SPLIT DOLLAR LIFE INSURANCE FUNDING: YOU MEAN PEOPLE STILL DO THAT?

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INTRODUCTION

After several torturous years of notices, reflection, meetings and debate, the IRS issued final Regulations for the taxation of split dollar financed life insurance effective for agreements entered into after September 17, 2003. This followed a series of notices beginning with Notice 2001-10 issued in January 2001, Notice 2002-8, which governs the taxation of split dollar arrangements entered into on or before September 17, 2003 and Notice 2002-59 dealing primarily with arrangements referred to as "Reverse Split Dollar Plans." The final Regulations came out just over a year from the release of the Proposed Regulations issued in July, 2002.

Despite the gloom and doom forecasted by many in the insurance industry and the legal profession, the final Regulations did not sound the death knell for split dollar planning. Granted, some of the luster was gone from the heady days of collateral equity split dollar arrangements using economic benefit measured by artificially low term rates that had never actually seen the light of day in connection with the actual issuance of a real life insurance policy. Nonetheless, in many instances the use of split dollar arrangements still make great sense and can provide a very nice tax result for clients.

It has been long enough since the issuance of the final Regulations that many who knew them well at the time they were first disseminated, and certainly those who never really dug in with them in the first place, no longer have a good grasp on the specifics of how split dollar works in today's world. Also often forgotten are those billions of dollars still represented by "grandfathered" split dollar

arrangements that were in place prior to the issuance of the final Regulations. As those arrangements mature, it will be important to know how to administer them and to be aware of the pitfalls and opportunities that exist for those plans.

The hallmark of the final Regulations was that the tax treatment of split dollar arrangements is determined by the *ownership of the policy*. This position represents a complete reversal of prior law, which disregarded the ownership of the policy and treated identically both collateral split dollar, in which the employee or donee owned the policy, and endorsement split dollar, in which the employer or the donor owned the policy. In both instances, the amount of compensation or gift was measured by the economic benefit deemed provided to the employee or donee. The economic benefit was measured by the term cost of the life insurance coverage for the year in question.

The bottom line is that split dollar arrangements are now comprehensively governed by the Regulations issued back in 2003. To understand split dollar, you must understand these Regulations. This article analyzes the issues that should be raised with both older arrangements and those being put in place currently.

SPLIT DOLLAR DEFINED

The Regulations under IRC §61 define split dollar insurance arrangements. Once defined as a split dollar arrangement, its taxation is defined under IRC §61 or §7872. The definition is quite broad:

A split dollar life insurance arrangement is *any arrangement* between an owner and a non-owner of a life insurance contract that satisfies the following criteria:

(i) Either party to the arrangement pays directly or indirectly all or a portion of the premiums on the life insurance contract including a payment by means of a loan to the other party that is secured by the insurance contracts;

(ii) At least one of the parties to the arrangement paying premium under the paragraph above is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract; and

(iii) The arrangement is not part of a group term insurance plan described in Section 79 unless the group-term life insurance plan provides permanent benefits to employees (as defined in §1.79-0). Reg. §1.61-22(b)(1).

The definition goes on to include compensatory arrangements where the employer or service recipient pays directly or indirectly all the portion of the premiums and the beneficiary is designated by the employee or service provider, or is a person that would be reasonably expected to be designated as the beneficiary. Also, if the employee or service provider has an interest in the cash value of the policy, it is a split dollar arrangement that is covered by the Regulations.

OWNERSHIP AND METHOD

Under the split dollar Regulations, if the owner is the employee or donee, §7872 dealing with below market loans will control the relationship. The employee or donee will receive a benefit measured by the current cost of the foregone interest.

If, on the other hand, the employer or donor owns the policy, the old economic benefit regime will apply and the term cost will be the measure of the benefit. The person named as the policy owner is generally considered as the owner of the contract. Having such a simple standard is deceptive, for its application can get extraordinarily complex.

One such complexity is illustrated by the response to public comments to Notice 2002-8, thus, the Regulations provide an exception for the simple ownership test of identifying the owner in the contract. Even if the employee or donee is listed as the owner on the policy, if the employee's benefit is limited to only annual death benefit coverage (the entire cash value is pledged to the employer), the employer shall be *deemed* the owner.

This deemed ownership rule provides an election for the parties. They can treat the arrangement as debt controlled by §7872, or they can elect to treat the arrangement under the economic benefit regime. They should consider which method provides better results and for how long. If the insured is young or the policy is a second-to-die policy with low term costs, they would typically chose economic benefit treatment and structure the agreement to provide the greater of premiums paid or cash value would be paid to the employer or donor at termination

of the agreement. If the parties elected economic benefit treatment and subsequently terminated the split dollar arrangement, there should be no taxable transfer of property, and with all the cash value paid to the employer, no economic gain should be reportable by the owner/employee.

The regime under the final Regulations applies for arrangements entered into September 18, 2003 and thereafter. It also applies to older arrangements preceding the effective date if there has been a material modification of the arrangement after September 17, 2003. The definition of material modification discussed below will be critical to parties under an older split dollar agreement (pre final Regulations) contemplating any change at all in the relationship. A foot fault in restructuring the arrangement that constitutes a material modification will subject the arrangement to the new regime under the final Regulations with potentially adverse consequences.

TAXATION UNDER EXISTING SPLIT DOLLAR ARRANGEMENTS

Older split dollar arrangements, entered into prior to September 18, 2003—whether collateral split dollar or endorsement—will continue to be taxed under the economic benefit doctrine, unless the parties elect to be taxed as a below-market interest loan in the case of a collateral split dollar. The amount to be considered as the transmitted economic benefit to the employee or donee typically will be the term cost of the life insurance protection. Rev. Rul. 66-110 allowed the parties to use the lower of government prescribed PS-58 term costs or the insurer's term rate. Invariably the insurer's term cost was lower. The use of artificially low term cost

was one of the perceived abuses that prompted the IRS's overhaul of financed whole life policies. In the employment context, the employer significantly subsidized the investment component that the employee owned in the policy. In the gift context, the donor greatly subsidized the cash value owned by the donee without paying a gift tax. In Notice 2001-10, the IRS formally withdrew PS-58 rates and supplanted them with Table 2001. This Table was basically ingraphed from Section 79 group term rates and to date continues to apply for measuring economic benefit under the Regulations.

In Notice 2002-8, the IRS established the ground rules for the taxation of split dollar arrangements existing prior to the final Regulations. Notice 2002-8 continues to be the primary guidance for interpreting how split dollar arrangements entered into before the publication of the final Regulations are taxed. The term "grandfathering" has been applied to these older arrangements, but it is critical to determine the effective date of the arrangements to determine whether they are grandfathered. Arrangements existing prior to January 28, 2002 can continue to use the insurer's term rate that has been consistently applied since inception of th arrangement to determine the economic benefit. For arrangements entered into after January 28, 2002, more stringent standards for the application of the insurer's term cost apply.

The Regulations define "grandfathering" as an arrangement "entered into" before the effective date. A split dollar life insurance arrangement is entered into on the latest the following dates:

(a) the date on which the life insurance contract under the arrangement is issued;

(b) the effective date of the life insurance contract under the arrangement;

(c) the date of which the first premium of the life insurance contract under the arrangement is paid;

(d) the date on which the parties to the arrangement enter into the agreement with regard to the policy; or

(e) the date on which the arrangement satisfies the definition of split dollar life insurance arrangement under the regulations. Reg. §1.61-22(j)(1).

To determine whether a split dollar arrangement is grandfathered, one must focus on which of these events occurred the latest. If one assumes simplistically that it is the date the arrangement was executed, but the policy was issued sometime later, the parties could be surprised that the assumed grandfathered treatment will not apply.

Although not perfectly clear, the assumption with regard to continued taxation of older arrangements is that the method and rates prescribed in Notice 2002-8 continues to govern the determination of the economic benefit. Employer/donor owned policies controlled by the final Regulations will continue to measure the applicable economic benefit by reference to term costs. Unfortunately, the final Regulations make no direct reference to the application of Table 2001, but merely state that the IRS will periodically issue term rates that will apply in

measuring the economic benefit for arrangements falling within the endorsement split dollar regime with the employer/donor owning the policy. Table 2001 is the only outstanding table for this purpose.

Options: To Convert, Terminate or Do Nothing.

Equity collateral split dollar plans existing prior to the final Regulations have several options going forward:

(a) convert to the interest-free loan regime;

(b) terminate the agreement and distribute the funds according to the terms of the arrangement; or

(c) do nothing.

If the parties elect to convert to debt and adopt below-market loan treatment, the conversion comes with a penalty of sorts. All prior premiums advanced by the employer/donor must be considered as debt when establishing the new method of taxation under Section 7872, unless they are repaid at the time of the conversion. Obviously, depending on the age of the policy, this amount can be quite large and, correspondingly, will determine the amount of imputed interest to be recognized each year as either compensation to the employee or gift to the donee.

Careful analysis of the conversion and termination options is critical in the context of equity split dollar agreements. If, under the agreement, only the premiums advanced by the employer are returned to it and the extra cash build-up stays with the employee, the IRS will in all likelihood attempt to tax the equity portion of the policy to the employee when the agreement is converted or

terminated. The employer/donor would be repaid the amounts owing under the arrangement from whatever source, but most probably a policy loan. In the employment situation, if the employer and employee are looking at a different type of bonus or non-qualified deferred compensation structure, terminating the agreement may be the most satisfactory option, though there may be an attempt to tax any cash value equity inuring to the benefit of the employee after repayment of the employer.

Depending on the amount of cash value in the policy versus the amount to be repaid to the employer/donor, under either the conversion to interest-free loan treatment or termination of the arrangement, the parties may face the consequence of having the IRS assert that the equity build-up inuring to the benefit of the employee/donee will constitute additional income or a gift. Only through a careful analysis of the expected equity build-up in the policy can the parties intelligently determine what to choose. But—and this is key—they 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 Section 101, the entire proceeds should be exempt from the income tax and no equity in the policy should be recognized on the payment of the proceeds. Of course, if the insured enjoys a long life, the economic benefit flowing from the arrangement and taxed as income or a gift will be quite large in later years because of the increased term costs.

The Service's concern over equity arrangements where the employee/donee was enjoying a buildup in the cash value of the policy for very little imputed income

undoubtedly prompted the promulgation of the Regulations. Notice 2002-8 announced that for older arrangements that have not converted to the loan regime, the IRS will attempt to tax the equity build-up in the policy at termination. The Notice says that, although there will not be incremental or annual taxation as the equity increases, it will be taxed when the agreement is terminated. Exactly on what theory of taxation the Service believes it can tax that equity build up is still uncertain.

If there is no equity, a termination should not or cannot produce realized gain. There may be reason in that case to wait until after the crossover point at which equity will equal premiums to terminate or convert the arrangement. The parties could establish a new financing arrangement as a below-market interest loan without treating prior premiums as part of the debt as required, but only if they pay off the premiums advanced to that point.

EQUITY SPLIT DOLLAR UNDER THE NEW REGIME

The concept of collateral equity split dollar does not exist in arrangements that involve employee/donee owned policies entered into after the effective date of the Regulations. The parties have to treat that relationship as a below-market interest loan that is taxed under Section 7872. The employer/donor loans money, which will probably bear less than the AFR interest charge. The employer/donor will get back a payment of a defined amount that has been loaned to the employee/donee. Although the loan will be secured by the cash value in the policy, the amount to be repaid is not determined by reference to it.

Equity arrangements can exist, however. Under the Regulations, the concept of equity split dollar will apply to employer/donor owned arrangements (endorsement), and they will continue to be taxed under the economic benefit regime. Under an endorsement equity arrangement, the employer/donor as a policy owner will receive back only the premiums advanced, thereby allowing the accretion of cash value above the gross premiums paid to go to the employee upon the eventual termination of the policy. The employee/donee will recognize an annual economic benefit equal to the term cost for that year and, additionally, will realize annual income based on the annual increase in cash value that inures to the benefit of the employee/donee.

The Regulations illustrate the annual taxation of incremental build-up with the following example:

> Employer and employee enter into a split dollar arrangement and the employer owns the policy. The agreement provides on the termination of the contract, or the employee's death, the employer will receive the lesser of the premiums paid or the cash value in the contract. The employee is to receive the remaining amounts. The example further shows that the death benefit protection is $1,500,000 and the annual premium is $60,000 for three years. The policy cash value on December 31 of year one is $55,000; year two, $140,000; and year three, $240,000.

Under the analysis provided in the illustration in year one, the employee reports as an economic benefit the cost of term coverage on $1,445,000 of life

insurance protection ($1,500,000 less $55,000 cash value payable to the employer). In year two, the employee reports $90,000, which represents the excess of cash value above the two year's of premium paid by R to which the employee is entitled and the current term cost of $1,360,000 of coverage ($1,500,000 less $120,000 payable to the employer and $20,000 of the policy cash value employee included in income in year two). Finally in year three, the employee reports $40,000 of incremental build-up for that year ($240,000 cash value less $180,000 payable to the employer and $20,000 increment reported in year two). The employee also reports the term cost of current life insurance protection of $1,260,000 ($1,500,000 less $180,000 of premium payable to the employer and $60,000 of incremental build-up included in the employee's income for years two and three).

The result in the illustrations applies even though the arrangement does not give direct access to the employee to borrow or otherwise use the cash value as it accretes to the employee's benefit. The Regulations instead impute the income if a non-owner has current access to a portion of the policy cash value. Current access is defined very broadly. In addition to the obvious ability of the employee to have direct or indirect access to the cash value, access is imputed if the cash value is inaccessible to the owner or the owner's creditors. Further, if the policy incurs a loss for the year, it appears that the Regulations do not allow the deduction of that loss.

Private Equity Split Dollar.

The use of private split dollar arrangements has existed for some time, and has been acknowledged, but perhaps not legitimized, by the IRS since 1996. In two 1996 private split dollar rulings, the parties entered into a non-equity arrangement whereby the donor in the family situation was to get back the greater of cash or gross premiums paid. The language in the rulings, however, did not require the arrangement to be non-equity and many such arrangements have been structured as equity private split dollar, returning to the owner the excess of the cash value over premiums paid. Applying the same tax rationale of the income taxation of split dollar endorsement agreements in the employment context, the IRS would assert that a taxable gift had been made on an annual basis to the extent of the incremental buildup in the private context.

If the parties to a grandfathered split dollar arrangement attempt to amend the agreement to convert from equity to non-equity, they have unquestionably materially modified the arrangement and are thus governed by the Regulations. Logically, it would appear that they would be thrown into the below-market interest regime of Section 7872. As indicated above, however, the Regulations specifically provide that if the arrangement provides the employee/donee only with insurance coverage, the employer/donor will be deemed to be the owner of the policy and thus the parties would continue under the economic benefit regime. This redefinition of ownership would allow a conversion of equity private split dollar to non-equity and the retention of economic benefit reporting. It would avoid additional gift tax at the

termination of the arrangement because of cash value buildup and would allow the continuation of the taxation under the economic benefit regime. The parties, however, must modify the agreement before there is equity attributable to the employee/donee. Termination at that point will result in the consideration of the equity as an additional gift.

The results of the retention of the economic benefit treatment can be highly significant. The term cost particularly—in second-to-die policies—may be much less than the amounts that will be paid under the below-market interest regime.

MATERIAL MODIFICATION

Because the old split dollar rules apply to arrangements entered into before the September 18, 2003, the parties should be careful not to modify the arrangement thereafter in any material way unless they do so intentionally. A material modification of pre-existing arrangements will make the Regulations applicable. The Regulations provide the following non-inclusive list of modifications that do not constitute material modifications:

(a) Change in mode of premium payment;

(b) Change of beneficiary, unless the beneficiary is party to the arrangement;

(c) Change in the interest payment on a policy loan;

(d) A change to preserve the status of the life insurance contract under Regs. §7702;

(e) Change solely for ministerial provision;

(f) Change mandated under a pre-September 18, 2003 split dollar agreement;

(g) Change in the owner as the result of a corporate acquisition;

(h) Change to policy required by a court or insurance commissioner required by insolvency; or

(i) A change solely in the insurance company that administers the policy as the result of the assumption of a reinsurance transaction. Reg. §1.61-22(j)(2)(ii).

The most interesting question raised by this fairly exhaustive list of non-material modifications is why a tax-free exchange of policies under Section 1035 is not listed. The ABA Split Dollar Task Force, in written comments dated December 31, 2002 submitted to the IRS, as well as in conferences with the IRS, raised the tax-free exchange as an assumed non-material modification. It did not appear to be a controversial issue.

Its absence, however, is quite troubling and one cannot assume that it would constitute a non-material change. Any party considering a swap of policies would be well advised to attempt to obtain a private letter ruling from the IRS that the swap was not a material change. It is conceivable that the IRS may wish to proceed on a case-by-case basis to determine the economic motivations behind the swap. For example, if there was significant equity buildup, the parties could attempt a swap of policies with much large death benefits and a reduction in cash value for greater death benefit coverage. The IRS may have perceived such an effort as a material

economic modification and one that would put it under the new regime. It would then conceivably throw the parties into an interest-free loan and force the parties to recognize the equity buildup at the time of the conversion under a sale and exchange theory under Section 61.

SPLIT DOLLAR LOANS

In contrast to the economic benefit rules, the loan regime for the taxation of split dollar agreements treats the arrangement as a loan between the parties that is governed by the general tax rules for debt instruments, including the original issue discount rules of IRC §§1271-1275, if the note carries sufficient interest. If the split dollar loan is a below-market loan, as will typically be the case, then its treatment will be governed by IRC §7872 and Reg. §1.7872-15. As noted previously, treatment of a split dollar arrangement under the loan regime is mutually exclusive with taxation under the economic benefit regime.

The Regulations are concerned predominantly with measuring adequate interest, the waiver of interest, indirect payments of interest, and the like. Whereas it is necessary to define these cases, the vast majority of split dollar loans are—and will be—either completely interest free or, much less often, provide for adequate interest. If no interest is charged, the majority of the Reg. §1.7872-15 rules are inapplicable, beyond determining the amount and timing of the forgone interest charge. If adequate interest in charged, the rules do not apply at all.

Similarly, it is very rare to come across a pure term split dollar loan in practice. In the context of employment, the employer almost always will require that the continuance of the agreement is dependent on the employee's continued

employment or be terminated upon the employee's death, both of which are subject to the hybrid term loan rules. In the private split dollar loan context, the loan will, in almost all instances, be a gift loan and terminate upon the death of the insured, which also will fall under the hybrid term loan rules.

<u>Interest Provisions.</u>

The Regulations have several provisions to prevent circumventing the below market interest rules, one of which is found in Reg. §1.7872-15(a)(4). This section provides that certain interest provisions provided for in split dollar loan arrangements are disregarded. If a split dollar loan agreement provides for the payment of interest by the borrower, but the lender will in fact, directly or indirectly, pay that interest, then the requirement for the borrower's payment of the interest is disregarded. The examples provide an illustration of this rule in which, concurrent with the execution of a split dollar loan agreement that obligates the borrower to pay interest to the lender, the lender and borrower enter into a deferred compensation arrangement whereby the borrower will pay to the lender an amount equal to the borrower's interest obligation each year. Under this scenario, the final Regulations provide that the borrower's obligation to pay interest to the lender will be disregarded and the agreement will be treated as an interest-free loan for purposes of its taxation.

<u>Waiver of Interest – Deferral Charge.</u>

Reg. §1.7872-15(h) generally provides that any accrued but unpaid interest on a split dollar loan that is subsequently waived, cancelled or forgiven will be

treated as if the interest had, in fact, been paid to the lender and then retransferred by the lender to the borrower. The Regulations add a provision to clarify that payments from the lender to the borrower that are in substance a waiver, cancellation or forgiveness of accrued, but unpaid, interest will be treated as amounts paid by the borrower to the lender and retransferred to the borrower on that date. The Regulations also provide that underpayments of interest on split dollar loans will be subject to a deferral charge, which is essentially equal to: (a) the underpaid amount, multiplied by (b) the highest rate of income tax applicable to the borrower for the taxable year in which the underpayment occurred, multiplied by (c) the average of the quarterly underpayment rates in effect under §6621(a)(2) for the applicable period.

Non-Recourse Loans.

In the case of a below market split dollar loan, the repayment of which is non-recourse to the borrower (such as in the case where the lender's sole recourse for nonpayment is against the cash value in the policy), the parties to the loan are required to execute a written representation that a reasonable person would believe that all payments under the note will be made, or they will be subject to the contingent payment rules of Reg. §1.7872-15(j). If this is the case, the parties may find that the tax repercussions are unfavorable, particularly if the arrangement provides for a split dollar term loan.

If the non-recourse loan is subject to the contingent payment method, there is some uncertainty about how those rules would apply. The contingent split dollar

loan provisions in Reg. §1.7872-15(j)(3)(ii)(D) make reference to contingent payments in the demand loan context. If the foregone interest payments on a split dollar demand loan are deemed transferred and retransferred each year, rather than all transferred in the year of the loan, based on the present value of future payments as in the case of a split dollar term loan, how would the contingent split dollar loan rules apply?

The Regulations require that for payments under non-recourse loans to qualify for the exception to avoid treatment as contingent payments, the parties must provide a written representation that states that a reasonable person would expect that all payments under the loan will be made. The representation must be signed by both the borrower and the lender, not later than the last day for filing the federal income tax return of either the borrower or the lender, whichever is earlier, for the tax year in which the lender makes the first split dollar loan. The representation must include the names, addresses and taxpayer identification numbers of both the borrower and the lender, as well as any indirect participants in the split dollar arrangement. This requirement effectively puts the IRS on notice of the split dollar arrangement and may increase the likelihood of audit. Because most split dollar loans are non-recourse to the borrower, this notice requirement will be frequently applied.

Of considerable concern may be the availability of this exception depending on the circumstances of the split dollar agreement. Particularly in the context of a split dollar demand loan, there is a question as to whether a "reasonable person"

would expect that all payments under the loan will be made. If the loan is non-recourse to the borrower and is secured only by the cash surrender value of the policy, is it reasonable to assume that the agreement will not be terminated prior to the point at which the cash surrender value exceeds the repayment obligation to the lender? Other than the borrower's assumed desire to increase the cash surrender value in the policy to the largest amount possible, there is no incentive for the borrower to see that the agreement stays in place until there is sufficient cash surrender value to repay the lender.

The determination of whether a reasonable person would expect all payments to be made under the loan is questionable under certain fact scenarios. If, for instance, in the context of an employment arrangement, the loan is not payable upon demand by the lender but will become due upon the termination of employment, and the cash value in the policy will not equal or exceed the premiums advanced for a number of years, is it reasonable to assume that the employee will not depart the employment prior to the equity cross over point in the cash value? If the obligation is non-recourse to the borrower and he is unhappy in his job, what is really to keep him from leaving? On the other hand, any policy in which the cash value will exceed the premiums paid within the first five years is probably a safe bet to assume it will reach that point prior to the termination of the agreement. This area is a deep shade of gray at this point and the Service has offered no guidance.

Frequency of Split Dollar Loans.

The Regulations treat each and every advancement of premiums as a separate loan. If a split dollar demand loan is utilized and premiums are paid on a monthly basis, then up to twelve different interest amounts per year must be calculated to determine the aggregate amount of forgone interest when the transfer of interest compensation (or gift) to the policy owner is deemed to occur on the last day of the year.

Worse yet, if a split dollar term loan is used, and premiums are advanced on a monthly basis but the entire aggregate loan amount is due on the same date, each and every advance of funds will have a separate AFR and term. Each monthly loan will result in the recognition of income by the borrower in an amount equal to the amount of the loan less the present value of the future payment.

Loan Treatment.

§1.7872-15(a)(2) treats the non-owner of the policy as the lender, while the owner is considered the borrower. It further provides that a payment made pursuant to a split dollar arrangement will be considered a loan for Federal tax purposes if the following three requirements are met:

1) The payment is made either directly or indirectly by the non-owner to the policy owner (including a payment by the non-owner directly to the insurance company on behalf of the owner);

2) The payment is a loan under general principals of Federal tax law or, if not, then a reasonable person would expect the payment to be repaid in full to the non-owner (either with or without interest); and

3) The repayment is to be made from, or is secured by, either the death benefit proceeds or the cash surrender value of the policy.

Section 7872 and the Regulations thereunder mandate that the foregone interest under an interest-free or below-market loan from the employer will be treated as compensation paid to the employee and then repaid to the employer as an interest payment, causing the employer to recognize income equal to that amount. The employer would have an offsetting deduction under §162 for the compensation deemed paid to the employee. The foregone interest is the amount of interest that would be owed if the appropriate AFR for the type of loan in question was used, less the actual amount of interest charged.

Three Types of Split Dollar Loans.

Under the Regulations, there are three types of split dollar loans, each with distinct tax treatment. Reg. §1.7872-15(b) defines the two basic types of split dollar loans as a demand loan or a term loan. Certain term loans receive special treatment and are often referred to as "hybrid" loans. The three types of loans are discussed below.

Split Dollar Demand Loans. A split dollar demand loan is one that is repayable in full at any time on the demand of the lender, or within a reasonable time after the lender's demand for repayment. Reg. §1.7872-15(b)(2). Under a split

dollar demand loan, the employer is deemed to pay as compensation to the employee the amount of foregone interest, and the employee is deemed to simultaneously repay that amount to the employer as interest paid on the loan. These transfers are deemed to occur on the last day of the calendar year to which they are attributable. Reg. §1.7872-15(e)(3)(iii)(B). The interest rate deemed to be paid on any split dollar demand loan outstanding for at least one year will be the blended annual rate published annually by the Service, which is the average of the applicable federal rates ("AFR") for demand loans outstanding for the entire year. Reg. §1.7872-15(e)(3)(iii)(B)(1).

In practice, the split dollar demand loan is the most common type of loan utilized in the employment context, because it is typical for either party to the split dollar agreement to have the right to cancel the agreement at any time after 30 days (or some other relatively short time period) notice. Upon termination of the agreement, the amount owed to the lender is typically due immediately.

In the context of a private split dollar loan, it may be best to exclude a unilateral termination provision if it is contemplated that the note held by the lender may be gifted by the lender at a later date. A discount from the face value of the note should be available if the ultimate timing of its repayment is uncertain. The inclusion of a unilateral termination provision in the agreement will vitiate the discount applicable to the note, because the transferee would be able to effectively call the debt at any time, which would fix the value of the obligation.

Split Dollar Term Loans. Reg. §1.7872-15(b)(2) defines a split dollar term loan as any split dollar loan other than a demand loan, unless payable on the death of an individual or conditioned on the future performance of substantial services by an individual. The term of a split dollar term loan generally will be the period from the date the loan is made until the loan's stated maturity date. As discussed earlier, true term loans are uncommon in the context of split dollar loans.

The interest rate deemed to be charged on a split dollar term loan will be the appropriate short, mid or long-term AFR in effect on the date the loan is made. On that date, the employee will be considered to have received an amount of compensation equal to the amount of the loan minus the present value of all future payments required to be made under the terms of the loan. Reg. §1.7872-15(e)(4)(iv). The amount of imputed income recognized by an employee upon the issuance of an interest-free term loan could be quite large if repayment is not required for a number of years.

Split Dollar Hybrid Loans. A split dollar hybrid loan is a split dollar term loan that is either: 1) payable not later than the death of the borrower; or 2) nontransferable and conditioned on the future performance of substantial services by the employee, as such terms are treated within the meaning of §83. Reg. §1.7872-15(b)(3), and (e)(5)(ii) and (iii). Split dollar term loans that are in the nature of a gift are also governed by similar rules.

Split Dollar Loan Payable Not Later Than the Death of the Borrower.

In the case of a split dollar term loan that is payable upon the death of the borrower (or the insured if someone other than borrower), the loan will be treated as a split dollar demand loan, as far as the timing of the interest payments is concerned, with the annual transfer and retransfer of interest. Unlike the demand loan, however, the appropriate AFR in effect on the date the loan is made will determine the amount of the foregone interest, rather than using the blended annual rate as with a typical demand loan. Reg. §1.7872-15(e)(5)(ii)(B).

Reg. §1.7872-15(e)(5)(ii)(C) states that the term of a split dollar loan payable on the earlier of the term certain or the death of the individual will be whichever is shorter. The term based on the death of an individual will be equal to the life expectancy of that person determined under the appropriate table in §1.72-9 on the day the loan is made.

Split Dollar Loan Conditioned on the Future Performance of Substantial Services. A split dollar loan that is not transferable and is conditioned on the future performance of substantial services by an individual is considered to have a term equal to the period from the date the loan is made until its stated maturity date, or seven years if no maturity date is given. For each year that the loan is outstanding, the AFR used in the determination of forgone interest is not the blended annual rate, but is instead the AFR appropriate for the loan's term for the month in which the loan is made. Reg. §1.7872-15(e)(5)(iii).

Gift Split Dollar Term Loans. Whether a gift split dollar term loan bears sufficient interest will be determined in the same fashion as a regular split dollar term loan. If the gift loan does not bear sufficient interest it will be treated as a split dollar hybrid loan, where the transfer and retransfer of interest occurs annually, as with a demand loan. As is the case with the other two types of split dollar hybrid loans, rather than using the blended annual rate, the amount of foregone interest is determined by reference to the appropriate AFR in effect at the time the loan was made. The term of a gift split dollar term loan will be the period from the time it is made until its stated maturity date: if no maturity date is stated, it will be assumed to be seven years. Reg. §1.7872-15(e)(5)(iv)(C).

The hybrid treatment described in the preceding paragraph only applies to gift split dollar term loans for Federal income tax purposes. For gift tax purposes under Chapter 12, the amount of the gift in the form of foregone interest will be determined under the typical term loan principals. The amount of the gift in such a situation will be equal to the amount of the loan, less the present value of all future payments, using a discount rate equal to the appropriate short, mid or long term AFR in effect at the time of the loan. Reg. §1.7872-15(e)(5)(iv)(D).

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