Split-Dollar Life Insurance

What Is Split Dollar?

Split dollar is an arrangement between an owner of a life insurance contract and a non-owner of the contract which specifies how the parties will share premium costs, cash value, and the death benefit. Either party to the arrangement may pay all or part of the premiums, and one of the parties paying the premiums is entitled to recover (either conditionally or unconditionally) all or a portion of those premiums, with such recovery made from, or secured by, the life insurance proceeds.

Often, a business and an employee or shareholder are the two parties dividing the premium payments and policy benefits, but it could be two individuals or an individual and a trust. In a business setting, an employer will often use split dollar to provide a valuable fringe benefit to a key employee or to attract a new employee into the business. For the employee, the split-dollar arrangement can provide life insurance protection for survivors at a lower current out-of-pocket cost than personally purchased life insurance.

Keep in mind that split dollar is a method of buying life insurance, not a reason for buying it. A need for life insurance should always exist before a split-dollar arrangement is considered.

Advantages to the Employer

- Split dollar can be an effective method of attracting and retaining valuable key employees.
- The employer may have access to the policy's cash value. (Cash values are a feature of permanent life insurance only. Withdrawals and loans will affect policy values and death benefits, and may have tax consequences.)
- The employer can be highly selective regarding which employees are covered.
- The arrangement does not need pre-approval by the IRS.

Advantages to the Employee

- Split dollar can provide needed personal life insurance protection at a reduced current out-of-pocket cost.
- Split dollar can be combined with a cross-purchase buy-sell agreement to even out the current premium cost in cases where there is a wide age difference among the parties to a transaction.

Disadvantage

- Split-dollar life insurance arrangements entered into after September 17, 2003, are subject to final federal tax regulations that are far less favorable than the prior tax treatment, particularly in the case of equity split-dollar arrangements (see Equity Split Dollar, below).

Graphic: How Split-Dollar Life Insurance Arrangements Work

Suitability

Split-dollar arrangements are well suited to various types of employment-related situations:

- An employer who does not have a group term life insurance plan, or who has a group plan but wishes to provide coverage for one or more select individuals over and above the basic plan, can use split dollar to provide the protection.

- An employer can use a split-dollar arrangement to help provide estate liquidity for an employee's estate. The employer can set up the policy ownership to avoid the federal estate tax (which is usually not possible with nonqualified deferred compensation), although there may be some gift tax cost.

- A corporation may wish to assist its shareholders in establishing an insured cross-purchase buy-sell agreement by contributing to the premium cost of the policy. Since the corporation is likely in a lower tax bracket than the shareholder, the corporation may be able to pay the (nondeductible) split-dollar premiums more economically than the shareholder can.

When considering options for employers to insure key employees, always keep in mind that a split-dollar arrangement must provide economic benefits to both parties to the agreement. The split-dollar regulations do not cover life insurance arrangements where a company purchases life insurance to insure the life of a key employee or shareholder and retains all the rights and benefits of the contract. Thus, if the party advancing premiums is not entitled to recover any portion of those premiums under the terms of the arrangement, general principles of life insurance taxation will apply to the premium payments rather than one of the split-dollar tax regimes.

Regulators frown on arrangements that are inappropriately structured in an attempt to avoid the application of the rules—for example, by using separate life insurance contracts that are, in substance, one life insurance contract. Employers seeking a more predictable tax environment may want to consider executive bonus life insurance arrangements as a possible alternative to split dollar. (See Business Insurance – Executive Bonus Arrangements.)

Caution: The tax rules in this area are complex and subject to a wide assortment of IRS rulings and regulations. When speaking to clients regarding an existing split-dollar arrangement or a new split-dollar proposal, an advisor should always strongly recommend the advice and guidance of an experienced tax attorney.

Sarbanes-Oxley and Public Corporations

The Sarbanes-Oxley Act of 2002 (SOX), enacted in response to highly publicized corporate accounting scandals, raised a concern over the suitability of split-dollar arrangements for certain executives in public corporations. This legislation generally prohibits "extensions of credit" from public corporations to "executive officers." Because a split-dollar arrangement may possibly be viewed as a prohibited extension of credit for federal securities law purposes under SOX, many corporations have simply discontinued their arrangements. Executive bonus life insurance arrangements, which involve W-2 compensation rather than a loan, may be a useful alternative for public corporations.

Because of this, public corporations must always use extreme caution and follow the guidance of counsel with respect to:

(1) whether to install new split-dollar arrangements covering an executive officer,

(2) whether to make further premium advances under existing split-dollar arrangements involving executive officers, and

(3) any current developments that may affect the applicability of split dollar to executive officers.

Click here for more detail on the impact of Sarbanes-Oxley on split-dollar arrangements.

Policy Ownership

Formal ownership of the life insurance policy used to fund a split-dollar arrangement generally determines the federal tax consequences that result from the arrangement.

Endorsement Method

Under the endorsement method, the employer owns the policy, and an agreement spells out the employee's rights. Typically, the agreement will give the employee the right to name a personal beneficiary for the employee's share of the death proceeds as prescribed in the split-dollar agreement between the parties.

Collateral Assignment Method

In the collateral assignment method, the employee (or a third party such as an irrevocable life insurance trust, or ILIT) owns the policy and names a personal beneficiary, but assigns policy benefits to the employer as collateral for the employer's premium advances under the arrangement. A third party, often the employee's ILIT or an adult child, also may be the policy owner. This "third party collateral assignment method" is often used for estate tax planning purposes, as we will discuss in more detail later.

Special Income Inclusion Rules

Employer-owned life insurance is subject to additional specific income inclusion rules and exceptions as set forth under the Pension Protection Act of 2006. Click here to jump to the Employer-Owned Life Insurance section for a discussion of these rules and exceptions.

Paying the Premiums

In an employer-pay-all arrangement, the employer advances the entire premium. The sharing of the death benefit under this arrangement can be designed so that the employer recovers all net premiums paid or the cash value of the policy at the time of the employee's death, with the balance of the proceeds payable to the employee's beneficiary.

A split-dollar rollout occurs when the arrangement terminates (often at the employee’s retirement) and the employer is repaid for its aggregate premium advances under the arrangement. These repayments are sometimes called "receivables." After the rollout, the employee may use dividends (when applicable) and paid-up additions to offset any further premium payments.

Regulation and Taxation

"Abusive" Practices and The Road to Final Treasury Regulations

For years prior to the final Treasury regulations, companies used split-dollar life insurance to help employees defer taxation on the yearly accumulation of the policy’s cash value, as well as to provide significant death benefits. This "abuse" of the split-dollar rules raised concern at the IRS. Therefore, in Notice 2001-10, the IRS ruled that any enrichment employers give employees using split-dollar insurance plans is generally taxable. The IRS followed this with revenue notices 2002-8 and 2002-59, as well as proposed regulations, which together make many of the former tax benefits of split dollar a thing of the past. Notice 2002-59 halts "an abusive tax avoidance transaction using split-dollar life insurance."

To read about Notice 2002-59 in more detail, click here.

Revocation of Prior Guidance

Certain revenue rulings that have provided split-dollar guidance for taxpayers in the past have been declared obsolete by the IRS, with certain limitations [Rev. Rul. 2003-105, 2003-40 I.R.B. 1].

Click here for a list of those rulings.

Taxation Under the Final Regulations

The final Treasury regulations provide guidance on the taxation of split-dollar arrangements for purposes of the federal income, employment, self-employment, and gift taxes. Final Treasury regulations govern:

(1) new split-dollar arrangements entered into after September 17, 2003, and

(2) pre-existing arrangements that are "materially modified" on or after that date.

Treasury and the IRS have provided guidance on certain modifications that will not be deemed "material," and which can therefore be made without subjecting a pre-September 18, 2003, arrangement to the final regulations.

Click here for a list of these non-material modifications.

The taxation of all other split-dollar arrangements entered into on or before September 17, 2003, are governed by IRS Notice 2002-8.

For more information on taxation under IRS Notice 2002-8, click here.

For purposes of determining the tax treatment of split-dollar life insurance arrangements, two mutually exclusive tax regimes apply—the "economic benefit regime" and the "loan regime." A split-dollar arrangement must be fully and consistently accounted for by both parties under one of these two tax regimes.

Since ownership of the life insurance contract generally determines which regime applies, the parties to the arrangement choose the applicable regime simply by designating one party or the other as the owner of the life insurance contract.

The details of each of these tax regimes follow in the Economic Benefit Regime section and the Loan Regime section.

The Economic Benefit Regime

Under the economic benefit regime [Reg. §1.61-22(d)-(g)], the owner of the life insurance contract is treated as providing economic benefits to the non-owner, and those economic benefits must be accounted for fully and consistently by both the owner and the non-owner. The value of the economic benefits, reduced by any consideration paid by the non-owner to the owner, is treated as provided from the owner to the non-owner.

In a typical employment context, the economic benefit regime generally will govern taxation when the employer owns the policy and the employee's rights are spelled out in an endorsement to the policy.

The tax consequences of the provision of economic benefit will depend on the relationship between the owner and the non-owner. Thus, the provision of the benefit may constitute a payment of compensation, a dividend distribution under IRC §301, a capital contribution, a gift, or a transfer having some other tax character. The economic benefit must be taken into account by the non-owner based on its tax character.

Let’s look at two brief examples:

> **Example #1:** In a split-dollar life insurance arrangement in which an employer provides an employee with economic benefits, the employee would take those economic benefits into account by reporting them as compensation on the employee's federal income tax return for the year in which the benefits are provided, and the employer would take the economic benefits into account by reporting them on the appropriate employment tax and information returns.
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> **Example #2:** In a split-dollar life insurance arrangement in which a donor provides economic benefits to the beneficiaries of an irrevocable life insurance trust, the donor would take those economic benefits into account by reporting them on the federal gift tax return required to be filed

by the donor. The trust, however, generally would not be required to take any action to take the benefits into account because those economic benefits would be excludable from gross income under IRC §102.

Note that if the only economic benefit enjoyed by the employee (or donee) is current life insurance protection, the employer (or donor) is deemed to be the owner of the policy for tax purposes. Consequently, a non-equity split-dollar arrangement in an employment or gift context will always be taxed under the economic benefit regime, regardless of actual policy ownership.

Ownership Ordering Rules

If two or more people are designated as the policy owners, the first-named person is generally treated as the owner of the entire contract.

If two or more people are named as policy owners of a life insurance contract and each person has, at all times, all the incidents of ownership with respect to an undivided interest in the contract, those people are treated as owners of separate contracts for purposes of the final regulations—although not for purposes of IRC §7702 and other rules for the taxation of life insurance contracts. (An undivided interest in a life insurance contract consists of an identical fractional or percentage interest or share in each right, benefit, and obligation with respect to the contract).

For example, if an employer and an employee own a life insurance contract and share equally in all rights, benefits, and obligations under the contract, they are treated as owning two separate contracts. Ordinarily, neither contract would be treated as part of a split-dollar life insurance arrangement. However, if the employer and employee agree to enter into a split-dollar life insurance arrangement with respect to what otherwise would have been treated as the employer's (or the employee's) separate contract, the purported undivided interests will be disregarded, and the entire arrangement will be treated as a split-dollar life insurance arrangement.

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 the split-dollar final regulations.

Ownership Attribution Rules

Compensatory split-dollar life insurance arrangements are those negotiated with an employee in an employment context where one party is the service provider and the other the service recipient. In compensatory arrangements, the employer or service recipient will be treated as the owner of the life insurance contract if the contract is owned by:

- a member of the employer's controlled group [determined under the rules of IRC §414(b) and (c)]
- a trust described in IRC §402(b), sometimes referred to as a "secular trust"
- a grantor trust (including a rabbi trust) treated as being owned by the employer, or
- a welfare benefit fund [within the meaning of IRC §419(e)(1)]

Non-Equity Split-Dollar Life Insurance Arrangements

A non-equity split-dollar arrangement is when one party (say, the employer) typically provides the other party (the employee) with current life insurance protection but not any interest in the policy's cash value.

Current life insurance protection is determined on the last day of the non-owner's taxable year (unless the parties agree to use the policy anniversary date). Taxpayers may change the valuation date with the consent of the IRS. This “last day” rule is subject to an anti-abuse provision intended to discourage manipulation of the policy cash value to understate the economic benefit. Thus, in the case of non-equity arrangements taxed under the economic benefit regime, the owner is deemed to provide current life insurance protection to the other party equal to:

the excess of the death benefit (including paid-up additions, determined on the valuation date just described)

over

(1) the amount payable to the owner at the insured's death, plus

(2) the amount of any outstanding policy loan.

The taxable cost of the current life insurance protection on an annual basis is the amount of the annual coverage multiplied by the Table 2001 factor or other rates permitted under Notice 2002-8, reduced by any premiums paid by the insured.

Click here to display the Table 2001 rates.

There are also a couple of special rules you should be familiar with:

> **Special Rule #1:** Non-equity split-dollar life insurance arrangements entered into in a compensatory context or a gift context are subject to the economic benefit regime. If the parties modify the arrangement so it is no longer a non-equity arrangement, and afterwards the employer, service recipient, or donor owns the life insurance contract (determined without regard to the special rule for non-equity arrangements), such owner continues to be treated as the owner of the life insurance contract and the normal rules of the economic benefit regime for equity split-dollar life insurance arrangements apply. However, if, after the modification, the employer, service recipient, or donor is **not** the owner, such non-owner is treated as having made a transfer of the contract to the employee, service provider, or donee as of the date of the modification. For purposes of these rules, the replacement of a non-equity arrangement with a successor equity arrangement will be treated as a modification of the non-equity arrangement.
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> **Special Rule #2:** Another special rule addresses the transfer of a split-dollar life insurance contract from an owner to a non-owner when payments were being treated as split-dollar loans under Reg. §1.7872-15. Under this rule, the economic benefit regime applies from the date of the transfer, and the payments made (both before and after the transfer) are not treated as loans on or after the date of the transfer. The transferor must take into account all economic benefits under the arrangement.

Equity Split-Dollar Life Insurance Arrangements

Under an equity split-dollar life insurance arrangement, one party to the arrangement typically receives an interest in the cash value (or equity) of the life insurance contract disproportionate to that party's share of policy premiums. That party also typically receives the benefit of current life insurance protection under the arrangement.

In a typical business setting, equity split dollar is an arrangement in which the employer's share of the cash value and death benefit is limited to its aggregate net premiums paid. Any cash value in excess of the employer's aggregate net premiums inures to the benefit of the employee. Thus, the employee gradually builds up an "equity" interest in the cash value as well as having current life insurance protection.

Equity split-dollar arrangements were the primary impetus behind the series of IRS actions that culminated with the issuance of final Treasury regulations on split-dollar arrangements.

In an equity split-dollar life insurance arrangement, the value of the economic benefit provided by the owner to the non-owner for a taxable year equals the combined total of:

- the cost of any current life insurance protection provided to the non-owner,
- the amount of policy cash value to which the non-owner has current access (to the extent that such amount was not actually taken into account for a prior taxable year), and
- the value of any other economic benefits provided to the non-owner (to the extent not actually taken into account for a prior taxable year).

The non-owner has current access to any portion of the policy cash value to which such non-owner has a current or future right, and that is:

- directly or indirectly accessible by the non-owner
- inaccessible to the owner, or
- inaccessible to the owner's general creditors

The IRS intends that "access" be construed broadly 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.

For a more detailed explanation of determining "access," click here.

Investment in the Contract

Only the owner of a life insurance contract can have an investment in that contract—the non-owner has no investment in the split-dollar contract under IRC §72(e) prior to a transfer of the contract. Also, any amount paid by the non-owner to the owner for any economic benefit is included in the owner's gross income.

A non-owner employee is precluded from having a 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 was exhausted prior to the non-owner's acquisition of the contract.

Similarly, the fact that the split-dollar arrangement may require the non-owner to reimburse the owner for the cost of the death benefit protection provided to the non-owner does not mean that such payment is not income to the owner. In effect, the owner is "renting out" part of the benefit of the life insurance contract to the non-owner for consideration, and such consideration constitutes income to the owner.

Taxation of Amounts Received under the Life Insurance Contract

Any amount received under the life insurance contract (other than an amount received by reason of death) and provided, directly or indirectly, to the non-owner is treated as though paid by the insurance company to the owner and then from the owner to the non-owner. This rule applies to "specified policy loans."

Thus, dividends, policy loans, partial surrender proceeds, and so on are deemed to have been paid first to the owner, and then to the non-owner. Such amounts are taxed to the owner under the IRC §72 annuity rules. The non-owner generally will report amounts received as compensation, gift, or dividend, depending on the relationship between the parties. An employee, for example, would have compensation income upon the receipt of a policy loan, unlike the usual treatment of a policy loan to the policy owner.

Death Benefit Exclusion

The IRC §101(a) death benefit exclusion applies to exclude death benefit proceeds paid to a beneficiary (other than the owner of the life insurance policy) from the beneficiary's gross income only to the extent such amount is allocable to current life insurance protection provided to the non-owner under the split-dollar arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account as an economic benefit provided by the owner to the non-owner.

Why does the IRC §101(a) exclusion not extend to the entire amount of death benefit proceeds paid to the beneficiary on the death of the insured? In the view of the IRS, to the extent a non-owner has neither paid for nor taken into account the current life insurance protection, the proceeds paid to the estate or designated beneficiary of the non-owner constitute a separate transfer of cash that is not shielded under IRC §101(a). Instead, proceeds are deemed payable to the owner, and excluded from the owner's income by reason of the IRC §101(a), and then paid by the owner to the non-owner's beneficiary (regardless of whether paid directly or by the insurance company) in a transfer to be taken into account under the split-dollar regulations.

The tax character of death benefit proceeds transferred (or deemed to be transferred) by the owner to the non-owner is determined by the relationship between the owner and the non-owner. For example, death benefit proceeds received by the beneficiary of a non-owner shareholder that were paid (or payable) to a corporation will be treated as a dividend distribution to the shareholder. The same principle applies where death benefit proceeds under a life insurance contract subject to a split-dollar life insurance arrangement are payable to a beneficiary of a non-owner service provider, except that the death benefit proceeds would constitute a compensation payment to the service provider for past services rather than a corporate distribution.

Transfer of Life Insurance Contract to the Non-owner

A transfer of a life insurance contract (or an undivided interest therein) underlying a split-dollar arrangement occurs on the date that the non-owner becomes the owner of the entire contract (or an undivided interest therein). Until ownership of the contract is formally changed, the owner will continue to be treated as the owner for tax purposes. The fair market value of an undivided interest must be the proportionate share of the fair market value of the entire contract without regard to any discounts or other arrangements between the parties.

After a transfer of an entire life insurance contract, the transferee generally becomes the owner for federal income, employment, and gift tax purposes, including for purposes of the split-dollar regulations. Thus, if the transferor pays premiums after the transfer, the payment of those premiums may be includible in the transferee's gross income if the payments are not split-dollar loans under Reg. §1.7872-15. Alternatively, the arrangement will be subject to the loan regime if the payments constitute split-dollar loans under Reg. §1.7872-15.

The Loan Regime

Under the loan regime of Reg. §1.7872-15, a payment made pursuant to a split-dollar arrangement is a split-dollar loan and the owner and non-owner are treated, respectively, as borrower and lender if:

- the payment is made either directly or indirectly by the non-owner to the owner;
- the payment is a loan under general principles of federal tax law or, if not a loan, a reasonable person would expect the payment to be repaid in full to the non-owner (with or without interest); and
- the repayment is to be made from, or is secured by, either the policy's death benefit proceeds or its cash surrender value, or both.

Thus, under the loan regime, the non-owner of the life insurance policy (lender) is treated as making loans of all or part of the premiums to the policy owner (borrower). The loan regime applies to a typical **equity** collateral assignment arrangement in which the employee owns the policy and uses it as collateral for the employer's advance of premium payments. The loan regime does NOT apply to a

non-equity collateral assignment split-dollar arrangement involving employment or a gift, where the employer or donor is treated as the owner and the economic benefit regime applies. For example, non-equity private split dollar (which involves gifts) would not be subject to the loan regime.

During the earlier years of a split-dollar arrangement, policy surrender and load charges may significantly reduce the policy's cash surrender value, resulting in under-collateralization of a non-owner's right to be repaid for premium payments. Nevertheless, as long as a reasonable person would expect the payment to be repaid in full, the payment is treated as a split-dollar loan under Reg. §1.7872-15 (rather than as a transfer under Reg. §1.61-22(b)(5)) on the date the payment is made.

Beware of Repayment "Games"

Reg. §1.7872-15(a)(2) does not cause a payment to be treated as a loan for federal tax purposes if, because of an agreement between the owner and non-owner, the arrangement does not provide for repayment by the owner to the non-owner. For example, if a non-owner makes a payment purported to be a split-dollar loan to an owner, and 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, Reg. §1.7872-15(a)(2) will not cause the payment to be treated as a loan. See Reg. §1.61-22(b)(5) for the treatment of payments by a non-owner that are not split-dollar loans.

Below-Market Loans

The loan regime seeks to account for the benefits provided by the lender to the borrower with below-market loans. Each payment under a covered split-dollar arrangement is treated as a separate loan for federal tax purposes.

If a split-dollar loan *does not* provide for sufficient interest, the loan is a below-market split-dollar loan subject to the imputed interest rules of IRC §7872 and Reg. §1.7872-15. If the split-dollar loan *does* provide for sufficient interest, then, except as provided in Reg. §1.7872-15, the loan is subject to the general rules for debt instruments (including the original-issue-discount or OID rules).

If a split-dollar loan is a below-market loan, then, in general, the loan is recharacterized as a loan with interest at the "applicable federal rate" (AFR), coupled with an imputed transfer by the lender to the borrower. The timing, amount, and characterization of the imputed transfers between the lender and borrower of the loan will depend on whether the loan is a demand loan or a term loan, and the relationship between the lender and the borrower. For example, the imputed transfer generally would be characterized as compensation if the lender is the borrower's employer.

If a split-dollar loan is repayable on demand, the short-term AFR applies in calculating the imputed interest. Since this rate changes monthly, the calculation normally would have to be made monthly. However, tax law permits taxpayers to use a blended annual rate when a demand loan has a fixed principal that is outstanding for an entire calendar year [IRC §7872(e)(2); see also Rev. Rul. 86-17, 1986-1 CB 377]. The IRS releases the blended annual rate in a revenue ruling issued in July of each year. The blended annual rates for recent years appear below:

Year	Rate
2021	0.13%
2022	1.40%
2023	4.65%

Special Rules for Certain Term Loans

Special rules are provided for:

- split-dollar term loans payable on the death of an individual,

- certain split-dollar term loans that are conditioned on the future performance of substantial services by an individual, and
- gift split-dollar term loans.

Under the loan regime, these are treated as split-dollar term loans for purposes of determining whether the loan provides for sufficient interest. However, if the loan does not provide for sufficient interest when the loan is made, the forgone interest is determined on the loan annually similarly to a split-dollar demand loan.

The rate used to determine the amount of forgone interest each year is the AFR based on the term of the loan, determined on the date the split-dollar loan is made. The rate is not re-determined annually.

Split-Dollar Loans with Stated Interest That Is Subsequently Waived, Canceled or Forgiven

If a split-dollar loan provides for stated interest that is subsequently waived, canceled, or forgiven, the parties must make appropriate adjustments to reflect the difference between the interest payable at the stated rate and the interest actually paid by the borrower at that time. Further, if stated interest is subsequently waived, canceled, or forgiven, an amount is treated as re-transferred from the lender to the borrower.

The final regulations add new rules under which:

- this re-transferred amount generally is increased by a deferral charge; and
- a payment by the lender to the borrower that, in substance, is a waiver, cancellation, or forgiveness is treated as a waiver, cancellation, or forgiveness for tax purposes.

Nondeductibility of Interest by Borrower

In general, interest on a split-dollar loan is not deductible by the borrower under IRC §§264 and 163(h).

Nonrecourse Loans

If a payment on a split-dollar loan is nonrecourse to the borrower and the loan does not otherwise provide for contingent payments, Reg. §1.7872-15 treats the loan as a split-dollar loan that provides for contingent payments unless the parties to the split-dollar life insurance arrangement provide a written representation with respect to the loan [see Reg. §1.7872-15(d)(2)].

The final regulations eliminated the requirement in the proposed regulations that a nonrecourse split-dollar loan provide for interest payable at a stated rate. However, the final regulations include a new rule that disregards certain stated interest if such interest is to be paid directly or indirectly by the lender, or a person related to the lender [see Reg. §1.7872-15(a)(4)].

If a split-dollar loan is nonrecourse and the parties to the split-dollar life insurance arrangement had made the representation under Reg. §1.7872-15(d)(2), although adjustments are required to be made by the parties if the interest paid on the split-dollar loan is less than the interest payments required under the split-dollar loan if all payments were made, a deferral charge is not imposed.

Payment Ordering Rules

Payments made by a borrower to a lender pursuant to a split-dollar life insurance arrangement are applied in the following order:

- to accrued but unpaid interest (including any OID) on all outstanding split-dollar loans in the order the interest accrued

- to principal on the outstanding split-dollar loans in the order in which the loans were made
- to payments of amounts previously paid by the lender pursuant to the split-dollar life insurance arrangement that were not reasonably expected to be repaid
- to any other payment with respect to a split-dollar life insurance arrangement

This payment ordering rule applies only to payments that are made to or for the benefit of the lender [Reg. §1.7872-15(k)].

Special rules apply for split-dollar loans that provide for certain variable rates of interest, contingent interest payments, lender or borrower options, and below-market split-dollar loans with indirect participants.

Impact of IRC Section 409A

The American Jobs Creation Act of 2004 added IRC §409A. This section generally provides that unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. IRC §409A is discussed at length under "Executive Compensation: Deferred Compensation Arrangements". Click here to jump to that section.

Traditionally, split-dollar arrangements were not considered to be arrangements that deferred the receipt of compensation. However, §409A can apply to split-dollar plans in cases where such arrangements do, in fact, provide for deferral of compensation as contemplated by IRC §409A. As a general rule, split-dollar arrangements subject to taxation under Treasury Regulations §1.61-22 (the "economic benefit regime") provide for a deferral of compensation that is subject to IRC §409A.

However, death-benefit-only arrangements and arrangements providing for short-term deferrals of compensation are not subject to IRC §409A. As a general rule, split-dollar arrangements subject to taxation under Treasury Regulations §1.7872-15 (the "loan regime") do not provide for a deferral of compensation and therefore are not subject to IRC §409A.

Grandfathered Amounts

IRC §409A is not effective with respect to amounts deferred in taxable years beginning before January 1, 2005, unless the plan under which the amount was deferred was materially modified after October 3, 2004.

Click here for more on the grandfather rules.

Impact on Arrangements Subject to the Economic Benefit Regime

According to Treasury Regulations §1.61-22, this type of split-dollar arrangement generally provides for deferred compensation taxable under the §409A rules if, under the terms of the arrangement and the relevant facts and circumstances, the service provider (i.e., employee) has a legally binding right during a taxable year of the service provider to compensation that, pursuant to the terms of the arrangement, is or may be includible in the income of the service provider in a later taxable year of the service provider. For this purpose, the right to compensation that is described in Treasury Regulations §1.61-22(d)(2)(i) and (3) as the cost of current life insurance protection is treated as provided under a death benefit plan and is not deferred compensation for purposes of IRC §409A. Thus, a service provider will not be taxed under the §409A rules on the current cost of life insurance protection under the split-dollar arrangement. If, however, under the split-dollar arrangement and under the relevant facts and circumstances, the service provider has a legally binding right during the taxable year to economic benefits (e.g., policy cash values) to which the service provider has current access or that are payable in a later taxable year, the service provider will be subject to tax under the §409A rules.

Impact on Arrangements Subject to the Loan Regime

According to Treasury Regulations §1.7872-15, this type of split-dollar arrangement generally will not give rise to deferrals of compensation subject to the §409A rules.

Grandfathered Split-Dollar Arrangements

A split-dollar arrangement can be grandfathered under the final regulations or IRC §409A or both.

For more on these rules and how they may or may not apply to a particular arrangement, click here.

Employment Tax and Self-Employment Tax

An imputed transfer under the split-dollar loan regime that is treated as an imputed transfer of compensation will have consequences under the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) if the adjustment represents wages to the borrower.

Gift Taxation of Split-Dollar Arrangements

The final Treasury regulations apply for federal gift tax purposes, including private split-dollar life insurance arrangements.

Thus, if an irrevocable life insurance trust (ILIT) is the owner of the life insurance contract underlying the split-dollar life insurance arrangement, and a reasonable person would expect that the donor, or the donor's estate, will recover an amount equal to the donor's premium payments, those premium payments are treated as loans made by the donor to the trust and are subject to the loan regime. In such a case, payment of a premium by the donor is treated as a split-dollar loan to the trust in the amount of the premium payment. If the loan is repayable upon the death of the donor, the term of the loan is the donor's life expectancy determined under the appropriate table under Reg. §1.72-9 as of the date of the payment, and the value of the gift is the amount of the premium payment less the present value of the donor's right to receive repayment (as determined under IRC §7872 and Reg. §1.7872-15).

If the donor is treated under Reg. §1.61-22(c) as the owner of the life insurance contract underlying the split-dollar life insurance arrangement, the donor is treated as making a gift to the trust. The value of the gift is the value of the economic benefits provided to the trust, less the amount of any premium paid by the trustee.

For example, assume that under the terms of the split-dollar life insurance arrangement, on termination of the arrangement or the donor's death, the donor or donor's estate is entitled to receive an amount equal to the greater of the aggregate premiums paid by the donor or the cash surrender value of the contract. In this case, the donor makes a gift to the trust equal to the cost of the current life insurance protection provided to the trust, less any premium amount paid by the trustee. Thus, a payment by the donor will not constitute a gift if the trust pays the portion of the premium equal to the cost of the current life insurance protection and the donor pays the balance of the premium.

On the other hand, if the donor or the donor's estate is entitled to receive an amount equal to the lesser of the aggregate premiums paid by the donor or the cash surrender value of the contract, the amount of the economic benefits provided to the trust by the donor equals:

- the cost of any current life insurance protection provided to the trust,
- the amount of policy cash value to which the trust has current access (to the extent that such amount was not actually taken into account for a prior taxable year), and
- the value of any other economic benefits provided to the trust (to the extent not actually taken into account for a prior taxable year).

The value of the donor's gift of economic benefits equals the value of those economic benefits provided to the trust for the year minus the amount of premiums paid by the trustee.

The final regulations treat the donor as the owner of a life insurance contract where the donee is named as the policy owner if, under the split-dollar life insurance arrangement, the only economic benefit provided to the donee by the donor under the arrangement is the value of current life insurance protection. Any amount paid by a donee, directly or indirectly, to the donor for such current life insurance protection would generally be included in the donor's gross income.

Where the donor is the owner of the life insurance contract that is part of the split-dollar life insurance arrangement, amounts received by the irrevocable life insurance trust (either directly or indirectly) under the contract (e.g., as a policy owner dividend or proceeds of a specified policy loan) are treated as gifts by the donor to the ILIT as provided in Reg. §1.61-22(e). The donor must also treat as a gift to the trust the amount set forth in Reg. §1.61-22(g) upon the transfer of the life insurance contract (or undivided interest therein) from the donor to the trust.

The federal gift tax consequences of the transfer of an interest in a life insurance contract to a third party will continue to be determined under established gift tax principles, notwithstanding who is treated as the owner of the life insurance contract under the final regulations [see, e.g., Rev. Rul. 81-198, 1981-2 C.B. 188].

Estate Taxation of Split-Dollar Arrangements

For federal estate tax purposes, regardless of who is treated as the owner of a life insurance contract under the final split-dollar regulations, the inclusion of the death proceeds of a split-dollar life insurance arrangement in a decedent's gross estate will continue to be determined under IRC §2042. Thus, the death proceeds will be included in the decedent's gross estate under IRC §2042(1) if receivable by the decedent's executor, or under IRC §2042(2) if the death proceeds are receivable by a beneficiary other than the decedent's estate, and the decedent possessed any incidents of ownership with respect to the policy.

In a split-dollar arrangement, death proceeds payable to the employee's personal beneficiary are generally includible in the employee's gross estate for federal estate tax purposes. Regardless of the nominal ownership of the policy, the employee usually has the right to designate the beneficiary of his or her portion of the death proceeds, and perhaps other incidents of ownership as well.

Endorsement Method Arrangements

If the endorsement method was used for the split-dollar arrangement, the employee could get rid of any incidents of ownership by irrevocably assigning all policy rights to a third party. However, if the employee is a controlling (more than 50%) shareholder, this may not work. In this situation, the corporation's incidents of ownership in the policy will be attributed to the controlling shareholder [Reg. §20.2042-1(c) (6)]. So, even after assigning all direct incidents of ownership, the controlling shareholder-employee is still treated as having indirect incidents of ownership.

Another risk is that an employee may die within three years of the assignment. The assignment of the policy rights would become a transfer within three years of death, bringing the death proceeds into the gross estate [IRC §2035(a)].

Of course, if the death proceeds are payable to the employee's surviving spouse, the marital deduction will shelter them from the federal estate tax. But there could still be an estate tax problem at the spouse's subsequent death.

Collateral Assignment Method Arrangements

The employee's direct incidents of ownership under the regular collateral assignment method cause the employee portion of the death proceeds to be includible in the gross estate.

If the employee's irrevocable trust or another third party is the policy owner, the employee will hold no direct incidents of ownership. However, the employer's security interest under the collateral assignment could be viewed by the IRS as creating indirect incidents of ownership for a controlling shareholder.

For this reason, a "restricted" or "limited" collateral assignment has been used to avoid attribution of the employer's incidents of ownership to a controlling shareholder. Here, the employer's rights as collateral assignee do not include the right to borrow the policy's cash value or any other right or power that would be deemed an incident of ownership potentially attributable to the employee.

It appears that the ownership attribution rules (discussed earlier) in the final regulations are used only to determine policy ownership for federal income tax purposes, and that incidents of ownership will continue to be the pertinent test for federal estate tax purposes.

Important Cases Regarding Split-Dollar Life Insurance

There are important cases involving the use of split-dollar arrangements to fund intergenerational transfers of wealth that are instructional. The cases all involve the question of which tax regime governs intergenerational split-dollar transactions. The Morrissette case, in particular, has generated much interest as a win for taxpayers.

The Morrissette case (*Estate of Morrissette v. Commissioner*, Docket No. 4415-14) involved the Morrissette's fortune, amassed through a large moving company (Interstate Van Lines). After Mr. Morrissette's death, Mrs. Morrissette pooled company shares into a revocable trust. The trust advanced $30 million in premiums to fund dynasty irrevocable life insurance trusts for her three children using split-dollar arrangements. The policy proceeds were designed to fund the buy-sell agreements as part of the overall business succession plan after paying Mrs. Morrissette's revocable trust the value of the premiums advanced (or the cash surrender value of the policies, if greater). Mrs. Morrissette reported gifts to the dynasty trusts under the economic benefit regime under Reg. §1.61-22 equal to the cost of the current life insurance protection (determined using Table 2001), less the amount of premiums paid by the dynasty trusts. Her estate eventually valued the receivables at roughly $7.5 million for tax purposes.

Despite arguments by the IRS that the facts of the case warranted a factual determination of whether the arrangement should have been taxed under the loan regime, the Tax Court granted summary judgment to Morrissette on this issue, holding that applying the economic benefit regime was proper in this case and that the dynasty trusts received no additional economic benefit beyond current life insurance protection. The Morrissette revocable trust was ruled to be the deemed owner of the life insurance contracts under the special ownership rules (see Reg. §1.61-22(b)(2)).

Caveat: While the decision of the Tax Court in upholding application of the economic benefit regime rules under the final regulations is a win for the wealth planning and insurance communities, note that this favorable partial ruling in 2016 is not the end of the Morrissette case. The litigation is ongoing with respect to several remaining issues. Many commentators urge caution in utilizing the techniques in these cases as blueprints for a successful outcome when using split-dollar arrangements in a wealth planning setting.

Other cases of importance:

Estate of Marion Levine v. Commissioner, T.C. No. 9345-15 (filed April 8, 2015)

Estate of Cahill v. Commissioner, T.C. No. 10451-16 (filed May 3, 2016—settled)

Estate of Gettler v. Commissioner, T.C. No. 21532-16 (filed October 3, 2016)

ERISA Considerations

Split-dollar arrangements generally fall within the meaning of "welfare benefit plans" subject to ERISA. However, unfunded welfare benefit plans are exempt from the disclosure, participation, vesting, funding, and plan termination insurance provisions of ERISA Title I. The Department of Labor takes the position that a plan is unfunded if the general creditors of the employer can reach the plan assets. Further, arrangements that cover only a select group of executives or other highly compensated employees, or that cover less than 100 participants, are generally exempt from ERISA's reporting and disclosure requirements. Even so, summary plan descriptions can be a valuable employee communication tool, and an employer may choose to provide them to split-dollar participants even though the arrangement is exempt from ERISA Title I.

A split-dollar arrangement should name a fiduciary, spell out a method for funding and making payouts, and detail a claims procedure.

Charitable Split Dollar

After the IRS took regulatory action against charitable split-dollar arrangements, Congress enacted a federal law in 1999 designed to eliminate them. This was accomplished, in part, by disallowing federal income tax deductions for contributions made to charity under "personal benefit contracts" in which there is a payment (or expectation of a payment) of premiums on any life insurance, endowment, or annuity contract that directly or indirectly benefits the donor, the donor's family, or other related entities.

Under the typical charitable split-dollar arrangement, the taxpayer created an irrevocable life insurance trust, which then applied for a policy on the taxpayer's life. The trustee entered into a separate split-dollar agreement with a charity which specified exactly how the premiums and death proceeds would be shared. The trustee designated both the charity and members of the taxpayer's family as beneficiaries of the policy, as called for in the split-dollar agreement.

The donor gave cash or property to the charity each year with the understanding that the charity would use such assets to pay its share of the premiums. The advertised benefit of this arrangement—before the IRS and Congress intervened—was that the donor's annual transfers to charity were deductible as charitable contributions, even though the donor's family personally benefited.

The federal law not only disallowed a federal income tax deduction for such contributions, it also imposed an excise tax on charities participating in such arrangements. The tax is levied in the amount of any premium payments—in other words, a 100% tax. Charities are required to report all such payments annually.

Further, the IRS has indicated that a charity's federal income tax exemption could be jeopardized by participating in charitable split dollar since it is deemed to be providing a private benefit rather than carrying out its charitable purposes.

References for Legal Counsel

Revenue rulings marked with an asterisk (*) have been revoked except to the extent they provide guidance for split-dollar arrangements grandfathered under IRS Notice 2002-8.

Reg. §1.409A

Nondeductibility of Premiums

IRC §§264(a)(1), 163(h)

Income Tax Exclusion for Death Proceeds

IRC §101(a), 101(j), 6039I

Rev. Rul. 64-328, 1964-2 C.B. 11*

Current Taxation of Employee

Reg. §1.61-22(d)-(g) (economic benefit regime)

Reg. §1.7872-15 (loan regime)

IRS Notice 2002-8, 2002-1 C.B. 398

Burnet v. Wells, 289 U.S. 670 (1933)

Sercl v. U.S., 82-2 USTC ¶9528 (8th Cir. 1982)

Genshaft v. Comm'r, 64 T.C. 282 (1975)

Johnson v. Comm'r, 74 T.C. 1316 (1980)

Bagley v. U.S., 30 AFTR2d ¶72-5054 (D.C. Minn. 1972)

Healey v. U.S., 843 F.Supp. 562 (D.C.S.D. 1994)

Rev. Rul. 64-328, 1964-2 C.B. 11*

Rev. Rul. 66-110, 1966-1 C.B. 12*

Rev. Rul. 67-154, 1967-1 C.B. 11

Rev. Rul. 78-420, 1978-2 C.B. 67*

Rev. Rul. 79-50, 1979-1 C.B. 138*

T.A.M. 9452004

T.A.M. 9604001

T.A.M. 9918060

Ltr. Rul. 8547006

Ltr. Rul. 7832012

Gain on Policy Surrender

IRC §72(e)

Reg. §1.72-11(c)

Gift Taxation of Split Dollar

Reg. §1.61-22(d)-(g)

Reg. §1.7872-15

IRS Notice 2002-8, 2002-1 C.B. 398

Rev. Rul. 78-420, 1978-2 C.B. 67*

Rev. Rul. 81-198, 1981-2 C.B. 188

Ltr. Rul. 9636033

Estate Taxation of Split Dollar

IRC §2042

Reg. §20-2042-1(c)(6) (controlling shareholder situation)

Estate of Milton Levy v. Comm'r, 70 T.C. 873 (1978)

Schwager v. Comm'r, 64 T.C. 781 (1975)

Estate of Alfred Dimen v. Comm'r, 72 T.C. 198 (1979)

Estate of Howard Carlstrom v. Comm'r, 76 T.C. 142 (1981), IRS acq. 1981-2 C.B. 1

Estate of James Tomerlin v. Comm'r, T.C. Memo 1986-147

Estate of Gordon Thompson v. Comm'r, T.C. Memo 1981-200

Rev. Rul. 76-274, 1976-2 C.B. 278

Rev. Rul. 79-429, 1979-2 C.B. 321

Rev. Rul. 79-129, 1979-1 C.B. 306

Rev. Rul. 82-145, 1982-2 C.B. 213

Ltr. Rul. 9026041

Ltr. Rul. 9348009

Ltr. Rul. 9511046

Ltr. Rul. 9636033

Split-Dollar Rollouts

Ltr. Rul. 7916029

Ltr. Rul. 8310027

Equity Split Dollar

Reg. §1.61-22(d)-(g)

Reg. §1.7872-15

IRS Notice 2002-8, 2002-1 C.B. 398

Private Split Dollar

Reg. §1.61-22(d)-(g)

Reg. §1.7872-15

Ltr. Rul. 9636033

Ltr. Rul. 9745019

Ltr. Rul. 200910002