-dollar Arrangement?

Generally, no. A MEC is a life insurance contract as defined under IRC §7702A, entered into or materially modified after June 21, 1988, in which the cumulative premiums paid in the first seven years of the policy exceed the amount needed to provide for a paid-up policy based on statutorily set level annual premiums (the "seven-pay test"). In effect, this test requires the policy to provide a minimum level of insurance coverage for each dollar amount of premium over the policy's first seven years.²⁷⁹

If the policy is a MEC, withdrawals, surrenders and policy loans, *including pledges of the MEC as collateral for a loan*, are taxed as ordinary income until they exceed any gain in the contract (cash value over premiums paid).²⁸⁰ An additional 10 percent penalty tax may apply to the amount included in gross income.²⁸¹ If a policy is a MEC, it remains a MEC. The status cannot be changed, even upon an exchange of the policy.

Thus, where a life insurance policy will be pledged as collateral for a split-dollar loan, MEC status likely is unfavorable.²⁸²

D.75. Are There Any Issues with Using Split-dollar Loans in Conjunction with Variable Policies?

Premium loans secured by variable life insurance policies could subject the lender to the margin loan limits and registration requirements of the Federal Reserve Board, pursuant to Regulation U. There is some concern that split-dollar loans secured by variable policies would be impacted by this regulation.

Under Regulation U, third-party loans secured by variable life insurance policies (other than from the issuing carrier) are indirectly secured by the mutual fund shares underlying the policy, which qualify as

²⁷⁸ See Brody, Richey, and Baier, *Insurance-Related Compensation*, Art. VI.F.4, *supra* note 151.

²⁷⁹ Melvin A. Warshaw, "Recent Trends Affecting Large Trust-Owned Life Insurance," *Estate Planning Journal (WG&L)*, Mar 2012.

²⁸⁰ IRC § 72(e)(10).

²⁸¹ Unless certain limited exceptions apply. See IRC §72(v), which excludes from the penalty distributions 1) made on or after the date on which the taxpayer attains age 59½, 2) which is attributable to the taxpayer's becoming disabled or 3) which is part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his beneficiary.

²⁸² While some commentators have noted that the economics of a split-dollar loan may differ from a traditional loan (e.g., serve a purely compensatory purpose) such that a pledge of the MEC in these circumstances may not trigger adverse income tax consequences (see Lawrence Brody, "Top Twenty-Five Insurance Planning Mistakes Estate Planners Make," presented for The Meltzer Group, Dec. 9, 2010), the prudent approach will be to not pledge a MEC as collateral for a split-dollar loan.

margin stock.²⁸³ Unless the lender is a broker/dealer, the maximum loan value for the purpose of purchasing or carrying margin stock is 50 percent of the current market value of the margin stock securing the loan.²⁸⁴ In addition, non-bank lenders must satisfy various registration and reporting requirements imposed by the Federal Reserve for these types of loans.²⁸⁵

Although some commentators question whether the regulation would apply to compensatory or private split-dollar arrangements used to fund the purchase of a variable policy since it is really a form of compensation or a gift rather than a true extension of credit, there is no definitive analysis. Again, if a split-dollar loan is being considered, the issue should be factored into the product selection analysis.²⁸⁶

EXIT/TERMINATION/ROLLOUT

D.76. What Is a Split-dollar “Exit,” “Termination” or “Rollout”?

As discussed with grandfathered arrangements (see **Question C.33**), an exit, a termination or a rollout (collectively, an “**exit**”) of any split-dollar arrangement generally refers to the unwinding of the arrangement during the insured’s lifetime. The exit generally involves two components:

1. Repayment of the premiums advanced by the business, plus any policy cash value in excess of this amount, in non-equity arrangements
2. Release of the business’ interest in the policy or a transfer of the policy, in an amount equal to the insured’s interest in the policy to the insured or other third-party owner (e.g., the insured’s ILIT)

D.77. Why Are Exits Important for Split-dollar Arrangements?

Rising Term Costs. Just like with grandfathered arrangements, the term insurance cost used to measure the cost of current life insurance protection provided under the arrangement will increase each year as the insured ages (for joint policies, significantly after the death of the first insured) (see **Question D.17**). Eventually, the tax costs to the insured on the imputed income, as well as any corresponding gift tax costs if there is an imputed gift to a third-party owner, such as an ILIT, may become too burdensome or uneconomical.

Reimbursement Obligation. The reimbursement amount due to the business will grow with each premium it pays, effectively reducing the value of the death benefit due to the insured from the policy, unless paid-additions, a return of premium rider, or an increasing death benefit option are used to maintain the death benefit level.

Insured’s Retirement/Termination. In employment relationships, employers will often want, or the agreement will provide for, termination when the employee retires, or otherwise leaves employment. Parties to the arrangement will want to ensure that there are sufficient proceeds to reimburse the business if the arrangement is terminated prior to the insured’s death.

Interest Volatility and Accumulation. If split-dollar loans are made on an annual basis to cover premiums, they will be subject to fluctuations in interest rates, potentially making it difficult to predict how much overall interest will be incurred during the arrangement. In addition, if interest is accrued on the split-dollar loans, it can result in a substantial sum over several years.

D.78. What Are the Key Factors in Selecting and Implementing an Exit Strategy for a Split-dollar Arrangement?

²⁸³ FRRS 5-878.1 (1987); FRRS 5-917.191 (1988); FRRS 5-919.111 (1987).

²⁸⁴ 12 C.F.R. §§ 221.3 and 221.7.

²⁸⁵ See Donald O Jansen, “Split-Dollar Insurance and Premium Financing Planning (Part 2),” *ALI-ABA Estate Planning Course Materials Journal*, Aug. 2008, for a more detailed look at these issues and requirements.

²⁸⁶ See Lawrence Brody and Mary Ann Mancini, “Sophisticated Life Insurance Techniques,” ABA Section of Taxation Meeting, May 2011.

To select an appropriate strategy and timing for implementation, an advisor should analyze the following (see checklist at **Appendix AP.8**)²⁸⁷:

1. **Policy Ownership.** Who formally owns the policy — the business (documented under the endorsement method) or the insured, his or her ILIT, or another third party (documented under the collateral assignment method)?
2. **ILIT Owner.** If an ILIT owns the policy, is it a grantor trust for federal income tax purposes with regard to the insured?
3. **Business Organization and Relationship to Insured.** Is the business a public company, a C corporation, an S corporation or a partnership/LLC? And what is the relationship to the insured? Executive, key employee, shareholder, owner? The business organization and its relationship to the insured will affect the tax consequences.
4. **Insurance Need.** Does the insured still have a need or desire for the insurance?
 - a. If so, how much death benefit is provided under the arrangement, and based on what duration and assumptions?
 - b. Is the insurance coverage amount still appropriate for the situation?
5. **Policy Performance.** Has the policy performed according to initial projections? Does it or will it have sufficient policy cash value to support repayment of the business? Are the assumptions used still accurate?
6. **Disposition of Policy Equity.** Is the arrangement an equity arrangement (equity goes to the insured) or a non-equity arrangement (equity goes to the business)?
7. **Policy Equity.** Does the policy currently have any equity (i.e., cash value in excess of amount due as repayment to business), and if so, how much?
8. **Tax Regime.** Which tax regime under the final regulations applies to the arrangement?
 - a. Economic benefit regime for endorsement and compensatory and private non-equity collateral assignment arrangements.
 - b. Loan regime for equity collateral assignment arrangements.
9. **Policy Flexibility.** What type of product is involved and can it be modified or exchanged for a product that better supports the arrangement?
10. **Planned Exit.** Was an exit strategy reviewed at inception? If so, which party assumed the risk that the policy would not perform sufficiently to support repayment to the business from policy cash value?
11. **Bonus Options.** Can or will the business and/or insured agree to switch to a bonus arrangement to support the policy?
 - a. Does the insured understand that the bonus will be taxable as income and that there also will be a corresponding taxable gift of an equivalent amount if the policy is owned by an ILIT, which may raise GST tax and exemption allocation issues if the insured intends for the ILIT to be fully GST tax exempt?
12. **ILIT Issues.** Are there fiduciary or other considerations the ILIT trustee must address in considering a modification or termination of the arrangement or the underlying policy?

²⁸⁷ See Brody and Ratner, "What To Do With Those Existing Split-Dollar Plans," *supra* note 152. See also David Houston & Maggie Mitchell, "Skeletons in the Closet: What to Do with "Grandfathered" Split-Dollar Arrangements," *The AALU Quarterly*, Spring 2012.

D.79. What Are Potential Exit Options for a Split-dollar Arrangement?

Based on the information collected in response to the questions in **Question D.78**, the following options may be available for a typical split-dollar arrangement²⁸⁸:

Economic Benefit (Non-Equity) Arrangements. Typically, economic benefit arrangements are non-equity arrangements. The insured's need for coverage, the timeframe for the duration of the arrangement and the performance of the policy will determine how to proceed.

- **Rollout Policy.** The business may want to transfer the policy (or its interest in the policy) to the insured (or his or her ILIT) via a distribution or a sale of the policy.
 - *Considerations.*
 - The final regulations applicable to the transfer of a policy from an owner (the business) to a non-owner (the insured) would apply to determine the policy's value and tax consequences (see **Question D.29**).
 - If the policy or the insured's interest in the policy is owned by a third party (ILIT), then there will be an imputed gift of a corresponding amount, unless the third party has the assets to purchase the policy.
 - Transfer for value issues under IRC §101(a) must be reviewed, since that provision will include in gross income otherwise excludable death benefits if the policy is transferred for valuable consideration, which can include the satisfaction and release of obligations under a split-dollar agreement. The transfer of a policy to the insured, an ILIT that is a wholly owned grantor trust with regard to the insured, a partner of the insured, a partnership in which the insured is a partner or a corporation in which the insured is a shareholder or officer will be exempt from the inclusion rule. A transfer of the policy to anyone else (e.g., to the insured's child or spouse) could inadvertently run afoul of these rules, resulting in taxation of the death benefit in excess of any consideration paid by the policyowner for the transfer.
- **Switch to a Loan.**²⁸⁹ With non-equity collateral assignment arrangements taxed under the economic benefit regime, the parties may consider switching to a split-dollar loan arrangement just before the policy cash value meets the business' reimbursement right. The business and insured convert all prior premium payments, less any repayments to the business, to a loan on the first day of the year in which the election to switch to loan treatment is made. The business and insured determine the loan terms (length, interest rate, payment schedule, etc.). The insured (or, more typically, his or her ILIT) continues as the owner of the policy. The business retains a security interest in the policy, evidenced by a collateral assignment reflecting its revised interest.
 - *Considerations.*
 - The parties can take advantage of low economic benefit costs in the early years while avoiding income tax on higher annual term insurance costs and any policy equity that accrues after the switch to a loan, and corresponding gift taxes if the policy is owned by an ILIT.

²⁸⁸ See Brody and Ratner, "What To Do With Those Existing Split-Dollar Plans," *supra* note 152; Charles L. Ratner and Stephen R. Leimberg, "A Planner's Guide to Split-Dollar After the Final Regulations," *Estate Planning Journal* (WG&L), Jan. 2004.

²⁸⁹ See safe harbor provided under Section VI.3 of Notice 2002-8. See also Lawrence Brody, Michael D. Weinberg, and Myron Kove, "Practice Alert: Experts' Critical Analysis of Final Split-Dollar Regulations," *Estate Planners Alert Newsletter* (RIA), Dec. 2, 2003.

- The split-dollar loan is not considered a deferred benefit subject to tax under IRC § 409A (see **Questions E.1-E.7** for a general review of the application of IRC § 409A).
- The conversion of a non-equity collateral assignment arrangement to taxation as a split-dollar loan may be a modification of the arrangement that results in a transfer of the policy from the business (as deemed owner of the policy) to the insured for purposes of the split-dollar regulations. The parties must factor in the potential tax consequences of the transfer (see **Question D.29**). Regardless, the promissory note given by the insured (or his or her ILIT) as part of the loan conversion should offset a taxable transfer.²⁹⁰
- This approach will not be available for arrangements between public companies and directors and covered executives under SOX, due to the prohibition against personal loans to such individuals (see **Question E.16**).
- The parties need to consider the performance of the policy, the applicable term insurance rates for determining the annual economic benefit to the insured, the current interest rates that would apply to a loan, and the possibility of an increase in those rates if the loan repayment were delayed.
- Where an ILIT holds the policy, the final regulations may divide the loan into two separate loans, one made by the business to the insured, with a corresponding loan from the insured to the ILIT (see **Question D.60**). In this case, the loan approach generally will work best if the ILIT is a grantor trust with respect to the insured, in order to avoid treating the imputed interest on the loan to the ILIT as taxable income to the insured.
 - Grantor trust status may also facilitate the insured engaging in an installment sale or other loan transactions with the ILIT, which could provide funding for the ILIT to repay the loan to the borrower and/or future premium payments on the policy, avoiding the need for future loans from the business to subsidize the premiums.
- Any additional premiums required to keep the policy in-force, will now be the insured's responsibility. Possible options to assist the insured in meeting these premiums include:
 - Additional split-dollar loans or a bonus plan for the annual premiums, if the business is willing to assist with the continued policy funding
 - A decrease in the policy death benefit or an exchange of the policy to reduce premiums needs
 - A possible private split-dollar arrangement between the insured and his or her ILIT, subject to the final regulations or an installment sale to the ILIT, as discussed below
- **Cash-out Policy.** If the business owns the policy and it has sufficient cash value, the business may simply want to surrender for the cash surrender value to repay itself and terminate the arrangement.
 - *Considerations.* Under IRC § 72, the business will recognize gain to the extent the cash value exceeds its investment in the contract.

²⁹⁰ See Brody, Richey, and Baier, *Insurance-Related Compensation*, Art. VI.F.4, *supra* note 151.

Loan Arrangements. Exits from split-dollar loans generally will require repayment due to the adverse tax consequences under the final regulations for the forgiveness or cancellation of loan interest and potentially principal, if it appears that the business never intended the principal to be re-paid. Thus, exit strategies for loans primarily focus on where to obtain assets to repay the outstanding debt.

- **Repay with Policy Cash Values.** If the policy has cash value, that value is withdrawn or borrowed against and applied to repay the business.
 - *Considerations.*
 - If an ILIT owns the policy, this option will *not* require additional gifts from the insured to fund the repayment.
 - This option likely will not be feasible if the policy is a MEC, since policy withdrawals and loans can have adverse income tax consequences.²⁹¹
 - The availability of cash value will depend on the performance of the policy and will not be an option for policies that are “underwater.”
 - Policy loans or withdrawals could limit the policy’s ability to sustain itself, or to provide a source of income going forward. Payment options include:
 - Additional split-dollar loans or a bonus plan for the annual premiums, if the business is willing to assist with the continued policy funding.
 - A decrease in the policy death benefit or an exchange of the policy to reduce premiums needs.
 - A possible private split-dollar arrangement between the insured and his or her ILIT, subject to the final regulations or an installment sale to the ILIT, as discussed below.
- **Repay with Other Assets.** The insured or ILIT uses, or if the ILIT holds only the policy, the insured provides, non-policy assets to repay the loan and the business releases its collateral assignment interest.
 - *Considerations.*
 - The use of non-policy assets may be preferable based on the policy economics but requires the insured to fund the ILIT with assets other than the policy.
 - This funding could be accomplished with taxable gifts, or through other, private leverage strategies implemented by the insured, assuming the ILIT is a grantor trust for federal income tax purposes with respect to the insured.
 - Grantor Retained Annuity Trusts (“**GRATs**”). With a GRAT, the insured creates and funds a separate irrevocable trust, retaining an annuity payment stream back for a determined term of years, based on the federal §7520 rate.
 - At expiration of the term, the remaining GRAT assets, the earnings and appreciation in excess of the §7520 rate, may either be distributed or loaned to the ILIT to repay the split-dollar loan.
 - The GRAT can be created and funded without gift tax, by using a “zero-out” GRAT.

²⁹¹ See **Question D.74** for a discussion on MECs.

- The settlor must survive the determined GRAT term, however; otherwise, the GRAT assets will be included in the settlor's taxable estate, and the GRAT will fail as a potential exit strategy.
 - A GRAT is not the most efficient method for using the insured's available GST tax exemption. Therefore, if the ILIT is GST-exempt, the GRAT should consider lending funds to the ILIT rather than naming it as the direct remainder beneficiary.
- Installment Sale of Assets to ILIT. The insured can sell assets to the ILIT in exchange for an interest-only installment note, bearing interest at the appropriate AFR for the month of the transaction, and providing for a balloon payment of principal at the end of the note term. The ILIT can use the assets and income thereon to pay off the split-dollar loan.
 - Since the ILIT is a grantor trust with respect to the insured, there is no gain recognition upon sale.
 - The ILIT, however, must have sufficient initial funds to reasonably demonstrate that it can meet its financial obligations under the sale note, which may require a gift of "seed funds."
 - The ILIT assets also must provide a sufficient investment return to meet both the pay-off of the split-dollar loan and the installment sale obligation. Otherwise, the settlor may need to contribute additional funds and/or implement another complementary strategy.
- If the ILIT is a non-grantor trust or another third party holds the policy, the business' release of its security interest under the collateral assignment still should not raise any transfer for value concerns under IRC § 101(a)(2), since the initial collateral assignment is not a transfer for value.²⁹²
- **Exit at Death.** The parties can agree to fund the exit with policy death benefits at the death of the insured.
 - *Considerations.*
 - If the loan arrangement stays in place until death, the key employee will be responsible for not only non-deductible interest payments annually until death but also income taxes on any imputed interest. This cost could reduce the arrangement's ability to produce discretionary retirement income or become too burdensome.
 - This option does not work for survivorship policies, because the death benefit will not be available unless the insured is the second spouse to die, as the policy's death benefit will not be paid until the death of the survivor of the insured.

D.80. What if Additional Premiums Are Required on the Policy After the Exit?

After the exit from a split-dollar arrangement, the policy may still require additional premiums to remain in force, particularly if policy cash value was used to fund the exit. These premiums will now be the insured's responsibility. Possible options to assist the insured in paying these premiums include:

- A decrease in the policy death benefit or an exchange of the policy to reduce premiums needs, as the split-dollar arrangement is terminated, a material modification is no longer a concern

²⁹² See Regs. § 1.101-1(b)(4).

- A possible private split-dollar arrangement between the insured and his or her ILIT, subject to the final regulations, or an installment sale to the ILIT, as described in **Question D.79**
- A bonus plan arrangement, if the business still wants an insured employee to have coverage and is willing to increase his or her compensation

CASE STUDIES

The following case studies review the tax and accounting requirements for various split-dollar arrangements upon termination of the plan. Note that the results of any particular case are highly sensitive to the case's unique facts and the federal and state tax rates and laws then applicable. These case studies are for illustration only and cannot be relied upon or used as the basis for any tax advice.

D.81. Loan Regime Split-dollar Between Business, as Employer, and Insured Executive's ILIT — First Year

Facts. A split-dollar loan agreement was established between X. Co. and executive E's ILIT after the effective date of the final regulations (Sept. 17, 2003). ILIT owns the policy (non-MEC) and is a grantor trust with regard to E for federal income tax purposes. X Co. paid the first annual premium to the insurance carrier. The split-dollar loan is nonrecourse to E and E's ILIT and is secured only by a collateral assignment of the policy cash values filed with the life insurance carrier. The loan is an interest-free demand loan. The applicable blended short-term AFR (annually compounding) that applies to test the sufficiency of interest under the loan is 0.22 percent.

Economics:

- | | |
|---|-----------|
| • Loans Made by X Co. for Premiums | \$150,000 |
| • Forgone Interest on Split-dollar Demand Loan
(\$150,000 x .0022) | \$330 |
| • X Co. Tax Bracket | 40% |
| • Executive E's Tax Bracket | 40% |
| • Gift Tax Rate | 40% |

Potential Tax Outcomes. Based on the above:

- *X Co.:*
 - Is deemed to have transferred the \$330 of forgone interest to E as compensation. X Co. can take a compensation deduction for this amount (subject to limitations under IRC § 162(m) regarding reasonableness of the compensation).
 - Must include the \$330 of forgone interest in its gross income as interest income.
 - Along with E, should attach to its federal income tax return for the year of the loan a copy of a written representation, signed by both X Co. and E, stating that the parties to the split-dollar loan represent that a reasonable person would expect that all payments under the loan will be made (a nonrecourse representation — see **Question D.42**).
 - The nonrecourse representation, if properly filed by both E and X Co., should avoid contingent payment treatment of the payments under the split-dollar demand loan, which could have adverse income tax consequences.
- *Executive E:*
 - Has compensation income equal to the forgone interest of \$330.

- Assuming tax at a maximum income tax rate of 40 percent, this could result in federal income tax of up to \$132.
 - This is phantom income to E. Unless X Co. agrees to bonus the tax liability to E as additional compensation, with any corresponding compensation deduction again, subject to limitations for reasonableness, E will need to use his own cash to pay the liability.
- Is deemed to make a corresponding interest payment on the split-dollar loan to X Co. of \$330, but cannot deduct the interest.
- Along with X Co., should attach to his federal income tax return for the year of the loan a copy of the nonrecourse representation.
- Makes a corresponding, imputed gift of \$330 to the ILIT.
 - Depending on the terms of the ILIT, including the number of beneficiaries who hold Crummey withdrawal powers, if any, E may be able to fully shelter the imputed gift through the use of annual exclusion gifts.
 - If annual exclusion gifts are not available, E could incur federal gift tax of up to \$132, assuming application of a top-40-percent gift tax rate, or must use \$132 of his remaining federal gift tax exemption to shelter the gift.
 - In addition, if E intends for the ILIT to be fully exempt from GST tax, he likely will need to allocate \$330 of his remaining federal GST tax exemption to preserve the ILIT's GST tax-exempt status.

D.82. Termination of a Loan Regime Split-dollar (with Equity)

Facts. A split-dollar loan arrangement was established between X. Co. and executive E's ILIT after the effective date of the final regulations (Sept. 17, 2003). ILIT owns the policy (non-MEC) and is a grantor trust with regard to E for federal income tax purposes. The split-dollar loan is nonrecourse to E and E's ILIT and is secured only by a collateral assignment of the policy cash values filed with the life insurance carrier. The ILIT and X Co. have properly filed nonrecourse representations for the loan. The split-dollar arrangement will terminate upon E's termination of employment, when repayment of the loan is due either from using policy cash values or other assets of the ILIT, as the policy owner. The split-dollar loan is a hybrid, performance-based below-market loan (see **Question D.50**), and the annual forgone interest has been imputed to E each year of the loan. E is ready to terminate employment. The policy is in an equity position; there is gain in the policy.

Termination. Policy cash value will be used to reimburse X Co. The policy is projected to be able to sustain itself in force without further premiums after the withdrawal.

Economics:

• Cumulative Loans Made by X Co. for Premiums	\$1,500,000
• Cash Surrender Value of Policy	\$2,250,000
• Difference between Loan Total and Cash Surrender Value	\$750,000
• X Co. Tax Bracket	40%
• Executive E's Tax Bracket	40%
• Gift Tax Rate	40%

Potential Tax Outcomes. Based on the above:

- X Co.:
 - Has been reporting annual compensation income to E equal to the forgone interest under the loan, which is potentially eligible for a compensation deduction, but has also been reporting annual interest income from E in a corresponding amount.
 - Receives \$1,500,000 as repayment of the loan, which should not be subject to tax as a return of principal.
- Executive E:
 - Has been reporting annual compensation income equal to the forgone interest under the loan, with a corresponding gift to the ILIT.
 - Has not been able to deduct the interest deemed paid by him to X Co. on the loan.
 - Should not incur income tax (as grantor of the ILIT) when the ILIT makes a withdrawal of \$1,500,000 of the policy cash value to repay X Co.²⁹³
 - Should not incur any gift tax upon the ILIT's repayment of the loan.
 - Has been making corresponding, imputed gifts to the ILIT of the annual forgone interest he has reported as income.
 - Depending on the terms of the ILIT, including the number of beneficiaries who hold Crummey withdrawal powers, if any, E may have been able to shelter the imputed gifts as annual exclusion gifts.
 - If E intended the ILIT to be fully exempt from GST tax, he likely should have been allocating a corresponding amount of his federal GST tax exemption to the imputed gifts to preserve the ILIT's GST tax-exempt status.

D.83. Termination of a Loan Regime Split-dollar (Without Equity)

Facts. A split-dollar loan arrangement was established between X. Co. and executive E's ILIT after the effective date of the final regulations (Sept. 17, 2003). ILIT owns the policy (non-MEC) and is a grantor trust with regard to E for federal income tax purposes. The split-dollar loan is nonrecourse to E and E's ILIT and is secured only by a collateral assignment of the policy cash values filed with the life insurance carrier. The ILIT and X Co. have properly filed nonrecourse representations for the loan. The split-dollar arrangement will terminate upon E's termination of employment, when repayment of the loan is due using either policy cash values or other assets of the ILIT, as the policy owner. The split-dollar loan is a hybrid, performance-based below-market loan (see **Question D. 50**), and the annual forgone interest has been imputed to E each year of the loan. E is ready to terminate employment. The policy has not performed well, so there is insufficient cash value for use in reimbursing X Co.

Termination. The policy owned by the ILIT will be surrendered for its cash value, with the proceeds paid to X Co. in partial reimbursement of the loan. X Co. will forgive the remainder of the loan balance.

Economics:

- | | |
|--|-------------|
| • Cumulative Loans Made by X Co. to Pay Premiums | \$1,500,000 |
| • Total Cash Surrender Value of Policy | \$1,150,000 |

²⁹³ Subject to IRC §7702(f)(7) and IRC §72. Under IRC §72, policy withdrawals are not subject to income tax to the extent of the ILIT's investment in the contract (approximately \$1,500,000, if no other withdrawals have been made).

• Difference in Cash Surrender Value of Policy and Loans Made by X Co.	(\$350,000)
• Other Trust Assets	\$0
• X Co. Tax Bracket	40%
• Executive E's Tax Bracket	40%
• Gift Tax Rate	40%

Potential Tax Outcomes: Based on the above:

- *X Co.:*
 - Has been reporting annual compensation income to E equal to the forgone interest under the loan, which is potentially eligible for a compensation deduction, but also has been reporting annual interest income from E in a corresponding amount.
 - Receives \$1,150,000 as repayment of the loan, which should not be subject to tax as a return of principal.
 - Reports \$350,000 as compensation income to E and takes a corresponding income tax deduction (subject to limitations under IRC §162(m) regarding reasonableness of the compensation).
 - Should review the possible application of IRC §409A to the arrangement as the application of that section can be triggered by forgiving or waiving repayments amounts under a split-dollar loan.
- *Executive E:*
 - Has been reporting annual compensation income equal to the forgone interest under the loan, with a corresponding gift to the ILIT.
 - Has not been able to deduct the interest deemed paid by him to X Co. on the loan.
 - Should not incur income tax (as grantor of the ILIT) when the ILIT surrenders the policy for \$1,150,000 of policy cash value to repay X Co.²⁹⁴
 - Has compensation income of \$350,000.
 - Assuming tax at a maximum income tax rate of 40 percent, the termination of the arrangement could result in a top federal income tax liability of \$140,000.
 - This is phantom income to E. Unless X Co. agrees to bonus the tax liability to E as additional compensation (which may not qualify for a corresponding compensation deduction due to reasonableness requirements), E will need to come up with his own cash to pay the liability.
 - Makes a corresponding, imputed gift of \$350,000 to the ILIT.
 - Depending on the terms of the ILIT, including the number of beneficiaries who hold Crummey withdrawal powers, if any, E may have been able to shelter the imputed gifts as annual exclusion gifts.

²⁹⁴ Subject to IRC § 7702(f)(7) and IRC § 72. Under IRC § 72, policy withdrawals are not subject to income tax to the extent of the ILIT's investment in the contract (approximately \$1,500,000, if no other withdrawals have been made).

- Otherwise, if annual exclusion gifts are not available, E could incur federal gift tax of up to \$140,000, assuming application of a top-40-percent gift tax rate or must use \$140,000 of his remaining federal gift tax exemption to shelter the gift.
- In addition, if E intends for the ILIT to be fully exempt from GST tax, he likely will need to allocate \$350,000 of his remaining federal GST tax exemption to preserve the ILIT's GST tax-exempt status.
- Termination of the loan arrangement could result in a combined federal income and gift tax liability to E of \$280,000.

Section E: Other Issues Under the Tax Code

IRC § 409A AND TAXATION OF NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENTS

E.1. What Is IRC § 409A?²⁹⁵

IRC § 409A provides rules regarding the recognition and taxation of compensation under nonqualified deferred compensation arrangements, including rules regarding distributions, time and form of payments, definition of separation from service, deferral elections, and anti-acceleration.²⁹⁶

E.2. When Did IRC § 409A Take Effect and Are There Any “Grandfathering” Protections?

IRC § 409A does not apply to amounts deferred in tax years beginning before Jan. 1, 2005, nor to earnings on such amounts, even if accrued after the Jan. 1 date, unless the plan is materially modified after Oct. 3, 2004 (“**409A grandfathered benefits**”).

For purposes of IRC § 409A, grandfathering applies at two levels: 1) at the plan level, which looks at when a nonqualified deferred compensation plan was implemented and 2) at the benefit level, which looks at when compensation amounts were deferred under an existing nonqualified deferred compensation plan.

Plan Level. As discussed at **Question E.6** with specific regard to split-dollar arrangements, while IRC § 409A provided time for non-compliant nonqualified deferred compensation arrangements to become compliant, all arrangements existing prior to the effective date of IRC § 409A must now be in compliance. Thus, there is essentially no “grandfathering” at the plan level.

Benefit Level. With regard to plan benefits, IRC § 409A applies to compensatory amounts deferred after Dec. 31, 2004, and to amounts deferred prior to Jan. 1, 2005, pursuant to agreements that are materially modified after Oct. 3, 2004 (the “**effective date**”). For purposes of § 409A, an amount is considered deferred prior to Jan. 1, 2005, if the service provider had a legally binding right to be paid the amount and such right was earned and vested. These amounts receive no grandfathering protection (“**409A non-grandfathered benefits**”).

E.3. Does IRC § 409A Apply to Split-dollar Arrangements?

Yes, the IRC § 409A regulations indicated that IRC § 409A may apply to certain types of **compensatory** split-dollar arrangements, between an employer and employee, that effectively provide deferred compensation. The IRS issued Notice 2007-34, which clarified what types of split-dollar arrangement were affected, including the impact on grandfathered split-dollar arrangements.

Generally, Notice 2007-34 provides that IRC § 409A does not apply to compensatory split-dollar arrangements that only provide death benefits to or for the benefit of the insured employee (the “**death benefit exception**”), or that fall under the short-term deferrals exception to IRC § 409A provided under the regulations (“**short-term deferral exception**”).

For affected compensatory split-dollar arrangements, increases in an insurance policy’s cash value that are attributable to 409A grandfathered benefits will be considered earnings on such benefits, and thus also will be grandfathered. However, increases in policy equity that are attributable to the continued

²⁹⁵ See generally Steve B. Lapidus and Jennifer M. Smith, “Notice 2007-34: Guidance on Application of § 409A to Split-dollar Insurance Arrangements,” *Greenberg Traurig Alert*, July 1, 2007 (accessed at <http://www.gtlaw.com/News-Events/Publications/Alerts/82642/Notice-2007-34-Guidance-on-Application-of-409A-to-Split-Dollar-Insurance-Arrangements>).

²⁹⁶ See Thomas Barrett, Michele, Beauchine, Kenneth Cymbal, John Donlon, Lori Epstein, Jeffrey Hollander, Jeffrey Jenei, Lillie Nkenchor and Barry Rabinovich, “Split-Dollar Life Insurance,” *MetLife Financial Solutions from Advanced Markets – Legal and Tax Trends*, Issue 2 (Winter 2011); Lawrence Brody and Mary Ann Mancini, “Memorandum to Advanced Underwriting Subscription Service Clients, Re: The Application of Section 409A to Employment-Related Split-Dollar Arrangements,” Dec. 5, 2007.

performance of services, to compensation earned, or to premium payments or other contributions made on or after Jan. 1, 2005, will not qualify as earnings on 409A grandfathered benefits.

If a split-dollar arrangement has both 409A grandfathered benefits and non-grandfathered benefits, any future increases in the policy's cash value must be allocated between both types of benefits. Any "reasonable" allocation method is acceptable, however Notice 2007-34 provides a safe harbor if the "proportional allocation method" described in the notice is used.

E.4. What Happens if a Split-dollar Arrangement Is Not in Compliance with § 409A?

If § 409A applies to a split-dollar arrangement that is not in compliance with the provisions for nonqualified deferred compensation plans, all 409A non-grandfathered benefits are currently includible in gross income if they are not subject to a substantial risk of forfeiture and have not been previously included in gross income. In addition to current inclusion in gross income, the taxable amounts also are subject to a 20 percent additional tax plus interest on any federal income tax underpayment.

If the policy is owned by a third party (such as an ILIT), the 409A non-grandfathered benefits that are taxed under § 409A will also be treated as a gift from the employee to the third-party owner.

E.5. What Specific Types of Compensatory Split-dollar Arrangements Are Affected by IRC § 409A?

Generally, IRC § 409A directly affects only economic benefit (i.e., non-loan) equity split-dollar arrangements, whether grandfathered or post-regulation arrangements,²⁹⁷ where the insured employee has a legally binding right during any tax year to access the policy's cash value or to receive any economic benefits, other than the cost of current life insurance protection, that are payable to (or on behalf of) the employee in a later year, and to which neither the death benefit nor the short-term deferral exception applies.

Practice Note: For post-regulation split-dollar arrangements, the already unfavorable tax treatment of economic benefit equity arrangements under the economic benefit regime of the final regulations (see **Questions D.20-D.22**) makes these types of arrangements impractical for tax planning purposes, and thus essentially non-existent. Accordingly, compliance issues with IRC § 409A will generally focus on existing, grandfathered equity split-dollar arrangements.

IRC § 409A **does not apply to:**

- *Non-equity endorsement or collateral assignment compensatory arrangements*, since they only provide death benefit protection to the insured employee, and thus fall under the § 409A's death benefit exception.
- *Split-dollar loans*, and grandfathered split-dollar arrangements that were classified or elected loan treatment under Notice 2002-8, assuming that the business has not agreed to and does not waive, cancel or forgive all or any portion of the loan and has no obligation to continue to pay premiums without charging a market rate of interest on the funds advanced or to pay premiums beyond normal retirement age.

E.6. What Happens to Compensatory Equity Arrangements That Were in Place Before the Effective Date of IRC § 409A?

IRS Notice 2007-34 provides a method for amending existing split-dollar arrangements that are covered by § 409A that will not result in a "material modification" of a grandfathered split-dollar arrangement, resulting in taxation of that arrangement under the final regulations. However, as of Jan. 1, 2009, all existing split-dollar arrangements covered by § 409A have to be in full compliance with the provisions of that section and the underlying regulations or amounts deferred after the effective date of § 409A (see **Question E.1**) will be subject to current taxation as provided in **Question E.4**.

²⁹⁷ See **Section B** for a discussion of endorsement, collateral assignment, non-equity and equity arrangements.

E.7. How Are § 409A Grandfathered Benefits Taxed upon the Lifetime Termination of a Compensatory Equity Split-dollar Arrangement?

Pre-regulations guidance (e.g., Notice 2002-8) still applies to determine the tax consequences for any policy equity under a grandfathered split-dollar arrangement that is not subject to § 409A. See **Section C** for a discussion of these rules.

IRC 101(J) AND TAXATION OF EMPLOYER-OWNED LIFE INSURANCE (EOLI)

E.8. What Is an EOLI Contract?

An EOLI contract is a life insurance contract issued after April 17, 2006, that:

- Is owned by a person *engaged in a trade or business*²⁹⁸ and under which such person (or a related person) is directly or indirectly a beneficiary under the contract
- Insures an employee of the trade or business of the policyowner or a related person (collectively, the “applicable policyholder”) on the date of the contract’s issuance²⁹⁹

E.9. Does the EOLI Classification Apply to All Policies Meeting the EOLI Requirements, Regardless of When Issued?

No. IRC § 101(j) does not apply to life insurance contracts issued prior to April 18, 2006, (“grandfathered policies”) or received in a § 1035 exchange after April 18, 2006, for a grandfathered policy unless there is a material increase in the death benefit or other material change that generally causes the contract to be treated as a new contract.

Notice 2009-48 provides a non-exclusive list of non-material changes, which includes 1) increases in death benefit that occur as a result of either the operation of Code § 7702 or the terms of the existing contract (provided the insurer’s consent to the increase is not required), 2) administrative changes, 3) changes from general account to separate account or from separate account to general account or 4) changes as a result of the exercise of an option or right granted under the contract as originally issued. For example, a death benefit increase is not a material change if it 1) is necessary to keep the contract in compliance with Code § 7702, 2) results from the application of policyholder dividends to purchase paid-up additions or 3) is the result of market performance or contract design with regard to a variable contract.

E.10. What Are the Consequences to EOLI Contract Status?

Unless an exception applies, IRC § 101(j) requires an applicable policy holder (the employer) *to include in gross income the death benefits received under an EOLI contract* in excess of the total premiums and other amounts paid by the policyholder for the contract.

E.11. Are Policies Underlying Split-dollar Arrangements EOLI Contracts?

Potentially. Generally, any policy underlying a split-dollar arrangement where the business owns the policy, and the business (or a related person) will receive the death benefits, constitutes an EOLI contract, which includes most employer-employee economic benefits split-dollar arrangements.

It appears that policies subject to split-dollar loans between and employer and employee (or the employee’s ILIT) would not constitute an EOLI contract, except to the extent the employee or his or her ILIT is somehow a related person for purposes of the EOLI contract definition.

²⁹⁸ Notice 2009-48 posed the question of whether a contract can be an EOLI contract if it is owned not by a person engaged in a trade or business, but by a related person who is not engaged in a trade or business. The IRS responded “No. A contract is an [EOLI] contract only if it is owned by a person engaged in a trade or business and is otherwise described in Code § 101(j)(3).”

²⁹⁹ For this purpose: 1) a “related person” means any person with a relationship to the policyowner as specified in Code § 267(b), § 707(b)(1), § 52(a) or § 52(b), and 2) an “employee” means an officer, director or certain highly compensated employees as defined in Code § 414(q).

Practice Note: Whenever there is any doubt about whether a policy subject to a business split-dollar arrangement may constitute an EOLI contract, the notice and consent requirement described in Question E. 13 should be met prior to issuance of the contract, in order to preserve the exceptions to death benefit taxation (as described in Question E.12).

E.12. Are There Any Exceptions to Death Benefit Inclusion for EOLI Contracts?

The following exceptions will exclude EOLI death benefits from gross income *if certain notice and consent requirements are met before the issuance of the EOLI contract* (as discussed in Question E.13):

- **Exception Based on Insured's Status.** The insured under the contract was 1) an employee at any time during the 12 months prior to his or her death or 2) at the time of the contract's issuance, a director or a highly compensated employee or individual.³⁰⁰
- **Exception Based on Payment to Insured's Heirs.** The contract death benefits are, by the date of the tax return for the taxable year in which the death benefit was received:
 - Paid to the insured's estate, family member(s) or other designated beneficiaries (apart from the policyholder), or a trust for the benefit of any such individuals, or
 - Used to purchase an equity (or capital or profits) interest in the applicable policyholder from any person described in clause above.

Practice Note: These exceptions exclude most EOLI death benefits from tax, again, assuming the notice and consent requirements below are satisfied prior to contract issuance.

E.13. What Are the Notice and Consent Requirements for Taking Advantage of the Exceptions to EOLI Contract Taxation?

Notice. Prior to issuance of the contract, the employee must receive written notification that the applicable policyholder:

- Intends to insure the employee's life,
- Reasonably expects to purchase a specified maximum amount of life insurance (stated either in dollars or as a multiple of salary) on the employee during the employee's tenure. Additional notice and consent is required if the EOLI coverage exceeds this amount, and
- Will be a beneficiary of any proceeds payable upon the death of the employee.

Consent. Prior to issuance of the contract, the employee must consent, in writing, to being the insured under the contract and to the continuation of coverage after termination of the insured's employment. The contract must be issued 1) within one year after the employee's consent or 2) before the termination of the employee's employment, whichever is earlier.

See **Appendix AP.10** for a sample notice and consent form.

E.14. Are There Any Corrective Actions the Employer Can Take if It Fails to Obtain the Employee's Notice and Consent Prior to Policy Issuance?

Corrective actions for failing to obtain notice and consent are extremely limited. Per Notice 2009-48, the only situations in which the IRS will not challenge inadvertent failures to satisfy the notice and consent requirements are when:

³⁰⁰ For this purpose, 1) a "highly compensated employee" is defined in Code § 414(q), ignoring paragraph (1)(B)(ii) (i.e., any employee who is a 5-percent owner or had compensation from the employer in excess of \$115,000 (inflation adjusted)), and 2) "highly compensated individual" is defined in Code § 105(h)(5), but substituting 35 percent for 25 percent (i.e., an individual who is one of the 5 highest paid officers, a shareholder who owns (with the application of the constructive ownership rules of Code § 318) more than 10 percent of the employer's stock, or among the highest paid 35 percent of all employees).

- The applicable policyholder made a good faith effort to satisfy the requirements. Such good faith efforts may include maintaining a formal system for notice and obtaining consents from new employees.
- The failure to satisfy the requirements was inadvertent.
- The failure to obtain the notice and consent was discovered and corrected by the due date of the tax return for the taxable year in which the EOLI contract was issued. Failure to obtain consent cannot be corrected if the insured employee has died.³⁰¹

Otherwise, removing the “taint” of an EOLI contract issued without prior notice and consent typically involves 1) cancelling the existing policy and issuing a new one or 2) affecting a material increase in the policy death benefit or other material change in the contract. The N&C requirements must be satisfied prior to the issuance of a new policy or to a material change in an existing policy.

Where the insured employee is no longer insurable, however, neither of these methods may be feasible. In these cases, the business could attempt to transfer the policy to the insured employee, which would be taxable as compensation to the employee, but not as a transfer for value because the policy is transferred to the insured.³⁰² At a later date, the employee could transfer the policy back to the business. The employee’s transfer of the policy to the business is sufficient to satisfy the N&C requirements,³⁰³ and if the employee is a shareholder or partner of the business, the return transfer will avoid the transfer for value rules. Alternatively, if both the business and the insured employee own interests in a separate partnership, the employee’s transfer of the policy back to the business would also fall under an exception to the transfer for value rules.

These approaches are complicated and have numerous drawbacks, particularly when compared to the relative simplicity and ease of providing notice to and obtaining consent from the insured employee. For example, the employee could die while holding the policy or the IRS might seek to collapse the transfers through application of the step transaction doctrine.

Practice Note: Again, if there is any doubt about whether a new policy that will be issued in connection with a business split-dollar arrangement will be an EOLI contract, the parties to the arrangement should satisfy the notice and consent requirements prior to policy issuance in order to preserve all available exceptions to income taxation. It is much easier to obtain notice and consent than to try and correct the issue later.

E.15. Are There Any Reporting Requirements Associated with EOLI Contracts?

Yes. Under IRC § 6039I, policyholders of EOLI contracts must file Form 8925 with their annual federal tax return for each year that an EOLI contract is owned. Form 8925 reports certain information regarding EOLI contracts, including the number of employees insured under EOLI contracts, the total amount of EOLI insurance in force and the number of non-consenting insured employees (if any). The policyholder must keep whatever records may be necessary for purposes of determining whether the requirements of IRC §§ 101(j) and 6039I are met.

If the required Form 8925 is not filed for a prior year, the potential consequences and the options, if any, for correcting such a missed filing are not clear. The instructions to Form 8925 do not discuss any penalties or potential consequences, although the IRS may argue that certain failure to file penalties apply.

SARBANES-OXLEY ACT OF 2002

E.16. How Does Sarbanes-Oxley Impact Split-dollar Planning?

³⁰¹ Notice 2009-48, Q&A 13.

³⁰² See Code § 101(a)(2) for the transfer for value rules and related exceptions.

³⁰³ See Notice 2009-48 (Q & A 8).

Generally, SOX § 402 prohibits a public company from extending credit directly or indirectly in the form of a personal loan to any directors or covered executives. SOX § 402 does contain a “grandfather” clause exempting public company loans that were in place on July 30, 2002 (the date of enactment of SOX), “so long as there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date.”

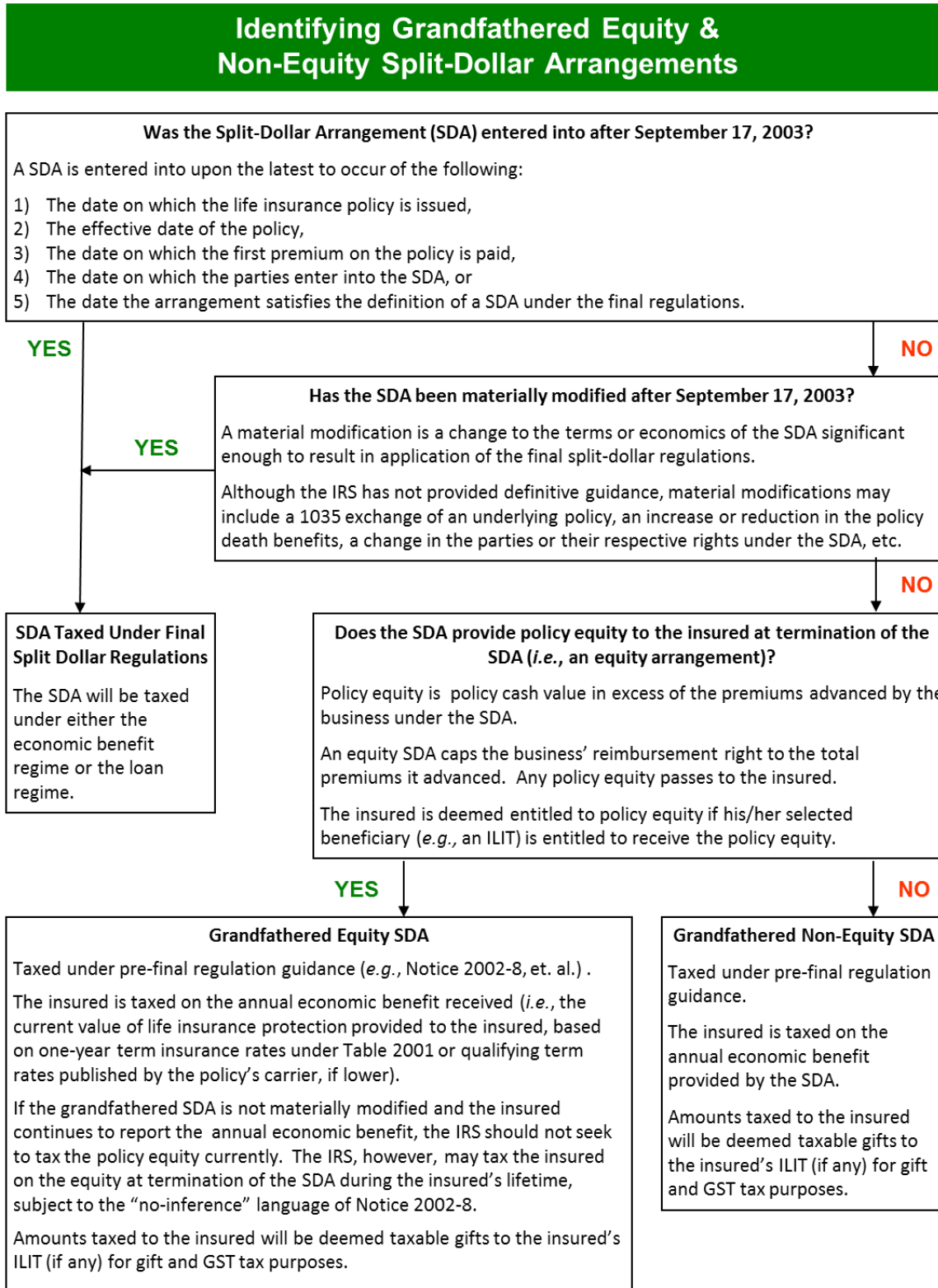
Depending on the interpretation of this provision, its application could be quite broad. Generally, most commentators and advisors believe that SOX classifies split-dollar loans and collateral assignment arrangements between public corporations and directors and covered executives as prohibited personal loans. There is uncertainty as to whether non-equity, economic-benefit split-dollar arrangements may be similarly affected, since they are not formally considered or taxed as loans.

Unfortunately, SOX does not specifically address the treatment of split-dollar arrangements. Further, the IRS declined to address the issue when issuing the final regulations, stating that SOX falls within the jurisdiction of the Securities and Exchange Commission (“**SEC**”). Yet, to date, the SEC has not provided any clarification on this matter. Accordingly, questions regarding the use of split-dollar arrangements for public company officers and/or executives may arise from time to time. Due to the imposition of criminal and civil penalties for violation of the prohibited loan provision, use of split-dollar loans involving public companies and directors and covered executives should be avoided. Even endorsement or non-equity arrangements should be reviewed carefully in light of the potential risk. For public companies, IRC § 162 bonus arrangements may be a more suitable option.

Note that although SOX does not technically apply to nonprofit organizations, many of these organizations have voluntarily adopted certain SOX-like provisions, including prohibitions on personal loans to directors and executives. If working with a nonprofit, be sure to review the organizations policies and whether a split-dollar arrangement with an organization’s director or executive would be in compliance.

Appendix of Charts and Select Sample Forms

AP.1. CHART: Decision Tree for Grandfathered Split-dollar Arrangements



AP.2. CHART: Taxation — Grandfathered Versus Post-regulation Arrangements

(References in Parentheses Are to Question Numbers in the Guide)

	Grandfathered Arrangements	Post-Regulation Arrangements	
		Economic Benefit	Loans
Agreements Effected	Entered into on or before and not “materially modified” after September 17, 2003 (C.1-C.3)	Entered into or “materially modified” after September 17, 2003 (D.1 and D.2)	
Rules Governing Taxation	Notice 2002-8 and other guidance issued prior to the final regulations (A.4 and C.6)	Reg. § 1.61-22 (D.8; D.10-D.34)	Reg. § 1.7872-15 (D.8; D.35-D.60)
Typical Documentation Method	Endorsement (business-owned) if non-equity Collateral assignment (insured or trust-owned) if equity (B.2-B.5; C.4-C.5)	Endorsement or collateral assignment (non-equity only) (B.2-B.5; D.61-D.64)	Collateral assignment (B.2-B.5; D.65-D.68)
Insured Taxed Annually on Term Cost of Current Life Insurance Protection (Annual Economic Benefit)	Yes (C.7-C.13)	Yes (D.11-D.19)	N/A
Insured Taxed on Forgone/Imputed Interest	N/A	N/A	Yes (D.43-D.50)
Impact on Insured’s Contributions/Payments Under Arrangement	Offsets taxable annual economic benefit to insured. Business is not taxed on insured’s contribution. Insured may receive tax basis in policy. (C.14-C.15)	Offsets taxable annual economic benefit to insured. Business is taxed on contribution. Business (not insured) receives tax basis in policy. (D.24-D.25)	Applied first to outstanding interest on all loans and then to principal. Offsets any taxable forgone/imputed interest to insured. Business recognizes interest income (whether paid or accrued). (D.54)
Insured Taxed on Access to Policy Equity/Cash Value	Likely upon exit/rollout or material modification of arrangement, subject to “no-inference” language (C.17-C.18)	Current taxation of any entitlement or access to policy cash value (D.20-D.23)	No (D.36)

	Grandfathered Arrangements	Post-Regulation Arrangements	
		Economic Benefit	Loans
Taxation on Exit/Policy Rollout	<p>Likely taxation of any policy equity, subject to “no-inference” language</p> <p>(C.17-C.18)</p>	<p>If policy is transferred to insured, s/he must recognize as income the fair market value of the policy, less consideration paid for the transfer, and any economic benefits previously paid for or recognized by insured other than the cost of current life insurance protection. Insured takes an equivalent tax basis in the policy.</p> <p>Business can take a corresponding deduction for amounts included in insured’s income, plus all amounts previously included in insured’s income as economic benefits (other than for current life insurance protection).</p> <p>(D.33-D.34)</p>	<p>For any outstanding loans, if the business forgives or waives repayment of interest, the interest amount, plus a deferral charge based on the underpayment of tax penalty rate, is taxable to the insured.</p> <p>Any forgiveness or waiver of principal due also will be taxed to the insured.</p> <p>(D.60)</p>
Imputed Gifts if Policy Held by Third Party/Insurance Trust	<p>Yes, equal to annual economic benefit and any policy equity taxed to the insured</p> <p>(C.19-C.20)</p>	<p>Yes, equal to any annual economic benefits (including access to cash value) taxed to the insured</p> <p>(D.33-D.34)</p>	<p>Yes, based on amounts taxed to the insured (e.g., forgone interest, any amount waived or forgiven under loan)</p> <p>(D.60)</p>

AP.3. CHART: Post-Regulation Arrangements: Economic Benefit Versus Loan Regime

(References in Parentheses Are to Question Numbers in the Guide)

	Economic Benefit	Loan
Rules Governing Taxation	Reg. § 1.61-22 (D.8; D.10-D.34)	Reg. § 1.7872-15 (D.8; D.35-D.60)
Policyowner (Determines Regime Application)	Business (D.5-D.8)	Insured or Insured's Irrevocable Life Insurance Trust (ILIT) (D.5-D.8)
Typical Documentation Method	Endorsement or collateral assignment (non-equity only) (B.2-B.5; D.61-D.64)	Collateral assignment (B.2-B.5; D.65-D.68)
Amounts Taxed Annually to Insured	Value of 1) term cost of current life insurance protection, 2) current access to policy cash value and 3) any other economic benefits under the arrangement (D.10-D.34)	Demand and hybrid loans: If below-market, insured taxed on forgone interest on loan each year Term loans: If below-market, insured recognizes all forgone interest for entire loan term in first year of loan (D.35-D.60)
Insured Taxed on Access to Policy Equity/Cash Value	Current taxation of any entitlement or access to policy cash value (D.20-D.23)	No (D.36)
Impact on Insured's Contributions/Payments Under Arrangement	Offsets taxable annual economic benefit to insured. Business is taxed on contribution. Business (not insured) receives tax basis in policy for contributions. (D.24-D.25)	Applied first to outstanding interest on all loans and then to principal. Offsets any taxable forgone/ imputed interest to insured. Business recognizes interest income (whether paid or accrued). (D.54)
Tax Basis in Policy During Arrangement	Basis in policy accrues solely for the benefit of the business, as policy owner, regardless of insured's contributions (D.25)	Basis in policy accrues for the benefit of insured (or ILIT), as policy owner (D.55)
Income Taxation of Policy Death Benefits (assumes no transfer for value under IRC §10(a) and compliance with IRC §101(j))	Business and Insured: Exempt under IRC § 101(a) (but, for insured, only to extent s/he has reported/paid annual cost of insurance protection; otherwise benefits treated as received tax-free by business and transferred to insured as income) (D.28)	Insured: Exempt under IRC § 101(a) Business: Not exempt under IRC §101(a), but to extent received as a recovery of principal, not taxable (D.54)

	Economic Benefit	Loan
Taxation on Exit/Rollout	<p>If the policy is transferred to insured, s/he must recognize as income the fair market value of the policy, less consideration paid for the transfer, and any economic benefits previously paid for or recognized by insured other than the cost of current life insurance protection. Insured takes an equivalent tax basis in the policy.</p> <p>Business can take a corresponding deduction for amounts included in insured's income, plus all amounts previously included in insured's gross income as economic benefits (other than for current life insurance protection).</p> <p>(D.29)</p>	<p>For any outstanding loans, if the business forgives or waives repayment of interest, the interest amount, plus a deferral charge based on the underpayment of tax penalty rate, is taxable to the insured. Any forgiveness or waiver of principal due also will be taxed to the insured.</p> <p>(D.52-D.53)</p>
Imputed Gifts if Policy Held by Third Party/ILIT	<p>Yes, based on amounts taxed to insured under the arrangement (e.g., annual economic benefits, transfer of contract)</p> <p>(D.33-D.34)</p>	<p>Yes, based on amounts taxed to insured (e.g., forgone interest, any amount waived or forgiven under loan)</p> <p>(D.60)</p>
When to Consider	<ul style="list-style-type: none"> • Young insured or a survivorship arrangement (very low annual term insurance costs initially) • Parties want a non-equity arrangement or expect delay in policy equity buildup, and then will switch to loan regime (economic benefit regime unfavorably taxes equity arrangements) • Insured wants predictability regarding annual taxable economic benefits (loans subject to interest rate fluctuations) • Business wants to own or control the policy <p>(D.71)</p>	<ul style="list-style-type: none"> • Insured is older or after the first death occurs in a survivorship arrangement, particularly if interest rates are low (annual term insurance rates can be high for older insureds and will spike upon the death of the first insured under a survivorship policy) • Parties want to provide the insured (or ILIT) with tax-free access to policy equity (only loan regime allows insured or ILIT to have current or future access to policy cash values without current taxation) • Parties are entering a compensatory equity arrangement (split-dollar loans should not be taxed as nonqualified deferred compensation arrangements under IRC § 409A) <p>(D.60)</p>

AP.4. CHART: Post-regulation Split-dollar: Types of Split-dollar Loans

(References in Parentheses Are to Question Numbers in the Guide)

	Demand Loan	Term Loan	Hybrid Loan
What Is the Loan Term?	<p>Payable in full on demand of lender</p> <p>(D.45)</p>	<p>Fixed term of years, as specified by parties</p> <p>(D.45)</p>	<p>1) Life expectancy if loan is payable on death of an individual, or 2) specified term (or if none, 7 years) if loan is conditioned on future performance of services (e.g., payable on termination of employment or later of death or termination)</p> <p>(D.45)</p>
What Is Adequate Interest to Avoid Below-Market Loan Classification?	<p>Applicable federal rate (AFR) equal to the blended annual short-term AFR published in a Revenue Ruling by the IRS in July of each year</p> <p>(D.46)</p>	<p>AFR specified for the loan term and compounding period (e.g., annually, semi-annually, etc.) as of date of the loan</p> <ul style="list-style-type: none"> • Short-term AFR: loan 3 years or less • Mid-term AFR: loan over 3 to 9 years • Long-term AFR: Loan over 9 years <p>(D.48)</p>	<p>AFR specified for the loan term and compounding period as of date of the loan</p> <ul style="list-style-type: none"> • Payable on death loans: life expectancy is determined under IRC § 72 actuarial tables • Loans based on performance will use AFR for a 7-year term loan unless a different maturity date is specified in loan <p>(D.50)</p>
When Is Loan Tested to Determine if it Charges Adequate Interest?	<p>Annually for each year loan is outstanding, based on whether the interest rate charged equals the blended AFR for that year</p> <p>(D.46)</p>	<p>As of the loan date, based on whether the present value of all payments due under the loan (determined using the applicable AFR) equals the face amount of the loan</p> <p>(D.48)</p>	<p>As of the loan date, based on whether the present value of all payments due under the loan (determined using the applicable AFR) equals the face amount of the loan</p> <p>(D.50)</p>

	Demand Loan	Term Loan	Hybrid Loan
How Is Insured Taxed if Loan Is Below-Market?	<p>Insured taxed each year on forgone interest (excess of adequate interest (determined annually) over interest actually charged)</p> <p>Annual taxable amount will vary with annual fluctuations in the blended AFR</p> <p>(D.47)</p>	<p>Insured taxed, in first year of loan, on the difference between the present value of all loan payments and the loan's face amount</p> <p>Recognition of all forgone interest is accelerated into first year of loan</p> <p>(D.49)</p>	<p>Insured taxed each year on forgone interest (excess of adequate interest (determined as of initial loan date) over interest actually charged)</p> <p>Annual taxable amount is fixed, based on AFR specified for loan date</p> <p>(D.50)</p>
Can Insured Deduct Interest Payments?	<p>No (although interest may be deductible if the loan is deemed made by the insured as an "indirect participant," such as where there is an imputed loan from the business to the insured, and then from the insured to his or her ILIT (see D.60))</p> <p>(D.59-D.60)</p>		
How Is Business Taxed if Loan Is Below-market?	<p>Business must include interest deemed paid as interest income. It may be able to take a compensation deduction for amount included in insured's income as compensation.</p> <p>(D.47)</p>	<p>Loan is treated as having OID generally equal to amount taxable to the insured, which the business must take into account under the OID rules.</p> <p>(D.49)</p>	<p>Business must include interest deemed paid as interest income. It may be able to take a compensation deduction for amounts included in insured's income as compensation.</p> <p>(D. 50)</p>
When to Consider	<ul style="list-style-type: none"> • For ease of administration in determining annual interest due • To take advantage of low rates (blended AFR for demand loans is usually one of the lowest AFRs available) • Not recommended for loans between corporations and majority shareholders due to estate tax inclusion concerns with regard to the underlying policy <p>(D.66)</p>	<ul style="list-style-type: none"> • Parties intend to charge interest at or above the appropriate AFR (otherwise, likely to cause acceleration of all forgone interest over the loan term into the year the loan is made) • Corporate/majority shareholder loans (but hybrid loans may be a better option) • Parties want to make a large loan and lock in stated interest for specified term • Note that acceleration of income recognition can make term loans less tax/cost efficient <p>(D.66)</p>	<ul style="list-style-type: none"> • Parties want to lock in an interest rate but want to charge a rate lower than the AFR or don't want to require current interest payments • The parties want to avoid the acceleration of interest income recognition associated with term loans • The term of the arrangement will be tied to performance of services • Corporate/majority shareholder loans <p>(D.66)</p>

**AP.5. CHECKLIST: Review Need for and Maintenance of Grandfathered Split-dollar Arrangement
Is Grandfathered Arrangement Still Needed?**

1. Do the arrangement and policy continue to fulfill the insured's coverage needs?
2. What are the ongoing premium requirements and projected annual economic benefit costs? Are they manageable and do they continue to make economic sense for both of the parties?
3. Does the policy's projected performance continue to support the originally desired income flow, employer repayment and/or future premium/insurance costs?
4. If the policy values are less than originally illustrated, can the policy be effectively rehabilitated with additional premiums, change of investment philosophy, or an exchange of contracts without resulting in a material modification? Will any such policy changes eliminate guarantees or otherwise change the terms of coverage?

Has Grandfathered Arrangement Been Properly Administered/Maintained?

If the grandfathered arrangement will remain in place, review the arrangement's administration to confirm the following, and take corrective actions, as needed:

1. Existence of a written agreement or other documentation confirming the arrangement, as well as proper filing of collateral assignments or death benefit endorsements with the carrier that issued the underlying policy.
 - a. If not, determine if the agreement can be created now to reflect the operative terms of the arrangement. File appropriate collateral assignment or endorsement forms with the carrier.
2. The insured and business have properly accounted for, reported and paid income/employment taxes with regard to the annual economic benefits provided to the insured under the arrangement (if not fully offset under a contributory plan).
 - a. If not, ensure proper reporting for current and future tax years. Review with an experienced accountant which previous tax years may be affected by reporting and the risks for amending those returns to correct prior reporting.
3. If the policy owner is an ILIT or other third party, the insured has also properly reported and paid gift taxes on any corresponding imputed gifts to an ILIT or other third-party owner of the policy, as well as allocated any required GST tax exemption (if the ILIT is intended to be GST-tax-exempt).
 - a. If not, review the tax years affected and review with experienced accountant filing amended or late returns to reflect gifts and allocation of GST tax exemption.
4. The arrangement has been reviewed and, if necessary, brought into compliance with IRC §409A regulations dealing with deferred compensation arrangements.
 - a. Amend arrangements that violate IRC §409A (no loss of grandfathered status should result from the amendment). Report any employee equity accrued since 2005 as income (and pay associated penalties). The employee's basis in the policy should increase due to the tax reporting.
5. There have been no changes to the arrangement or the underlying policy that could constitute material modifications subjecting the arrangement to tax under the final regulations.
 - a. If there has been a material modification, determine the year of occurrence and correct prior reporting to reflect modified tax consequences under the applicable regime of the final regulations (i.e., the economic benefit or loan regime).

AP.6. CHECKLIST: Formation/Documentation of Economic Benefit Split-dollar Arrangement

- **Agreement:** Business and insured execute a written split-dollar agreement, specifying:
 - Who will purchase and own the policy?
 - Endorsement arrangement: business
 - Collateral assignment arrangement: insured (or insured's ILIT)
 - How will policy dividends be applied (e.g., to buy additional term insurance)?
 - How will the premiums be paid?
 - Will the insured make any contributions?
 - Who will actually pay the premiums to the insurance carrier?
 - Who will calculate the value of the annual economic benefits to the insured?
 - What is the repayment amount due to the business (i.e., the greater of the total premiums advanced by the business or the policy's cash value)?
 - Where will the repayment come from? Policy cash value, policy death benefits, other assets?
 - Who will hold the rights and various incidents of ownership in the policy (e.g., right to name beneficiaries, to surrender the policy, to borrow from the policy)?
 - How and when will the death benefits be distributed?
 - When will the agreement terminate? Upon the insured's death, retirement or departure? Upon mutual agreement?
- **Notice and Consent:** Business provides notice to the insured and obtains his or her consent to the purchase of the life insurance coverage **prior to purchase of the policy** in accordance with the requirements of IRC § 101(j) for employer-owned life insurance arrangements (otherwise the death benefits payable to the business may not be excluded from gross income under § 101(a)).
- **File Forms with Carrier:** File forms with insurance carrier:
 - Endorsement Arrangements: Business files an endorsement to the insured or the insured's ILIT (using an endorsement form provided by the carrier issuing the policy) of the right to designate the beneficiary of the policy death benefits in excess of the amounts owed to the business.
 - Collateral Assignment Arrangements: The insured (or the insured's ILIT, if it holds the policy) files a collateral assignment with the issuing carrier, assigning a security interest in the policy to the business equal to its interest in the policy (i.e., greater of total premiums paid by the business or the policy cash value).

AP.7. CHECKLIST: Formation/Documentation of a Split-dollar Loan Arrangement

1. **Agreement/Note:** Insured (and insured's ILIT, if the policy owner) and business execute a promissory note stating:
 - a. The sum of the loan
 - b. The specified interest rate and compounding period (or none if the loan will be interest-free)
 - c. The note term (demand, specified term of years or hybrid (at insured's death or retirement))
 - d. Whether interest will be paid or accrued
 - e. The payment schedule for interest and principal
 - f. As each premium paid constitutes a separate loan, the terms for all subsequent loans expected to be made under the agreement
2. **Corporate Resolution:** If the business is a corporation, the board passes a corporate resolution authorizing the transaction and the disbursement of loan proceeds under the note.
3. **Collateral Assignment:** The insured (or the insured's ILIT, if it holds the policy) files a collateral assignment with the issuing carrier, assigning a security interest in the policy to the business equal to the total amounts due to the business under the loan.
4. **Nonrecourse Representation:** Each of the business and the policy owner (e.g., the insured or his or her ILIT) completes and attaches a copy of a nonrecourse representation in compliance with Reg. § 1.7872-15(d)(2)(ii) to its federal income tax return for each taxable year in which the business makes a loan to which the representation applies.

AP.8. CHECKLIST: Questions for Reviewing/Selecting Split-dollar Exit Strategies

1. **Grandfathered:** Is the split-dollar arrangement grandfathered (entered into on or before, or materially modified after Sept. 17, 2003) or subject to tax under the final split-dollar regulations?
2. **Documentation:** How is the arrangement documented, under the endorsement method or the collateral assignment method?
3. **Policy Ownership:** Who formally owns the policy — the business or the insured, his or her ILIT, or another third party?
 - a. If an ILIT owns the policy, is it a grantor trust for federal income tax purposes with regard to the insured?
4. **Business Organization and Relationship to Insured:** Is the business a public company, a C Corporation, an S corporation or a partnership/LLC? And what is the relationship to the insured? Executive, key employee, shareholder, owner?
5. **Insurance Need:** Does the insured still have a need or desire for the insurance? Has the insured experienced any health changes?
 - a. If so, how much death benefit is provided under the arrangement, and based on what duration and assumptions? Is the insurance coverage amount still appropriate for the situation?
6. **Policy Performance:** Has the policy performed according to initial projections? Does it or will it have sufficient policy cash value to support repayment of the business? Are the assumptions used still accurate?
 - a. What are the surrender charges?
 - b. If the cash value is insufficient, how long until it will be, and on what assumptions?
7. **Disposition of Policy Equity:** Is the arrangement an equity arrangement (equity goes to the insured) or a non-equity arrangement (equity goes to the business)?
8. **Policy Equity:** Does the policy currently have any equity (i.e., cash value in excess of amount due as repayment to business), and if so, how much?
9. **Investment in Contract:** Does the insured (or his or her ILIT) have any basis in the policy resulting from contributions or previously taxed economic benefits?
10. **Tax Regime:** Which tax regime applies to the arrangement?
 - a. Pre-regulation guidance for grandfathered arrangements
 - b. Economic benefit regime under the final regulations for endorsement and compensatory and private non-equity collateral assignment arrangements
 - c. Loan regime under the final regulation for equity collateral assignment arrangements.
11. **Policy Flexibility:** What type of product is involved and can it be modified or exchanged for a product that better supports the arrangement? Can the premium payments or death benefits be adjusted or the product exchanged? Can the terms of the arrangement be modified (all subject to the material modification issues for grandfathered arrangements)?
 - a. If the changes to the policy or any terms for the grandfathered split-dollar arrangement constitute a material modification, what will the tax consequences be under the final regulations?

- b. Do the benefits of the modification outweigh these consequences?
12. **Planned Exit:** Was an exit strategy reviewed at inception? If so, which party assumed the risk that the policy would not perform sufficiently to support repayment to the business?
 13. Does the business have the desire or flexibility to forgive part or all of its repayment right? What are the tax consequences to these actions?
 14. **Bonus Options:** Can or will the business and/or insured agree to switch to a bonus arrangement to support the policy?
 15. Does the insured understand that the bonus will be taxable as income and that there also will be a corresponding taxable gift of an equivalent amount if the policy is owned by an ILIT (which may raise GST tax and exemption allocation issues if the insured intends for the ILIT to be fully GST tax exempt)?
 16. **ILIT Issues:** Are there fiduciary or other considerations the ILIT trustee must address in considering a modification or termination of the arrangement or the underlying policy?

AP.9. SAMPLE FORM: Nonrecourse Representation for Post-regulation Split-dollar Loan

**REPRESENTATION TO SPLIT-DOLLAR AGREEMENT PURSUANT TO
TREAS. REG. § 1.7872-15(d)(2)**

(_____, LENDER; _____, BORROWER)

THIS REPRESENTATION is made effective as of the ____ day of _____, 20____, by _____
(hereinafter the “**Lender**”) and by _____ (hereinafter, the “**Borrower**”).

RECITATIONS:

WHEREAS, this Representation relates to a split-dollar loan agreement (hereinafter the
“**Agreement**”) by and between the Lender and the Borrower dated _____ regarding
_____ insurance policy number _____ (the “**Policy**”);

WHEREAS, the Borrower is the owner of the Policy;

WHEREAS, pursuant to the Agreement, the Lender agreed to pay the premiums due under the Policy
subject to repayment by the Borrower of the Repayment Amount, as defined in the Agreement;

WHEREAS, Treas. Reg. § 1.7872-15(d)(1) provides that, except as provided in Treas. Reg. § 1.7872-
15(d)(2), if a payment on a split-dollar loan is nonrecourse to a borrower, the payment is a contingent
payment for purposes of Treas. Reg. § 1.7872-15;

WHEREAS, Treas. Reg. § 1.7872-15(d)(2)(i) provides that an otherwise noncontingent payment on a
split-dollar loan that is nonrecourse to a borrower is not a contingent payment under Treas. Reg. §
1.7872-15 if the parties to the split-dollar life insurance arrangement represent in writing that a reasonable
person would expect that all payments under the loan will be made;

WHEREAS, Treas. Reg. § 1.7872-15(d)(2)(ii) prescribes the time and manner for providing this written
representation;

WHEREAS, the Agreement constitutes a split-dollar life insurance arrangement regarding a split-dollar
loan for purposes of Treas. Reg. § 1.7872-15(d); and

WHEREAS, both the Lender and Borrower agree that a reasonable person would expect that all
payments required under the Agreement will be made and wish to make the written representation
specified by Treas. Reg. § 1.7872-15(d)(2)(i).

REPRESENTATION

NOW, THEREFORE, the Lender and the Borrower hereby represent as follows:

*In accordance with Treas. Reg. § 1.7872-15(d)(2), the Lender and Borrower, as parties to the Agreement,
represent that a reasonable person would expect that all payments under the loan made pursuant to the
Agreement will be made.*

1. The names, addresses and taxpayer identification numbers (“**TINs**”) of the Lender and the
Borrower are as follows:

Lender

Name: _____

Address: _____

TIN: _____

Borrower

Name: _____

Address: _____

TIN: _____

2. This Representation applies to all subsequent split-dollar loans made pursuant to the Agreement.

3. This Representation may be executed in multiple counterparts and all such counterparts shall collectively constitute an original, which may be evidenced by any one counterpart.

IN WITNESS WHEREOF, the Lender and the Borrower have executed this Representation effective as of the day and year first above written.

_____, Lender

_____, Borrower

AP.10. SAMPLE FORM: Notice and Consent Form for IRC§ 101(j) Employer-owned Life Insurance

**IRC §101(j) EMPLOYER-OWNED LIFE INSURANCE CONTRACT
NOTICE AND CONSENT FORM**

**Notice to Employee and Consent to Employer-Owned Life Insurance Contract
Pursuant to Internal Revenue Code § 101(j)**

To: [ENTER NAME OF INSURED EMPLOYEE/INDIVIDUAL]

[ENTER NAME OF POLICYOWNER] (the "**Company**") intends to insure your life with a life insurance policy or policies, which could have an aggregate maximum face amount of \$_____.00 [ENTER AGGREGATE MAXIMUM AMOUNT OF DEATH BENEFIT COMPANY INTENDS TO PURCHASE ON THIS INDIVIDUAL THROUGH ONE OR MORE LIFE INSURANCE POLICIES]. This life insurance coverage may continue after you are no longer employed with the Company. The Company will be a beneficiary of all or part of the proceeds that are payable upon your death.

By signing below, you acknowledge receiving this Notice and you consent to being insured by the Company.

Receipt of this Notice is hereby acknowledged. I consent to being insured by the Company as described in this Notice.

Signature

Printed Name

Date

About PartnersFinancial

PartnersFinancial is a national community of industry-leading, independent life insurance and financial professionals. For more than 25 years, the organization has supported its members as they build insurance industry knowledge and expertise. In the process, PartnersFinancial members created a powerful culture of idea-sharing and collaboration — all for the benefit of their clients.

PartnersFinancial members take advantage of the organization's preferred market access and clout to offer clients a comprehensive selection of high-quality insurance and wealth transfer solutions. Members also have access to an extensive range of resources, technology, tools, and knowledge-sharing forums and events. As part of NFP, a national insurance, benefits and investments company, PartnersFinancial also offers members access to capabilities that go beyond an individual company's scope.

Neither NFP Insurance Services, Inc. nor its affiliates provide tax or legal advice. Advice from a client's tax and legal advisors is recommended.

This material was created by NFP Corp., its subsidiaries or affiliates for distribution by their registered representatives, investment advisor representatives and/or agents. This material was created to provide accurate and reliable information on the subjects covered but should not be regarded as a complete analysis of these subjects. It is not intended to provide specific legal, tax or other professional advice. The services of an appropriate professional should be sought regarding your individual situation. Neither NFP nor its subsidiaries or affiliates offer tax or legal advice.

Securities and Investment Advisory Services may be offered through NFP Advisor Services, LLC, (NFPAS) member FINRA/SIPC. PartnersFinancial is a platform of NFP Insurance Services, Inc. (NFPISI), which is an affiliate of NFPAS. NFPAS is affiliated with NFP.