

Split-Dollar Proposed Regulations Published

On July 2, 2002, the IRS issued proposed regulations that contain guidance regarding income, employment and gift taxation of split-dollar arrangements. This tax update summarizes some of the major provisions of these proposed regulations.

I. Split-Dollar Arrangement Defined

- A. **General Criteria.** The proposed regulations broadly define a split-dollar arrangement as any arrangement (except section 79 group-term life insurance plan) between an owner of a life insurance contract and a non-owner of the contract under which either party pays all or a portion of the premiums, and one of the parties is entitled to recover all or any portion of the premiums and such recovery is made from, or secured by, the proceeds of the contract.
- B. **Special Rules For Compensatory and Shareholder Arrangements.** In addition, the regulations treat any arrangement between an owner and a non-owner of a life insurance policy as a split-dollar arrangement, even if the above general criteria is not satisfied, where the arrangement is:
1. Entered into in connection with the performance of services, which is not part of a section 79 group-term life plan, under which the employer pays directly or indirectly all or a portion of the premiums and the beneficiary of all or a portion of the death benefit is named by the employee, or is a person whom the employee would reasonably be expected to name as beneficiary; or
 2. Entered into between a corporation and a person in his capacity as a shareholder, under which the corporation pays directly or indirectly all or a portion of the premiums and the beneficiary of all or a portion of the death benefit is named by the shareholder or is a person whom the shareholder would reasonably be expected to name as beneficiary.

II. Mutually Exclusive Tax Regimes

- A. **General Overview.** As indicated in Notice 2002-8 the proposed regulations provide two mutually exclusive tax regimes generally based on which party owns the life insurance policy: economic benefit tax regime or loan tax regime. Generally, the

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economic benefit regime applies to endorsement split-dollar, while the loan tax regime is applicable to collateral assignment arrangements. However, this general ownership rule, that the person named as the policy owner is treated as the owner of the contract, is subject to two exceptions both involving non-equity split dollar arrangements.

Special Rules For Non-Equity Arrangements. If at all times the only economic benefit provided to the non-owner is the value of the current life insurance protection then: (1) the employer will be treated as the owner where the arrangement is entered into in connection with the performance of services or (2) the donor will be treated as the owner under a split-dollar arrangement between a donor and a donee.

- B. **Consistency Requirement.** Both the owner and non-owner are required to fully and consistently account for all amounts under the rules as either an economic benefit transaction or loan transaction.
- C. **Non-Owner Payments.** To the extent the non-owner to a split-dollar arrangement makes payments that are neither loans or payments of economic benefits the general income tax, employment tax and gift tax rules apply to such premium payments.
- D. **Comments From The Advanced Markets.** Note the broad language used by the IRS in describing a split-dollar arrangement. Is the IRS attempting to include any arrangement in which the business is a source of premium dollars?

III. General Definitions

- A. **Owner Defined.** In general, the regulations define an owner as the person named as the policy owner on the life insurance contract. Where the policy has two or more owners and each owner has an incident of ownership with respect to an undivided interest in the contract (such as in joint ownership) each person is treated as the owner of a separate contract. However, if each person does not have an undivided interest in the contract, the first-named person is treated as the owner of the entire contract.

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- B. **Non-Owner Defined.** Any person (other than the owner of the contract) that has a direct or indirect interest in the contract. For example, an employee whose spouse is named as the beneficiary of a life insurance contract owned by the employer would have an indirect interest in the contract and, would be treated as a non-owner.
- C. **Transfer of Ownership.** A transfer of ownership of a life insurance policy, or an undivided interest, that is part of a split-dollar arrangement occurs on the date that the non-owner becomes the owner of all or a portion of the contract.

IV. Taxation Under The Economic Benefit Regime

- A. **Non-Owner Taxed On The Value Of Economic Benefits.** Under the economic benefit tax regime the owner of the life insurance contract is treated as providing economic benefits to the non-owner. The value of the economic benefits, reduced by any consideration paid by the non-owner to the owner, is treated as transferred from the owner to the non-owner. The tax consequences (income, dividend or gift) of the transfer depends on the relationship of the parties to the arrangement. Furthermore, the economic benefits may be treated as provided from the owner to the non-owner and as separately provided from the non-owner to other person(s) (for example, as a payment of compensation from the employer to the employee and as a gift from the employee to a trust).
1. **Value Of Economic Benefits For Non-Equity Arrangements.** Where the only economic benefit provided to the non-owner is current life insurance protection the value of the economic benefit equals the excess of the average death benefit of the life insurance contract over the total amount payable to the owner under the split-dollar arrangement. The amount payable to the owner is increased by any outstanding policy loan. The cost of the non-owner's life insurance protection is equal to the non-owner's current life insurance protection multiplied by the life insurance premium rate. (The regulations do not contain any discussion of the life insurance rates.)
 2. **Value Of Economic Benefits For Equity Arrangements.** The Service requests comments regarding the valuation of economic benefits where the non-owner

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has any rights in the life insurance contract (i.e., cash value) beyond the current life insurance protection discussed above.

B. Taxation Of Amounts Received Under The Life Insurance Contract Prior To Transfer. Any living benefits (i.e., dividends, withdrawals, partial surrenders or proceeds of a "specified policy loan") received prior to the transfer of the life insurance contract to the extent provided directly or indirectly to a non-owner is treated as paid to the owner of the contract and then paid by the owner to the non-owner. The amount received is taxable to the owner under the rules of section 72. The non-owner is taxable on the amount it is required to take into account (discussed below) as compensation, dividend or gift depending on the relationship of the parties to the split-dollar arrangement.

1. Amount Required To Be Taken Into Account. The amount that must be taken into account by a non-owner is equal to the amount received by the owner (i.e., dividends, withdrawals, partial surrenders or proceeds of a "specified policy loan") reduced by:
 - i. the value of all economic benefits actually taken into account by the non-owner less the value that would have been taken into account were the arrangement a non-equity split-dollar arrangement, and
 - ii. any consideration paid by the non-owner for all economic benefits less any consideration paid by the non-owner that would have been allocable to economic benefit provided to the non-owner were arrangement a non-equity split-dollar arrangement.
2. Specified Policy Loan. A specified loan is a loan distributed directly from the insurance carrier to the non-owner; a loan where a reasonable person would not expect repayment from the non-owner; or the non-owner's obligation to repay the loan to the owner is capable of being satisfied upon repayment by either party to the insurance carrier. The loan will be treated as a loan to the employer followed by compensation to the employee.

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C. Other Miscellaneous Tax Consequences Prior To Policy Transfer.

1. To The Non-Owner. The non-owner in a split-dollar arrangement under the economic benefit tax regime does not acquire basis under section 72(e) in the contract. Death benefits paid to the beneficiary, other than the owner, are excluded from the beneficiary's income under IRC 101(a) to the extent such amount is allocated to current life insurance protection provided to the non-owner pursuant to the split-dollar arrangement, the cost which was paid, or taken into account, by the non-owner.
2. To The Owner. The owner in a split-dollar arrangement under the economic benefit tax regime acquires basis under 72(e) for the premiums he pays. In addition, the amounts paid by the non-owner to the owner for any economic benefits is included in the owner's gross income and is also included in the owner's basis. Amounts paid by the owner are not deductible except in the case of a transfer of a life insurance contract (or an undivided interest) in connection with the performance or services under Section 83.

D. Taxation On Transfer Of Interest. The proposed regulations provide a transfer of a policy occurs on the date that ownership of all or some part of the contract is formally changed. However, to the extent the ownership is transferred in connection with the performance of services under section 83 the transfer occurs when the transferee's rights are substantially vested. Thus, as provided in Notice 2002-8 a transfer does not occur merely because the cash surrender value of the contract exceeds the premiums paid. Furthermore, there is no transfer if the owner merely endorses a percentage of the cash value to the non-owner.

1. Amount To Be Taken Into Account On The Transfer. Upon the transfer of a policy or an interest in the policy the amount which the non-owner/transferee must take into account is the excess of the policy's fair market value over the sum of:
 - i. The amount the transferee paid to obtain the contract and
 - ii. The (1) value of all economic benefits actually taken into account by the non-owner less the value that would have been taken into account were the arrangement a non-equity split-dollar arrangement plus (2) any

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consideration paid by the non-owner for all economic benefits less any consideration paid by the non-owner that would have been allocable to economic benefit provided to the non-owner were arrangement a non-equity split-dollar arrangement)

2. Transferee's Investment In The Contract After The Transfer. Transferee's basis for purposes of 72(e) after the transfer equals the greater of the fair market value of the contract or the sum of:
 - i. The amount the transferee paid to obtain the contract and
 - ii. The (1) value of all economic benefits actually taken into account by the non-owner less the value that would have been taken into account were the arrangement a non-equity split-dollar arrangement plus (2) any consideration paid by the non-owner for all economic benefits less any consideration paid by the non-owner that would have been allocable to economic benefit provided to the non-owner were arrangement a non-equity split-dollar arrangement)

There is a special rule for determining the transferee's investment in the contract where the transfer is between a donor and donee and when only a portion of a contract is transferred.

V. Taxation Under The Loan Regime

- A. General Overview. The loan tax regime is applicable where a payment is made between an owner and non-owner under a split dollar arrangement and such payment is treated as a loan for Federal tax purposes. Loans are classified as demand loans or term loans and taxed accordingly. If the loan provides for sufficient interest, the loan is subject to the general rules for debt instruments – including the rules for original issue discount (OID). However, where a split-dollar loan fails to provide for sufficient interest, the loan is treated as a below-market split dollar loan under Section 7872.

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- B. **General Rule.** A payment made pursuant to a split-dollar arrangement is a split-dollar loan and the owner and the non-owner are treated respectively as borrower and lender if the payment is made either directly or indirectly from the non-owner to the owner; the payment is a loan under general principles of federal tax law, or if its not a loan under general principles of Federal tax law, a reasonable person would expect the payment to be repaid in full to the non-owner (whether with or without interest); and the repayment is to be made from, or is secured by, either the policy's proceeds or cash surrender value.
1. If the non-owner makes a payment under a split-dollar arrangement and is entitled to repayment of some but not all of the payment, the payment is treated as two payments: one repayable and one that is not. General tax rules are applicable where the payments are not split-dollar loans.
 2. If a payment on a split-dollar loan is nonrecourse to the borrower, the payment will be treated and taxed as a contingent payment unless the parties to the split-dollar arrangement provide a written representation that a reasonable person would expect that all payments under the loan will be made and the split-dollar loan provides for interest payable at a stated rate that is either a fixed or variable rate.
 3. A split dollar loan that that provides for one or more contingent payments and does not provide for certain variable rates of interest is accounted for under special rules similar to the noncontingent bond method. Under this method, the lender is required to calculate the yield of the split-dollar loan by preparing a projected payment schedule that includes all payments, contingent and noncontingent. This projected yield is used to determine whether or not the loan is a below market split-dollar loan.
- C. **Below-Market Split-Dollar Loans.** Where a split-dollar loan fails to provide for sufficient interest, the loan is treated as a below-market split dollar loan. In general, a below-market split-dollar loan is re-characterized as a loan with interest at the appropriate applicable federal rate (AFR), coupled with an imputed transfer of the foregone interest by the lender to the borrower. The characterization of the split-dollar loan and of the imputed interest transfers under Section 7872 depends upon the relationship between the lender and the borrower and any indirect participant.

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1. Indirect Split-Dollar Loans. If the effect of a below-market split-dollar loan is to transfer value from the lender to an indirect participant and from the indirect participant to the borrower, then the below-market split-dollar loan is restructured as two or more successive below-market loans. For example, when a split dollar loan is made from an employer to a child of an employee.
- D. Split Dollar Demand Loans. A split-dollar demand loan is any split-dollar loan that is payable in full at any time on the demand of the lender. Each calendar year that a split-dollar demand loan is outstanding, the loan is tested to determine if it provides for sufficient interest. A split-dollar demand loan provides for sufficient interest for the calendar year if the rate (based on annual compounding) at which the interest accrues on the loan's adjusted issue price during the year is no lower than the blended annual rate for the year. If the loan does not provide for sufficient interest, the loan is treated as a below-market split-dollar demand loan for that calendar year.
1. Treatment Of Below-Market Split-Dollar Demand Loans. Where a demand loan fails to charge sufficient interest, the loan is re-characterized as a loan with interest at the appropriate AFR rate, with any forgone interest imputed to be transferred by the lender to the borrower on the last day of the calendar year.
 2. Exception for death, liquidation or termination of the borrower. In the taxable year in which the borrower dies, is liquidated or otherwise terminated, any forgone interest is treated as transferred and retransferred on the last day of the borrowers final tax year.
 3. Exception for repayment. Any forgone interest is treated as transferred and retransferred on the day the split-dollar loan is repaid in full.
- E. Split-Dollar Term Loans. A split-dollar term loan is any split-dollar loan not classified as a demand loan.
1. Testing A Split-Dollar Term Loan For Sufficient Interest. A split-dollar term loan does not provide for sufficient interest if the amount loaned exceeds the imputed loan amount, which is the present value of all the payments due under the loan using a discount rate equal to the appropriate AFR rate (based on the

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loan's term) in effect on the date the loan is made. If the split-dollar loan does not provide for sufficient interest, it is treated as a below-market split dollar term loan.

2. **Treatment Of Below-Market Split-Dollar Term Loans.** In general, the loan is re-characterized as consisting of two portions: an imputed loan amount and an imputed transfer from the lender to the borrower. Generally, the imputed transfer (as calculated in E1) is treated as OID and occurs at the time the loan is made. However, if the following split dollar loans fail to provide sufficient interest, the foregone interest is determined annually, similar to a demand loan, but using an AFR that is appropriate for the loan's term as determined when the loan is issued: term loans payable upon the death of an individual, term loans conditioned on the future performance of substantial services and gift split-dollar term loans.
3. **Rules For Determining The Term Of A Split-Dollar Term Loan.** Generally, the term of a split-dollar term loan is stated in the split-dollar agreement and is based on the period from the date the loan is made until the loan's maturity date. However, special rules are used to determine the length of the split-dollar loans where the term loan contains unconditional options, is payable at the death of an individual, or is conditioned on the performance of future services.
4. **Split-dollar loans with a stated interest rate that is subsequently waived, cancelled or forgiven.** Where interest is subsequently waived, cancelled or forgiven, appropriate adjustment must be made by the parties to reflect the difference between the interest payable at the stated rate and the interest actually paid by the borrower at that time.

VI. Proposed Effective Dates

- A. The regulations apply to split-dollar arrangements entered into after the date the final regulations are published. Taxpayers may rely on these regulations for arrangements entered into prior to publication of the final regulation; however equity split-dollar arrangements may rely on the regulations only if the parties take into account the value of all economic benefits.

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- B. An arrangement that is entered into before the date the final regulations are published, but materially modified after the date is treated as a new arrangement entered into on the date of modification.
- C. Concurrent with the publication of the final regulations the IRS will obsolete the following rulings with respect to split dollar arrangements entered into after publication of the final regulations : Rev. Rul. 64-328, Rev. Rul. 66-110, Rev. Rul 78-420 (with respect to income tax consequences), Rev. Rul. 79-50 and Rev. Rul. 81-198 (with respect to income tax consequences).

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