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Split Dollar Spotlight: Loan Regime and Nonrecourse Loans

This excerpt comes from The Comprehensive Guide to Split Dollar Life Insurance. To find out more information on split dollar arrangements, visit https://go.nfp.com/Split_Dollar_Guide.

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
- 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 policy[1]

> **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.[2]

Split Dollar Tip: 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.[3]

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 $10,000[4], do not apply to exempt payments from treatment as split dollar loans.[5]

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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 law[6] 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.

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 loan[7] 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).[8]

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 repayable is subject to tax based on general federal tax principles, based on the relationship of the parties (e.g., employee/employer).[9] 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.[10] 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.

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.

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.

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.[11] 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.[12] *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.*[13]

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").[14]

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.

Unless otherwise stated therein, the nonrecourse representation applies to all subsequent split dollar loans made pursuant to the arrangement. E*ach 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 makes a loan to which the representation applies.*[15]

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.[16] 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.

Split Dollar Tip: 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.[17] 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).

Footnotes

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

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

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

[4] See IRC 7872(c)(2) and(c)(3).

[5] Reg. § 1.7872-15(a)(3).

[6] See e.g., Gibson Prods. Co v. U.S., 637 F.2d 1041 (5th Cir); Graf v. Comm'r, 80 T.C. 944 (1983).

[7] 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).

[8] See 68 Fed. Reg. 54,342 (Sept. 17, 2003).

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

[10] Reg. § 1.7872-15(a)(2)(iv), Ex. 2(ii).

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

[12] See Marla Aspinwall, "No Way Out! Split Dollar Loans May Be Traps for the Unwary."

[13] 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.

[14] Reg. § 1.7872-15(d)(2)(i).

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

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

[17] See PLRs 201041006 through 201041024.