

OMB determined that this rule is a "significant regulatory action" as defined in section 3(f) of the Order (although not economically significant, as provided in section 3(f)(1) of the Order). Any changes made to the rule subsequent to its submission to OMB are identified in the docket file, which is available for public inspection in the Regulations Division, Room 10276, Office of General Counsel, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410-0500.

#### *Environmental Impact*

A Finding of No Significant Impact with respect to the environment was made at the interim rule stage in accordance with HUD regulations at 24 CFR part 50, which implement section 102(2)(C) of the National Environmental Policy Act of 1969 (42 U.S.C. 4332). The Finding remains applicable to this final rule and is available for public inspection between the hours of 8 a.m. and 5 p.m. weekdays in the Regulations Division, Room 10276, Office of General Counsel, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410-0500.

#### *Unfunded Mandates Reform Act*

Title II of the Unfunded Mandates Reform Act of 1995 (2 U.S.C. 1531-1538) establishes requirements for federal agencies to assess the effects of their regulatory actions on state, local, and tribal governments and the private sector. This rule does not impose any federal mandates on any state, local, or tribal governments or the private sector within the meaning of the Unfunded Mandates Reform Act of 1995.

#### *Executive Order 13132, Federalism*

Executive Order 13132 (Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial direct compliance costs on state and local governments and is not required by statute, or the rule preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This rule is exclusively concerned with homeownership voucher assistance. This rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

#### *Impact on Small Entities*

The Secretary, in accordance with the Regulatory Flexibility Act (5 U.S.C. 605(b)) (RFA), has reviewed and

approved this rule and in so doing certifies that this rule will not have a significant economic impact on a substantial number of small entities. The reasons for HUD's determination are as follows:

(1) *A Substantial Number of Small Entities Will Not be Affected.* rule is exclusively concerned with public housing agencies that administer tenant-based housing assistance under section 8 of the United States Housing Act of 1937. Under the definition of "small governmental jurisdiction" in section 601(5) of the RFA, the provisions of the RFA are applicable only to those few PHAs that are part of a political jurisdiction with a population of under 50,000 persons. The number of entities potentially affected by this rule is therefore not substantial.

(2) *No Significant Economic Impact.* The rule does not change the amount of funding available under the Housing Choice Voucher Program. Accordingly, the economic impact of this rule will not be significant, and it will not affect a substantial number of small entities.

#### *Catalog of Domestic Assistance Number*

The Catalog of Domestic Assistance Number for the Housing Choice Voucher Program is 14.871.

#### **List of Subjects in 24 CFR Part 982**

Grant programs—housing and community development, Housing, Rent subsidies, Reporting and recordkeeping requirements.

■ Accordingly, for the reasons stated in the preamble, the interim rule for part 982 of title 24 of the Code of Federal Regulations, published on October 28, 2003, 67 FR 65864, as corrected on November 6, 2003, 67 FR 67522, is promulgated as final, without change.

Dated: September 9, 2003.

**Michael M. Liu,**

*Assistant Secretary for Public and Indian Housing.*

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## **DEPARTMENT OF THE TREASURY**

### **Internal Revenue Service**

#### **26 CFR Parts 1, 31, and 602**

**[TD 9092]**

**RIN 1545-BA44**

#### **Split-Dollar Life Insurance Arrangements**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations relating to the income, employment, and gift taxation of split-dollar life insurance arrangements. The final regulations provide needed guidance to persons who enter into split-dollar life insurance arrangements.

**DATES:** Effective Date: These regulations are effective September 17, 2003.

**Applicability Dates:** For dates of applicability of the final regulations, see §§ 1.61-22(j), 1.83-3(e), 1.83-6(a)(5)(ii), 1.301-1(q)(4), and 1.7872-15(n).

#### **FOR FURTHER INFORMATION CONTACT:**

Concerning the section 61 regulations, please contact Elizabeth Kaye at (202) 622-4920; concerning the section 83 regulations, please contact Erinn Madden at (202) 622-6030; concerning the section 301 regulations, please contact Krishna Vallabhaneni at (202) 622-7550; concerning the section 7872 regulations, please contact Rebecca Asta at (202) 622-3930; and concerning the application of these regulations to the Federal gift tax, please contact Lane Damazo at (202) 622-3090.

#### **SUPPLEMENTARY INFORMATION:**

##### **Paperwork Reduction Act**

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1792. The collections of information are in § 1.7872-15(d)(2) and (j)(3)(ii). Responses to these collections of information are required by the IRS to verify consistent treatment by the borrower and lender of split-dollar loans with nonrecourse or contingent payments. In addition, in the case of a split-dollar loan that provides for nonrecourse payments, the collections of information are voluntary and are required to obtain a benefit (that is, the treatment of a nonrecourse split-dollar loan as a noncontingent split-dollar loan).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent varies from 15 minutes to 30 minutes, depending on individual circumstances, with an estimated average of 17 minutes.

Comments concerning the accuracy of this burden estimate and suggestions for

reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

## Background and Explanation of Provisions

### 1. Summary of the Prior Notices of Proposed Rulemaking

On July 9, 2002, a notice of proposed rulemaking (REG-164754-01) was published in the **Federal Register** (67 FR 45414) proposing comprehensive rules for the income, gift, employment, and self-employment taxation of equity and non-equity split-dollar life insurance arrangements (the 2002 proposed regulations). In general, a split-dollar life insurance arrangement is an arrangement between two or more parties to allocate the policy benefits and, in some cases, the costs of a life insurance contract. Under an equity split-dollar life insurance arrangement, one party to the arrangement typically receives an interest in the policy 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. Under a non-equity split-dollar life insurance arrangement, one party typically provides the other party with current life insurance protection but not any interest in the policy cash value.

The 2002 proposed regulations provide two mutually exclusive regimes for taxation of split-dollar life insurance arrangements—a loan regime and an economic benefit regime. Under the loan regime (which is set forth in § 1.7872-15 of the 2002 proposed regulations), the non-owner of the life insurance contract is treated as loaning the amount of its premium payments to the owner of the contract. The loan regime generally governs the taxation of collateral assignment arrangements. Under the economic benefit regime (which is set forth in § 1.61-22(d) through (g) of the 2002 proposed regulations), the owner of the life insurance contract is treated as

providing economic benefits to the non-owner of the contract. The economic benefit regime generally governs the taxation of endorsement arrangements. The 2002 proposed regulations reserved on the rules for valuing economic benefits provided to the non-owner under an equity split-dollar life insurance arrangement governed by the economic benefit regime, pending receipt of comments from interested parties.

On May 9, 2003, a notice of proposed rulemaking (REG-164754-01) was published in the **Federal Register** (68 FR 24898) proposing rules for the valuation of economic benefits under an equity split-dollar life insurance arrangement governed by the economic benefit regime (the 2003 proposed regulations). The 2003 proposed regulations provide that, in the case of an equity split-dollar life insurance arrangement, the value of the economic benefits provided to the non-owner under the arrangement for a taxable year equals 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).

A public hearing on the 2002 proposed regulations was held on October 23, 2002, and a public hearing on the 2003 proposed regulations was held on July 29, 2003. In addition, interested parties submitted comments on the 2002 proposed regulations and on the 2003 proposed regulations.

### 2. Overview of the Final Regulations

These final regulations provide guidance on the taxation of split-dollar life insurance arrangements and apply for purposes of Federal income, employment, self-employment, and gift taxes. After consideration of all comments, the 2002 and 2003 proposed regulations are adopted as amended by this Treasury decision. In general, the amendments are discussed below.

#### Definition of Split-Dollar Life Insurance Arrangement

The final regulations generally define a split-dollar life insurance arrangement as any arrangement between an owner of a life insurance contract and a non-owner of the contract under which either party to the arrangement pays all or part of the premiums, and one of the parties paying the premiums 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 contract. The definition does not cover the purchase of an insurance contract in which the only parties to the arrangement are the policy owner and the life insurance company acting only in its capacity as issuer of the contract.

The final regulations also retain the special rules from the 2002 proposed regulations that treat certain arrangements entered into either in connection with the performance of services or between a corporation and another person in that person's capacity as a shareholder in the corporation as split-dollar life insurance arrangements regardless of whether the arrangements otherwise satisfy the general definition of a split-dollar life insurance arrangement. Neither the general rule nor the special rules cover so-called "key man" life insurance arrangements under which a company purchases a life insurance contract to insure the life of a "key" employee or shareholder but retains all the rights and benefits of the contract (including the rights to all death benefits and cash value).

The IRS and Treasury are concerned that certain arrangements may be inappropriately structured to avoid the application of these regulations (for example, by using separate life insurance contracts that are, in substance, one life insurance contract). The Commissioner will use existing authority to challenge any such transaction.

#### Mutually Exclusive Regimes

The final regulations retain the approach of using two mutually exclusive regimes—an economic benefit regime and a loan regime—for determining the tax treatment of split-dollar life insurance arrangements. As under the 2002 proposed regulations, ownership of the life insurance contract determines which regime applies. Several commentators on both the 2002 and the 2003 proposed regulations argued that the use of the two mutually exclusive regimes is an artificial and rigid approach that fails to account adequately for the economic reality of a split-dollar life insurance arrangement. However, the IRS and Treasury believe that the final regulations, like the 2002 and 2003 proposed regulations, properly account for the division of the costs and benefits of a split-dollar life insurance arrangement.

Several commentators asked that taxpayers be permitted to elect which regime would apply to their split-dollar life insurance arrangements. However,

in the view of the IRS and the Treasury, taxpayers effectively have the ability to elect which regime will apply by designating one party or the other as the owner of the life insurance contract.

One commentator asserted that there is no authority under section 7872 to treat payments made pursuant to split-dollar life insurance arrangements as loans. Therefore, this commentator recommends that taxation of split-dollar life insurance arrangements under section 7872 should occur only if affirmatively elected by the parties to the arrangement. The IRS and Treasury believe there is sufficient authority to require the application of section 7872 to split-dollar life insurance arrangements. There is no legislative history indicating that Congress did not intend section 7872 to apply to payments made pursuant to these arrangements.

A number of commentators expressed concern about the possible application of section 402 of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), Public Law 107-204, to all or certain split-dollar life insurance arrangements entered into by companies subject to Sarbanes-Oxley. These regulations do not address this issue, as interpretation and administration of Sarbanes-Oxley fall within the jurisdiction of the Securities and Exchange Commission.

The final regulations adopt the general rule in the 2002 proposed regulations for determining which regime applies to a split-dollar life insurance arrangement. The 2002 proposed regulations provided a special rule that the economic benefit regime applied to a split-dollar life insurance arrangement if the arrangement is entered into in connection with the performance of services, and the employee or service provider is not the owner of the life insurance contract; or the arrangement is entered into between a donor and a donee (for example, a life insurance trust) and the donee is not the owner of the life insurance contract. The final regulations adopt this special rule, but provide that this rule applies when the employer, service recipient or donor is the owner.

The final regulations add a rule regarding the treatment of a transfer of a life insurance contract under a split-dollar life insurance arrangement from an owner to a non-owner when payments under the arrangement had been treated, prior to transfer, as split-dollar loans under § 1.7872-15. Under this rule, the economic benefit regime applies to the split-dollar life insurance arrangement from the date of the transfer and the payments made (both before and after the transfer) are not

treated as split-dollar loans on or after the date of the transfer. The transferor of the life insurance contract must fully take into account all economic benefits provided under the split-dollar life insurance arrangement.

#### Owners and Non-Owners

The final regulations generally retain the rules in the 2002 proposed regulations for determining the owner and the non-owner of the life insurance contract. Thus, the owner generally is the person named as the policy owner. If two or more persons are designated as the policy owners, the first-named person generally is treated as the owner of the entire contract.

Several commentators argued that determining tax ownership based on whom the parties name as the policy owner of the life insurance contract represents a departure from general tax principles. Commentators suggested that a split-dollar life insurance arrangement is like any co-ownership situation in which two or more parties agree to share in the costs and benefits of a policy such that each party will be entitled to exercise certain rights with respect to the underlying policy and will have certain responsibilities.

The IRS and Treasury disagree with that argument. Split-dollar life insurance arrangements are structured in myriad ways, some formally as loans to the employee (for example, collateral-assignment arrangements), some formally as co-ownership arrangements between the employer and the employee, and some as arrangements in which the employer is, in form, the sole owner (for example, endorsement arrangements). In addition, split-dollar life insurance arrangements ordinarily involve division of the benefits and costs of the life insurance contract, but the division of benefits ordinarily does not correspond to the division of costs. Because the division of the burdens and benefits of the life insurance contract vary widely in split-dollar life insurance arrangements, and because title ownership generally is a factor in determining tax ownership, it is reasonable to determine tax ownership based on who is the named owner of the policy. In addition, this rule provides a clear objective standard so that both taxpayers and the IRS can readily determine which regime applies under the final regulations.

If two or more persons 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 persons are treated as owners of separate contracts for

purposes of these regulations (although not for purposes of section 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 the 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 Commissioner will consider all of the facts and circumstances of an arrangement to determine whether the parties have appropriately characterized the arrangement as one involving undivided interests and, therefore, not subject to these regulations.

The final regulations provide attribution rules for compensatory split-dollar life insurance arrangements. Under these rules, 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 sections 414(b) and 414(c)), a trust described in section 402(b) (sometimes referred to as a "secular trust"), a grantor trust treated as owned by the employer (including a rabbi trust), or a welfare benefit fund (within the meaning of section 419(e)(1)).

The final regulations retain the special rule for non-equity split-dollar life insurance arrangements. Under this special rule, non-equity arrangements entered into in a compensatory context or a gift context will be subject to the economic benefit regime. The final regulations provide rules for determining the tax treatment of the arrangement if the parties subsequently modify the arrangement so that it is no longer a non-equity arrangement. If, immediately after the modification, the employer, service recipient, or donor is the owner of the life insurance contract (determined without regard to the special rule for non-equity arrangements), the employer, service recipient, or donor continues to be treated as the owner of the life

insurance contract (such that the normal rules of the economic benefit regime for equity split-dollar life insurance arrangements will apply). If, immediately after the modification, the employer, service recipient, or donor is not the owner, the employer, service recipient, or donor 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.

### 3. Taxation Under the Economic Benefit Regime

#### a. In General

The final regulations retain the basic rules for taxation under the economic benefit regime that had been set forth in the 2002 and 2003 proposed regulations. Thus, the final regulations provide that, for these arrangements, the owner of the life insurance contract is treated as providing economic benefits to the non-owner of the contract, 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.

The tax consequences of the provision of economic benefits 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 distribution under section 301, a capital contribution, a gift, or a transfer having a different tax character. The benefit must be taken into account based on its character. For example, 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. In a split-dollar life insurance arrangement in which a donor provides economic benefits to 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 section 102.

#### Non-Equity Split-Dollar Life Insurance Arrangements

Under the final regulations, the tax treatment of a non-equity split-dollar arrangement generally follows the tax treatment of a non-equity split-dollar arrangement under Rev. Rul. 64-328 (1964-2 C.B. 11) and its progeny. The proposed regulations required that the average death benefit for the taxable year be used to compute current life insurance protection. Commentators objected to the use of an "average" death benefit. They explained that the computation of the average death benefit imposed additional administrative burdens on life insurance companies as well as both owners and non-owners. In addition, the commentators stated that the proposed regulations were not clear on how the average death benefit for the taxable year was to be determined. As an alternative, the commentators suggested that the death benefit as of the policy anniversary date would be an appropriate measure of the death benefit for purposes of determining current life insurance protection. In response to these commentators, the final regulations provide that, subject to an anti-abuse rule, 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 Commissioner.

#### Equity Split-Dollar Life Insurance Arrangements

The final regulations generally retain the rules set out in the 2002 and 2003 proposed regulations for the taxation of equity split-dollar life insurance arrangements. Therefore, the value of the economic benefits provided by the owner to the non-owner for a taxable year equals 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 owner and the non-owner also must account fully and consistently for any right in, or benefit of, a life insurance contract provided to the non-owner under an equity split-dollar life insurance arrangement.

The final regulations provide that the non-owner has current access to any

portion of the policy cash value to which the non-owner has a current or future right and that currently is directly or indirectly accessible by the non-owner, inaccessible to the owner, or inaccessible to the owner's general creditors. As indicated in the preamble of the 2003 proposed regulations, the IRS and Treasury intend that the concept of "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. Thus, for example, a non-owner has access to policy cash value if the non-owner can directly or indirectly make a withdrawal from the policy, borrow from the policy, or effect a total or partial surrender of the policy. Similarly, for example, the non-owner has access if the non-owner can anticipate, assign (either at law or in equity), alienate, pledge, or encumber the policy cash value or if the policy cash value is available to the non-owner's creditors by attachment, garnishment, levy, execution, or other legal or equitable process. Policy cash value is inaccessible to the owner if the owner does not have the full rights to policy cash value normally held by an owner of a life insurance contract. Policy cash value is inaccessible to the owner's general creditors if, under the terms of the split-dollar life insurance arrangement or by operation of law or any contractual undertaking, the creditors cannot, for any reason, effectively reach the policy cash value in the event of the owner's insolvency.

Commentators on the 2003 proposed regulations generally objected to the rule requiring the non-owner under an equity arrangement to include in income the portion of the policy cash value to which the non-owner has current access. Several commentators argued that section 72(e) specifically provides for tax-free inside build-up under a life insurance contract, precluding any taxation of policy cash value to the non-owner prior to a "realization event" (such as rollout of the policy). That argument ignores the plain language of section 72(e)(1), which states that the rules of section 72(e) apply only if no other provision of subtitle A of the Internal Revenue Code (Code) applies. In the case of an equity arrangement subject to the economic benefit regime, the relationship between the owner and the non-owner and the terms of the arrangement between them ordinarily make other provisions of subtitle A applicable, such as section 61(a)(1).

The tax-deferred inside build-up provided by section 72(e) properly

applies only to the taxpayer that owns the life insurance contract. If the owner of the contract provides any of the rights or benefits under the contract to another taxpayer, that provision of rights and benefits is subject to tax under the rules that otherwise follow from the relationship between the parties. For example, this result applies whenever an employer that owns a life insurance contract compensates an employee by giving the employee rights to the policy cash value. In that case, the employer (as the owner of the contract) enjoys tax-deferred inside build-up under section 72(e), but the employee has gross income under section 61(a)(1) equal to the value of the economic benefit attributable to the employee's rights to the policy cash value. Thus, the regulations are consistent with section 72(e).

Other commentators generally acknowledged that the 2003 proposed regulations properly tax the non-owner whenever the non-owner has "current access" to the policy cash value in an equity arrangement but argued that the tax should be imposed under section 83 rather than under section 61. In effect, these commentators argued that the employee's current access to policy cash value should give rise to transfers of property with respect to portions of the life insurance contract. The commentators argued that the primary difference between this suggested approach and the approach set out in the 2003 proposed regulations would be the treatment of inside build-up on amounts already taxed to the non-owner. Specifically, the commentators argued that, under the proposed section 83 approach, inside build-up on amounts already taxed to the non-owner would be tax-free to the non-owner under section 72(e); under the approach of the 2003 proposed regulations, the subsequent inside build-up is tax-deferred to the owner but not to the non-owner.

The IRS and Treasury believe that the approach set out in the 2003 proposed regulations remains appropriate and so have not followed the suggestion to adopt a section 83 approach. Section 83 applies only in connection with a transfer of property, but a non-owner may have currently includible income by reason of another rule—such as the doctrines of constructive receipt, cash equivalence, or economic benefit. It would be inappropriate to limit current taxation to circumstances that constitute transfers of property under section 83, and it would be inappropriate in this context to apply section 83 to circumstances that give rise to income

under other Code provisions or judicial doctrines.

Several commentators raised questions about the effect of state law limitations on access to policy cash value by the owner's creditors. These commentators read Example 2 in the 2003 proposed regulations as stating that any such state law restriction would in and of itself cause the non-owner to have current access to the policy cash value. Thus, these commentators argued, the 2003 regulations potentially imposed current tax on the policy cash value of any non-equity arrangement where state law limited the rights of the owner's creditors to reach the policy cash value. However, Example 2 indicated that the owner there had the right to receive the lesser of the policy cash value or total premiums; in other words, Example 2 indicated that the arrangement was an equity arrangement. The final regulations clarify that the non-owner has current access to policy cash value only if, under the arrangement, the non-owner has a current or future right to policy cash value; the non-owner will not have any such right in a true non-equity arrangement. If the non-owner does have such a right, any restriction on the owner's creditors to reach policy cash value, whether established by contract or by local law, results in an economic benefit to the non-owner.

Several commentators objected to the rule in the 2003 proposed regulations that the non-owner has current access to any portion of the policy cash value that cannot be accessed by the owner. These commentators argued that as long as policy cash value can be accessed by the owner's creditors in the event of insolvency, the owner should not be viewed as providing any economic benefit to the non-owner. That objection, however, overlooks the economic reality of an equity split-dollar life insurance arrangement. If the owner commits funds to a life insurance contract and undertakes that it will not withdraw those funds from the insurance contract, the amounts so committed do not remain a general asset of the owner. The owner of the life insurance contract in such an arrangement has parted with the ownership and use of the funds for the benefit of the non-owner. This contrasts with an irrevocable rabbi trust, where the employer effectively remains the tax owner of the assets held by the trustee and the rabbi trust assets may still be (and very often are) invested in the employer's business.

In response to the suggestions of commentators, the final regulations provide that the policy cash value, like

the amount of current life insurance protection, is determined as of the last day of the non-owner's taxable year unless the parties agree to use the policy anniversary date. The final regulations retain the anti-abuse rule preventing the parties from manipulating the policy cash value for purposes of determining the value of the economic benefit that the non-owner must take into account and extend that rule to the value of the current life insurance protection.

Taxpayers should note that, in certain cases, a separate tax rule may require a non-owner to include an amount in gross income under an equity split-dollar life insurance arrangement at a time earlier than would be required under these regulations. For example, section 457(f) generally requires an employee of a tax-exempt organization (other than a church organization under section 3121(w)(3)) or of a state or local government to include deferred compensation in gross income when the employee's rights to the deferred compensation are not subject to a substantial risk of forfeiture. An equity split-dollar life insurance arrangement governed by the economic benefit regime constitutes a deferred compensation arrangement.

Accordingly, an employee of a tax-exempt organization or of a state or local government may have to include an amount in gross income attributable to an equity split-dollar life insurance arrangement even if the employee does not have current access to the policy cash value under these regulations.

#### Other Tax Consequences

These final regulations retain the rule of the 2002 proposed regulations that the non-owner has no investment in the contract under section 72(e) prior to a transfer of the contract. The final regulations also retain the rule that any amount paid by the non-owner to the owner for any economic benefit is included in the owner's gross income.

Several commentators objected to the rule providing no investment in the contract to the non-owner for amounts paid to the owner. They argued that section 72(e)(6) provides for such investment in the contract. Commentators also objected to the rule requiring that the owner include in gross income any amount paid by the non-owner. These commentators argued that the owner does not have an accession to wealth as a result of the non-owner's payments because such payments ordinarily are made to fulfill the non-owner's obligation under the split-dollar life insurance arrangement to pay part of the premiums of the life insurance contract.

The regulations generally treat only one person as the owner of the life insurance contract. Because only the owner of a life insurance contract can have an investment in that contract, a non-owner employee cannot have basis in the contract for any of the costs of current life insurance protection. In addition, such costs should not be included in the non-owner's basis or investment in the contract if and when the non-owner becomes the owner of the contract because those payments were made for annual life insurance protection, which protection was exhausted prior to the non-owner's acquisition of the contract. Similarly, the fact that the split-dollar life insurance 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 these cases, the owner is "renting" out part of the benefit of the life insurance contract to the non-owner for consideration; such consideration constitutes income to the owner.

#### b. Taxation of Amounts Received Under the Life Insurance Contract

The final regulations retain the rule in the 2002 proposed regulations that 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 by the owner to the non-owner. As under the 2002 proposed regulations, this rule applies to certain policy loans (referred to in the regulations as "specified policy loans"). Although several commentators objected to this treatment of policy loans, the IRS and Treasury believe that the rule is necessary to ensure that parties to a split-dollar life insurance arrangement do not avoid current taxation of the non-owner with respect to amounts provided to the non-owner through the contract.

The final regulations retain the rule that section 101(a) applies to exclude death benefit proceeds paid to a beneficiary (other than the owner of the life insurance policy) from the gross income of the beneficiary only to the extent such amount is allocable to current life insurance protection provided to the non-owner under the split-dollar life insurance 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. Commentators objected to this rule, arguing that the

section 101(a) exclusion extends to the entire amount of death benefit proceeds paid on the death of the insured. They asserted that there is no authority to limit the exclusion to death proceeds allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account.

The IRS and Treasury disagree with that argument. Under the regulations, the owner is treated as providing economic benefits to the non-owner. Although the section 101(a) exclusion extends to the entire amount of death benefit proceeds, the IRS and Treasury believe that only the amount of the death benefit proceeds attributable to the current life insurance protection for which the non-owner paid or which the non-owner took into account under these regulations is excludable from the income of the non-owner's estate or designated beneficiary.

To the extent the 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 is a separate transfer of cash that is not shielded from tax by the section 101(a) exclusion. Specifically, those proceeds are deemed payable to the owner, and are excluded from the owner's income by reason of the section 101(a) exclusion, and then paid by the owner to the non-owner's beneficiary (whether or not paid to the beneficiary directly by the insurance company) in a transfer to be taken into account under these regulations.

The character of death benefit proceeds transferred or deemed transferred by the owner to the non-owner is determined by the relationship between the owner and the non-owner. Thus, death benefit proceeds received by the beneficiary of a shareholder who is a non-owner that were paid or payable to a corporation will be treated as a taxable 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 service provider who is a non-owner, except that the death benefit proceeds would constitute a compensation payment to the service provider for past services rather than a corporate distribution. This treatment is similar to the situation in Rev. Rul. 61-134 (1961-2 C.B. 250) which also denied exclusion under section 101(a) to death benefits paid under a corporate-owned life insurance

policy. In Rev. Rul. 61-134, various shareholders were the beneficiaries of a corporate-owned life insurance policy by reason of their capacity as shareholders. The ruling concluded that the death benefit proceeds received by the shareholders directly from the insurer constituted a taxable distribution of property from the corporation to the shareholders, even though the proceeds would have been excludable from the corporation's income if they had been paid directly to the corporation.

#### c. Transfer of Life Insurance Contract to the Non-Owner

The final regulations follow the 2002 proposed regulations in determining the tax treatment of a transfer of the life insurance contract from the owner to the non-owner. Consistent with the general rule for determining ownership, the final regulations provide that a transfer of a life insurance contract (or an undivided interest therein) underlying a split-dollar life insurance arrangement occurs on the date that the non-owner becomes the owner of the entire contract (or the undivided interest therein). Unless and until ownership of the contract is formally changed, the owner will continue to be treated as the owner for all Federal income, employment, and gift 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 these final 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 § 1.7872-15. Alternatively, the arrangement will be subject to the loan regime if the payments constitute split-dollar loans under § 1.7872-15.

#### 4. Taxation Under the Loan Regime

##### a. In General

The final regulations generally adopt the rules of the 2002 proposed regulations for the loan regime. Under § 1.7872-15, a payment made pursuant to a split-dollar life insurance arrangement is a split-dollar loan and the owner and non-owner are treated, respectively, as borrower and lender if (i) the payment is made either directly

or indirectly by the non-owner to the owner; (ii) the payment is a loan under general principles of Federal tax law or, if not a loan under general principles of Federal tax law, a reasonable person would expect the payment to be repaid in full to the non-owner (whether with or without interest); and (iii) 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.

Commentators questioned whether the additional standard ("if not a loan under general principles of Federal tax law, a reasonable person would expect the payment to be repaid in full to the non-owner (whether with or without interest)") is necessary. The IRS and Treasury recognize that, in the earlier years during which a split-dollar life insurance arrangement is in effect, 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 its premium payments. Nevertheless, so long as a reasonable person would expect the payment to be repaid in full, the payment is a split-dollar loan under § 1.7872-15, rather than a transfer under § 1.61-22(b)(5) on the date the payment is made. However, the rules in § 1.7872-15(a)(2) do 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, § 1.7872-15(a)(2) will not cause the payment to be treated as a loan. See § 1.61-22(b)(5) for the treatment of payments by a non-owner that are not split-dollar loans. The final regulations include a new rule under § 1.7872-15(a)(4) that disregards certain stated interest if such interest is to be paid directly or indirectly by the lender (or person related to the lender).

Under § 1.7872-15, each payment under a split-dollar life insurance arrangement is treated as a separate loan for Federal tax purposes. Commentators have suggested that treating each payment as a separate loan will be difficult to administer and overly burdensome for certain taxpayers and have suggested allowing an election to treat all payments made during a single year (or single calendar quarter) as one loan (made on a specified date during

the year). However, the final regulations adopt the approach in the 2002 proposed regulations that each premium payment is treated as a separate loan. Treating separate extensions of credit as separate loans is consistent with the 1985 proposed regulations under section 7872 and the legislative history of section 7872, and most accurately accounts for the benefits provided by the lender to the borrower when the loans are below-market.

If a payment on a split-dollar loan is nonrecourse to the borrower and the loan does not otherwise provide for contingent payments, § 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. In response to a commentator, the final regulations delete the requirement in the proposed regulations that a nonrecourse split-dollar loan provide for interest payable at a stated rate.

If a split-dollar loan does not provide for sufficient interest, the loan is a below-market split-dollar loan subject to section 7872 and § 1.7872-15. If the split-dollar loan provides for sufficient interest, then, except as provided in § 1.7872-15, the loan is subject to the general rules for debt instruments (including the rules for OID). In general, interest on a split-dollar loan is not deductible by the borrower under sections 264 and 163(h). Section 1.7872-15 provides special rules for split-dollar loans that provide for certain variable rates of interest, contingent interest payments, and lender or borrower options. Section 1.7872-15 also provides rules for below-market split-dollar loans with indirect participants.

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 upon the relationship between the lender and the borrower (for example, the imputed transfer is generally characterized as a compensation payment if the lender is the borrower's employer), and whether the loan is a demand loan or a term loan.

#### b. Special Rules for Certain Term Loans

Special rules are provided for split-dollar term loans payable upon 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 § 1.7872-15, these split-dollar loans are 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, forgone interest is determined on the loan annually similar to a split-dollar demand loan. Commentators requested clarification on whether the rate used for purposes of imputation under § 1.7872-15(e)(5) for these split-dollar loans is the AFR for the month in which the loan is made (redetermined annually) or the AFR as of the month in which the loan is made (determined on the date the loan is made). 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, and the rate is not redetermined annually.

#### c. Split-Dollar Loans With Stated Interest That Is Subsequently Waived, Cancelled or Forgiven

If a split-dollar loan provides for stated interest that is subsequently waived, cancelled or forgiven, appropriate adjustments are required to be made by the parties to reflect the difference between the interest payable at the stated rate and the interest actually paid by the borrower at that time. Further, the final regulations provide that, if stated interest is subsequently waived, cancelled or forgiven, an amount is treated as retransferred from the lender to the borrower. The final regulations add a new rule under which this amount generally is increased by a deferral charge. The final regulations provide a new rule that 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 under the final regulations. The final regulations also provide a new rule that, if a split-dollar loan is nonrecourse and the parties to the split-dollar life insurance arrangement had made the representation under § 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.

#### d. 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; and to any other payment with respect to a split-dollar life insurance arrangement. One commentator suggested limiting the payments to which the payment ordering rule applies to those that are made to or for the benefit of the lender. The final regulations adopt this suggestion in the payment ordering rule in § 1.7872-15(k).

#### e. Employment Taxes and Self-Employment Tax

An imputed transfer under § 1.7872-15 that is treated as an imputed transfer of compensation will have consequences for the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) if the adjustment represents wages to the borrower. In response to questions regarding the consequences of an imputed transfer for employment and self-employment tax purposes, the regulations under sections 1402(a), 3121(a), 3231(e), and 3306(b) were clarified to reference § 1.7872-15 as well as § 1.61-22.

#### 5. Gift Tax Treatment of Split-Dollar Life Insurance Arrangements

The final regulations apply for gift tax purposes, including private split-dollar life insurance arrangements. Thus, if an irrevocable life insurance trust 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 § 1.7872-15. 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 § 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 (determined under section 7872 and § 1.7872-15) of the donor's right to receive repayment. If, however, the donor makes premium payments that are not split-dollar loans, then the

premium payments are governed by general gift tax principles. In such a case, with each premium payment, the donor is treated as making a gift to the trust equal to the amount of that payment.

Different rules apply, however, if the donor is treated under § 1.61-22(c) as the owner of the life insurance contract underlying the split-dollar life insurance arrangement. Under these circumstances, 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.

As discussed earlier, 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 insurance trust (either directly or indirectly) under the contract (for example, as a policy owner dividend or proceeds of a specified policy loan) are treated as gifts by the donor to the irrevocable insurance trust as provided in § 1.61-22(e). The donor must also treat as a gift to the trust the amount set forth in § 1.61-22(g) upon the transfer of the life insurance contract (or undivided interest therein) from the donor to the trust.

The 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, for example, Rev. Rul. 81-198 (1981-2 C.B. 188). Similarly, for estate tax purposes, regardless of who is treated as the owner of a life insurance contract under the final regulations, the inclusion of the policy proceeds in a decedent's gross estate will continue to be determined under section 2042. Thus, the policy proceeds will be included in the decedent's gross estate under section 2042(1) if receivable by the decedent's executor, or under section 2042(2) if the policy 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. One commentator requested that these regulations address the extent to which a decedent's interest in a co-owned policy is included in that decedent's gross estate under section 2042, but the IRS and Treasury believe that issue is beyond the scope of these regulations and may be addressed in future guidance.

#### 6. Effective Date and Obsolescence of Prior Guidance

These final regulations apply to any split-dollar life insurance arrangement entered into after September 17, 2003. Additionally, these final regulations apply to any split-dollar life insurance arrangement entered into on or before September 17, 2003 if the arrangement is materially modified after September 17, 2003. However, a split-dollar life insurance arrangement that is otherwise described in Section IV, Paragraph 4 of Notice 2002-8 (2002-1 C.B. 398) will not be treated as materially modified for these purposes if the change in the split-dollar life insurance arrangement is

made solely to comply with Section IV, Paragraph 4 of Notice 2002-8.

These final regulations provide a non-exclusive list of changes that will not result in a material modification for purposes of the effective date. For example, the final regulations provide that a change solely in the mode of premium payment or a change solely in the interest rate payable on a policy loan under the life insurance contract will not be treated as a material modification.

The 2002 and 2003 proposed regulations provided rules under which taxpayers were permitted to rely on the 2002 and 2003 proposed regulations for arrangements entered into on or before September 17, 2003. This reliance also was intended to be available in circumstances under which taxpayers relied on the proposed regulations to determine that the arrangement would not be subject to the proposed regulations (for example, if the arrangement does not fall with the definition of a split-dollar life insurance arrangement).

Concurrent with the publication of these final regulations in the **Federal Register**, the IRS and Treasury are issuing Rev. Rul. 2003-105 (2003-40 I.R.B.) to obsolete certain revenue rulings with respect to split-dollar life insurance arrangements entered into or materially modified after September 17, 2003.

**Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory flexibility assessment is not required. It is hereby certified that the collection of information requirements in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the regulations merely require a taxpayer to prepare a written representation that contains minimal information (if the loan provides for nonrecourse payments) or a projected payment schedule (if the loan provides for contingent payments). In addition, the preparation of these documents should take no more than .28 hours per taxpayer. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business. The

Chief Counsel for Advocacy did not submit any comments on the regulations.

**Drafting Information**

The principal authors of these final regulations are Rebecca Asta of the Office of Associate Chief Counsel (Financial Institutions and Products), Lane Damazo of the Office of Associate Chief Counsel (Passthroughs and Special Industries), Elizabeth Kaye of the Office of Associate Chief Counsel (Income Tax and Accounting), Erinn Madden of the Office of Associate Chief Counsel (Tax-Exempt and Governmental Entities), and Krishna Vallabhaneni of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

**List of Subjects**

*26 CFR Part 1*

Income taxes, Reporting and recordkeeping requirements.

*26 CFR Part 31*

Employment taxes, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social security, Unemployment compensation.

*26 CFR Part 602*

Reporting and recordkeeping requirements.

**Proposed Amendments to the Regulations**

■ Accordingly, 26 CFR parts 1, 31, and 602 are amended as follows:

**PART 1—INCOME TAXES**

■ **Paragraph 1.** The authority citation for part 1 is amended to read in part as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*  
Section 1.7872-15 also issued under 26 U.S.C. 1275 and 7872. \* \* \*

■ **Par. 2.** Section 1.61-2 is amended by:

- 1. Redesignating paragraphs (d)(2)(ii)(a) and (b) as paragraphs (d)(2)(ii)(A) and (B), respectively.
- 2. Adding two sentences immediately following the second sentence in newly designated paragraph (d)(2)(ii)(A).

The additions read as follows:

**§ 1.61-2 Compensation for services, including fees, commissions, and similar items.**

- \* \* \* \* \*
- (d) \* \* \*
- (2) \* \* \*

(ii)(A) *Cost of life insurance on the life of the employee.* \* \* \* For example, if an employee or independent contractor

is the owner (as defined in § 1.61-22(c)(1)) of a life insurance contract and the payments with regard to such contract are not split-dollar loans under § 1.7872-15(b)(1), the employee or independent contractor must include in income the amount of any such payments by the employer or service recipient with respect to such contract during any year to the extent that the employee's or independent contractor's rights to the life insurance contract are substantially vested (within the meaning of § 1.83-3(b)). This result is the same regardless of whether the employee or independent contractor has at all times been the owner of the life insurance contract or the contract previously has been owned by the employer or service recipient as part of a split-dollar life insurance arrangement (as defined in § 1.61-22(b)(1) or (2)) and was transferred by the employer or service recipient to the employee or independent contractor under § 1.61-22(g). \* \* \*

■ **Par. 3.** Section 1.61-22 is added to read as follows:

**§ 1.61-22 Taxation of split-dollar life insurance arrangements.**

(a) *Scope—(1) In general.* This section provides rules for the taxation of a split-dollar life insurance arrangement for purposes of the income tax, the gift tax, the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), the Railroad Retirement Tax Act (RRTA), and the Self-Employment Contributions Act of 1954 (SECA). For the Collection of Income Tax at Source on Wages, this section also provides rules for the taxation of a split-dollar life insurance arrangement, other than a payment under a split-dollar life insurance arrangement that is a split-dollar loan under § 1.7872-15(b)(1). A split-dollar life insurance arrangement (as defined in paragraph (b) of this section) is subject to the rules of paragraphs (d) through (g) of this section, § 1.7872-15, or general tax rules. For rules to determine which rules apply to a split-dollar life insurance arrangement, see paragraph (b)(3) of this section.

(2) *Overview.* Paragraph (b) of this section defines a split-dollar life insurance arrangement and provides rules to determine whether an arrangement is subject to the rules of paragraphs (d) through (g) of this section, § 1.7872-15, or general tax rules. Paragraph (c) of this section defines certain other terms. Paragraph (d) of this section sets forth rules for the taxation of economic benefits provided under a split-dollar life insurance

arrangement. Paragraph (e) of this section sets forth rules for the taxation of amounts received under a life insurance contract that is part of a split-dollar life insurance arrangement. Paragraph (f) of this section provides rules for additional tax consequences of a split-dollar life insurance arrangement, including the treatment of death benefit proceeds. Paragraph (g) of this section provides rules for the transfer of a life insurance contract (or an undivided interest in the contract) that is part of a split-dollar life insurance arrangement. Paragraph (h) of this section provides examples illustrating the application of this section. Paragraph (j) of this section provides the effective date of this section.

(b) *Split-dollar life insurance arrangement*—(1) *In general.* 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 any 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 life insurance contract;

(ii) At least one of the parties to the arrangement paying premiums under paragraph (b)(1)(i) of this section 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 life insurance plan described in section 79 unless the group-term life insurance plan provides permanent benefits to employees (as defined in § 1.79-0).

(2) *Special rule*—(i) *In general.* Any arrangement between an owner and a non-owner of a life insurance contract is treated as a split-dollar life insurance arrangement (regardless of whether the criteria of paragraph (b)(1) of this section are satisfied) if the arrangement is described in paragraph (b)(2)(ii) or (iii) of this section.

(ii) *Compensatory arrangements.* An arrangement is described in this paragraph (b)(2)(ii) if the following criteria are satisfied—

(A) The arrangement is entered into in connection with the performance of services and is not part of a group-term life insurance plan described in section 79;

(B) The employer or service recipient pays, directly or indirectly, all or any portion of the premiums; and

(C) Either—

(1) The beneficiary of all or any portion of the death benefit is designated by the employee or service provider or is any person whom the employee or service provider would reasonably be expected to designate as the beneficiary; or

(2) The employee or service provider has any interest in the policy cash value of the life insurance contract.

(iii) *Shareholder arrangements.* An arrangement is described in this paragraph (b)(2)(iii) if the following criteria are satisfied—

(A) The arrangement is entered into between a corporation and another person in that person's capacity as a shareholder in the corporation;

(B) The corporation pays, directly or indirectly, all or any portion of the premiums; and

(C) Either—

(1) The beneficiary of all or any portion of the death benefit is designated by the shareholder or is any person whom the shareholder would reasonably be expected to designate as the beneficiary; or

(2) The shareholder has any interest in the policy cash value of the life insurance contract.

(3) *Determination of whether this section or § 1.7872-15 applies to a split-dollar life insurance arrangement*—(i) *Split-dollar life insurance arrangements involving split-dollar loans under § 1.7872-15.* Except as provided in paragraph (b)(3)(ii) of this section, paragraphs (d) through (g) of this section do not apply to any split-dollar loan as defined in § 1.7872-15(b)(1). Section 1.7872-15 applies to any such loan. See paragraph (b)(5) of this section for the treatment of a payment made by a non-owner under a split-dollar life insurance arrangement if the payment is not a split-dollar loan.

(ii) *Exceptions.* Paragraphs (d) through (g) of this section apply (and § 1.7872-15 does not apply) to any split-dollar life insurance arrangement if—

(A) The arrangement is entered into in connection with the performance of services, and the employer or service recipient is the owner of the life insurance contract (or is treated as the owner of the contract under paragraph (c)(1)(ii)(A)(1) of this section); or

(B) The arrangement is entered into between a donor and a donee (for example, a life insurance trust) and the donor is the owner of the life insurance contract (or is treated as the owner of the contract under paragraph (c)(1)(ii)(A)(2) of this section).

(4) *Consistency requirement.* A split-dollar life insurance arrangement described in paragraph (b)(1) or (2) of

this section must be treated in the same manner by the owner and the non-owner of the life insurance contract under either the rules of this section or § 1.7872-15. In addition, the owner and non-owner must fully account for all amounts under the arrangement under paragraph (b)(5) of this section, paragraphs (d) through (g) of this section, or § 1.7872-15.

(5) *Non-owner payments that are not split-dollar loans.* If a non-owner of a life insurance contract makes premium payments (directly or indirectly) under a split-dollar life insurance arrangement, and the payments are neither split-dollar loans nor consideration for economic benefits described in paragraph (d) of this section, then neither the rules of paragraphs (d) through (g) of this section nor the rules in § 1.7872-15 apply to such payments. Instead, general income tax, employment tax, self-employment tax, and gift tax principles apply to the premium payments. See, for example, § 1.61-2(d)(2)(ii)(A).

(6) *Waiver, cancellation, or forgiveness.* If a repayment obligation described in § 1.7872-15(a)(2) is waived, cancelled, or forgiven at any time, then the parties must take the amount waived, cancelled, or forgiven into account in accordance with the relationships between the parties (for example, as compensation in the case of an employee-employer relationship).

(7) *Change in the owner.* If payments made by a non-owner to an owner were treated as split-dollar loans under § 1.7872-15 and the split-dollar life insurance arrangement is modified such that, after the modification, the non-owner is the owner (within the meaning of paragraph (c)(1) of this section) of the life insurance contract under the arrangement, paragraphs (d) through (g) of this section apply to the split-dollar life insurance arrangement from the date of the modification. The payments made (both before and after the modification) are not treated as split-dollar loans under § 1.7872-15 on or after the date of the modification. The non-owner of the life insurance contract under the modified split-dollar life insurance arrangement must fully take into account all economic benefits provided under the arrangement under paragraph (d) of this section on or after the date of the modification. For the treatment of a transfer of the contract when the unmodified arrangement is governed by paragraphs (d) through (g) of this section, see paragraph (g) of this section.

(c) *Definitions.* The following definitions apply for purposes of this section:

(1) *Owner*—(i) *In general.* With respect to a life insurance contract, the person named as the policy owner of such contract generally is the owner of such contract. If two or more persons 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, each person is treated as the owner of a separate contract to the extent of such person's undivided interest. If two or more persons are named as policy owners of a life insurance contract but each person does not have, at all times, all the incidents of ownership with respect to an undivided interest in the contract, the person who is the first-named policy owner is treated as the owner of the entire contract.

(ii) *Special rule for certain arrangements*—(A) *In general.* Notwithstanding paragraph (c)(1)(i) of this section—

(1) An employer or service recipient is treated as the owner of a life insurance contract under a split-dollar life insurance arrangement that is entered into in connection with the performance of services if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in paragraph (d)(3) of this section; and

(2) A donor is treated as the owner of a life insurance contract under a split-dollar life insurance arrangement that is entered into between a donor and a donee (for example, a life insurance trust) if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in paragraph (d)(3) of this section.

(B) *Modifications.* If an arrangement described in paragraph (c)(1)(ii)(A) of this section is modified such that the arrangement is no longer described in paragraph (c)(1)(ii)(A) of this section, the following rules apply:

(1) If, immediately after such modification, the employer, service recipient, or donor is the owner of the life insurance contract under the split-dollar life insurance arrangement (determined without regard to paragraph (c)(1)(ii)(A) of this section), the employer, service recipient, or donor continues to be treated as the owner of the life insurance contract.

(2) If, immediately after such modification, the employer, service recipient, or donor is not the owner of the life insurance contract under the split-dollar life insurance arrangement (determined without regard to paragraph (c)(1)(ii)(A) of this section),

the employer, service recipient, or donor is treated as having made a transfer of the entire life insurance contract to the employee, service provider, or donee under the rules of paragraph (g) of this section as of the date of such modification.

(3) For purposes of this paragraph (c)(1)(ii)(B), entering into a successor split-dollar life insurance arrangement that has the effect of providing any economic benefit in addition to that described in paragraph (d)(3) of this section is treated as a modification of the prior split-dollar life insurance arrangement.

(iii) *Attribution rules for compensatory arrangements.* For purposes of this section, if a split-dollar life insurance arrangement is entered into in connection with the performance of services, the employer or service recipient is treated as the owner of the life insurance contract if the owner (within the meaning of paragraph (c)(1)(i) of this section) of the life insurance contract under the split-dollar life insurance arrangement is—

(A) A trust described in section 402(b);

(B) A trust that is treated as owned (within the meaning of sections 671 through 677) by the employer or the service recipient;

(C) A welfare benefit fund within the meaning of section 419(e)(1); or

(D) A member of the employer or service recipient's controlled group (within the meaning of section 414(b)) or a trade or business that is under common control with the employer or service recipient (within the meaning of section 414(c)).

(iv) *Life insurance contracts owned by partnerships.* [Reserved]

(2) *Non-owner*—(i) *Definition.* With respect to a life insurance contract, a non-owner is any person (other than the owner of such contract under paragraph (c)(1) of this section) that has any direct or indirect interest in such contract (but not including a life insurance company acting only in its capacity as the issuer of a life insurance contract).

(ii) *Example.* The following example illustrates the provisions of this paragraph (c)(2):

*Example.* (i) On January 1, 2009, Employer R and Trust T, an irrevocable life insurance trust that is not treated under sections 671 through 677 as owned by a grantor or other person, enter into a split-dollar life insurance arrangement in connection with the performance of services under which R will pay all the premiums on the life insurance contract until the termination of the arrangement or the death of E, an employee of R. C, the beneficiary of T, is E's child. R is the owner of the contract under paragraph

(c)(1)(i) of this section. E is the insured under the life insurance contract. Upon termination of the arrangement or E's death, R is entitled to receive the lesser of the aggregate premiums or the policy cash value of the contract and T will be entitled to receive any remaining amounts. Under the terms of the arrangement and applicable state law, the policy cash value is fully accessible by R and R's creditors but T has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R.

(ii) Because E and T each have an indirect interest in the life insurance contract that is part of the split-dollar life insurance arrangement, each is a non-owner under paragraph (c)(2)(i) of this section. E and T each are provided economic benefits described in paragraph (d)(2) of this section pursuant to the split-dollar life insurance arrangement. Economic benefits are provided by owner R to E as a payment of compensation, and separately provided by E to T as a gift.

(3) *Transfer of entire contract or undivided interest therein.* A transfer of the ownership of a life insurance contract (or an undivided interest in such contract) that is part of a split-dollar life insurance arrangement occurs on the date that a non-owner becomes the owner (within the meaning of paragraph (c)(1) of this section) of the entire contract or of an undivided interest in the contract.

(4) *Undivided interest.* 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. In the case of any arrangement purporting to create undivided interests where, in substance, the rights, benefits or obligations are shared to any extent among the holders of such interests, the arrangement will be treated as a split-dollar life insurance arrangement.

(5) *Employment tax.* The term employment tax means any tax imposed by, or collected under, the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), the Railroad Retirement Tax Act (RRTA), and the Collection of Income Tax at Source on Wages.

(6) *Self-employment tax.* The term self-employment tax means the tax imposed by the Self-Employment Contributions Act of 1954 (SECA).

(d) *Economic benefits provided under a split-dollar life insurance arrangement*—(1) *In general.* In the case of a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section, economic benefits are treated as being provided to the non-owner of the life insurance contract. The non-owner

(and the owner for gift and employment tax purposes) must take into account the full value of all economic benefits described in paragraph (d)(2) of this section, reduced by the consideration paid directly or indirectly by the non-owner to the owner for those economic benefits. Depending on the relationship between the owner and the non-owner, the economic benefits may constitute a payment of compensation, a distribution under section 301, a contribution to capital, a gift, or a transfer having a different tax character. Further, depending on the relationship between or among a non-owner and one or more other persons (including a non-owner or non-owners), the economic benefits may be treated as provided from the owner to the non-owner and as separately provided from the non-owner to such other person or persons (for example, as a payment of compensation from an employer to an employee and as a gift from the employee to the employee's child).

(2) *Value of economic benefits.* The value of the economic benefits provided to a non-owner for a taxable year under the arrangement equals—

(i) The cost of current life insurance protection provided to the non-owner as determined under paragraph (d)(3) of this section;

(ii) The amount of policy cash value to which the non-owner has current access within the meaning of paragraph (d)(4)(ii) of this section (to the extent that such amount was not actually taken into account for a prior taxable year); and

(iii) The value of any economic benefits not described in paragraph (d)(2)(i) or (ii) of this section provided to the non-owner (to the extent not actually taken into account for a prior taxable year).

(3) *Current life insurance protection—*  
(i) *Amount of current life insurance protection.* In the case of a split-dollar life insurance arrangement described in paragraph (d)(1) of this section, the amount of the current life insurance protection provided to the non-owner for a taxable year (or any portion thereof in the case of the first year or the last year of the arrangement) equals the excess of the death benefit of the life insurance contract (including paid-up additions thereto) over the total amount payable to the owner (including any outstanding policy loans that offset amounts otherwise payable to the owner) under the split-dollar life insurance arrangement, less the portion of the policy cash value actually taken into account under paragraph (d)(1) of this section or paid for by the non-owner under paragraph (d)(1) for the

current taxable year or any prior taxable year.

(ii) *Cost of current life insurance protection.* The cost of current life insurance protection provided to the non-owner for any year (or any portion thereof in the case of the first year or the last year of the arrangement) equals the amount of the current life insurance protection provided to the non-owner (determined under paragraph (d)(3)(i) of this section) multiplied by the life insurance premium factor designated or permitted in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter).

(4) *Policy cash value—*(i) *In general.* For purposes of this paragraph (d), policy cash value is determined disregarding surrender charges or other similar charges or reductions. Policy cash value includes policy cash value attributable to paid-up additions.

(ii) *Current access.* For purposes of this paragraph (d), a non-owner has current access to that portion of the policy cash value—

(A) To which, under the arrangement, the non-owner has a current or future right and;

(B) That currently is directly or indirectly accessible by the non-owner, inaccessible to the owner, or inaccessible to the owner's general creditors.

(5) *Valuation date—*(i) *General rules.* For purposes of this paragraph (d), the amount of the current life insurance protection and the policy cash value shall be determined on the same valuation date. The valuation date is the last day of the non-owner's taxable year, unless the owner and non-owner agree to instead use the policy anniversary date as the valuation date. Notwithstanding the previous sentence, if the split-dollar life insurance arrangement terminates during the taxable year of the non-owner, the value of such economic benefits is determined on the day that the arrangement terminates.

(ii) *Consistency requirement.* The owner and non-owner of the split-dollar arrangement must use the same valuation date. In addition, the same valuation date must be used for all years prior to termination of the split-dollar life insurance arrangement unless the parties receive consent of the Commissioner to change the valuation date.

(iii) *Artifice or device.* Notwithstanding paragraph (d)(5)(i) of this section, if any artifice or device is used to understate the amount of any economic benefit on the valuation date in paragraph (d)(5)(i) of this section, then, for purposes of this paragraph (d),

the date on which the amount of the economic benefit is determined is the date on which the amount of the economic benefit is greatest during that taxable year.

(iv) *Special rule for certain taxes.* For purposes of employment tax (as defined in paragraph (c)(5) of this section), self-employment tax (as defined in paragraph (c)(6) of this section), and sections 6654 and 6655 (relating to the failure to pay estimated income tax), the portions of the current life insurance protection and the policy cash value that are treated as provided by the owner to the non-owner shall be treated as so provided on the last day of the taxable year of the non-owner. Notwithstanding the previous sentence, if the split-dollar life insurance arrangement terminates during the taxable year of the non-owner, such portions of the current life insurance protection and the policy cash value shall be treated as so provided on the day that the arrangement terminates.

(6) *Examples.* The following examples illustrate the rules of this paragraph (d). Except as otherwise provided, both examples assume the following facts: employer (R) is the owner (as defined in paragraph (c)(1)(i) of this section) and employee (E) is the non-owner (as defined in paragraph (c)(2)(i) of this section) of a life insurance contract that is part of a split-dollar life insurance arrangement that is subject to the provisions of paragraphs (d) through (g) of this section; the contract is a life insurance contract as defined in section 7702 and not a modified endowment contract as defined in section 7702A; R does not withdraw or obtain a loan of any portion of the policy cash value and does not surrender any portion of the life insurance contract; the compensation paid to E is reasonable; E is not provided any economic benefits described in paragraph (d)(2)(iii) of this section; E does not make any premium payments; E's taxable year is the calendar year; the value of the economic benefits is determined on the last day of E's taxable year; and E reports on E's Federal income tax return for each year that the split-dollar life insurance arrangement is in effect the amount of income required to be reported under paragraph (d) of this section. The examples are as follows:

*Example 1.* (i) *Facts.* On January 1 of year 1, R and E enter into the split-dollar life insurance arrangement. Under the arrangement, R pays all of the premiums on the life insurance contract until the termination of the arrangement or E's death. The arrangement provides that upon termination of the arrangement or E's death, R is entitled to receive the lesser of the

aggregate premiums paid or the policy cash value of the contract and E is entitled to receive any remaining amounts. Under the terms of the arrangement and applicable state law, the policy cash value is fully accessible by R and R's creditors but E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R. To fund the arrangement, R purchases a life insurance contract with constant death benefit protection equal to \$1,500,000. R makes premium payments on the life insurance contract of \$60,000 in each of years 1, 2, and 3. The policy cash value equals \$55,000 as of December 31 of year 1, \$140,000 as of December 31 of year 2, and \$240,000 as of December 31 of year 3.

(ii) *Analysis.* Under the terms of the split-dollar life insurance arrangement, E has the right for year 1 and all subsequent years to borrow or withdraw the portion of the policy cash value exceeding the amount payable to R. Thus, under paragraph (d)(4)(ii) of this section, E has current access to such portion of the policy cash value for each year that the arrangement is in effect. In addition, because R pays all of the premiums on the life insurance contract, R provides to E all of the economic benefits that E receives under the arrangement. Therefore, under paragraph (d)(1) of this section, E includes in gross income the value of all economic benefits described in paragraphs (d)(2)(i) and (ii) of this section provided to E under the arrangement.

(iii) *Results for year 1.* For year 1, E is provided, under paragraph (d)(2)(ii) of this section, \$0 of policy cash value (excess of \$55,000 policy cash value determined as of December 31 of year 1 over \$55,000 payable to R). For year 1, E is also provided, under paragraph (d)(2)(i) of this section, current life insurance protection of \$1,445,000 (\$1,500,000 minus \$55,000 payable to R). Thus, E includes in gross income for year 1 the cost of \$1,445,000 of current life insurance protection.

(iv) *Results for year 2.* For year 2, E is provided, under paragraph (d)(2)(ii) of this section, \$20,000 of policy cash value (\$140,000 policy cash value determined as of December 31 of year 2 minus \$120,000 payable to R). For year 2, E is also provided, under paragraph (d)(2)(i) of this section, current life insurance protection of \$1,360,000 (\$1,500,000 minus the sum of \$120,000 payable to R and the aggregate of \$20,000 of policy cash value that E actually includes in income on E's year 1 and year 2 federal income tax returns). Thus, E includes in gross income for year 2 the sum of \$20,000 of policy cash value and the cost of \$1,360,000 of current life insurance protection.

(v) *Results for year 3.* For year 3, E is provided, under paragraph (d)(2)(ii) of this section, \$40,000 of policy cash value (\$240,000 policy cash value determined as of December 31 of year 3 minus the sum of \$180,000 payable to R and \$20,000 of aggregate policy cash value that E actually includes in gross income on E's year 1 and year 2 federal income tax returns). For year 3, E is also provided, under paragraph (d)(2)(i) of this section, current life insurance

protection of \$1,260,000 (\$1,500,000 minus the sum of \$180,000 payable to R and \$60,000 of aggregate policy cash value that E actually includes in gross income on E's year 1, year 2, and year 3 federal income tax returns). Thus, E includes in gross income for year 3 the sum of \$40,000 of policy cash value and the cost of \$1,260,000 of current life insurance protection.

*Example 2. (i) Facts.* The facts are the same as in *Example 1* except that E cannot directly or indirectly access any portion of the policy cash value, but the terms of the split-dollar life insurance arrangement or applicable state law provide that the policy cash value in excess of the amount payable to R is inaccessible to R's general creditors.

(ii) *Analysis.* Under the terms of the split-dollar life insurance arrangement or applicable state law, the portion of the policy cash value exceeding the amount payable to R is inaccessible to R's general creditors and E has a current or future right to that portion of the cash value. Thus, under paragraph (d)(4)(ii) of this section, E has current access to such portion of the policy cash value for each year that the arrangement is in effect. In addition, because R pays all of the premiums on the life insurance contract, R provides to E all of the economic benefits that E receives under the arrangement. Therefore, under paragraph (d)(1) of this section, E includes in gross income the value of all economic benefits described in paragraphs (d)(2)(i) and (ii) of this section provided to E under the arrangement.

(iii) *Results for years 1, 2 and 3.* The results for this example are the same as the results in *Example 1*.

(e) *Amounts received under the contract—(1) In general.* Except as otherwise provided in paragraph (f)(3) of this section, any amount received under a life insurance contract that is part of a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section (including, but not limited to, a policy owner dividend, proceeds of a specified policy loan described in paragraph (e)(2) of this section, or the proceeds of a withdrawal from or partial surrender of the life insurance contract) is treated, to the extent provided directly or indirectly to a non-owner of the life insurance contract, as though such amount had been paid to the owner of the life insurance contract and then paid by the owner to the non-owner. The amount received is taxable to the owner in accordance with the rules of section 72. The non-owner (and the owner for gift tax and employment tax purposes) must take the amount described in paragraph (e)(3) of this section into account as a payment of compensation, a distribution under section 301, a contribution to capital, a gift, or other transfer depending on the relationship between the owner and the non-owner.

(2) *Specified policy loan.* A policy loan is a specified policy loan to the extent—

(i) The proceeds of the loan are distributed directly from the insurance company to the non-owner;

(ii) A reasonable person would not expect that the loan will be repaid by the non-owner; or

(iii) The non-owner's obligation to repay the loan to the owner is satisfied or is capable of being satisfied upon repayment by either party to the insurance company.

(3) *Amount required to be taken into account.* With respect to a non-owner (and the owner for gift tax and employment tax purposes), the amount described in this paragraph (e)(3) is equal to the excess of—

(i) The amount treated as received by the owner under paragraph (e)(1) of this section; over

(ii) The amount of all economic benefits described in paragraphs (d)(2)(ii) and (iii) of this section actually taken into account by the non-owner (and the owner for gift tax and employment tax purposes) plus any consideration described in paragraph (d)(1) of this section paid by the non-owner for such economic benefits described in paragraphs (d)(2)(ii) and (iii) of this section. The amount determined under the preceding sentence applies only to the extent that neither this paragraph (e)(3)(ii) nor paragraph (g)(1)(ii) of this section previously has applied to such economic benefits.

(f) *Other tax consequences—(1) Introduction.* In the case of a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section, this paragraph (f) sets forth other tax consequences to the owner and non-owner of a life insurance contract that is part of the arrangement for the period prior to the transfer (as defined in paragraph (c)(3) of this section) of the contract (or an undivided interest therein) from the owner to the non-owner. See paragraph (g) of this section and § 1.83-6(a)(5) for tax consequences upon the transfer of the contract (or an undivided interest therein).

(2) *Investment in the contract—(i) To the non-owner.* A non-owner does not receive any investment in the contract under section 72(e)(6) with respect to a life insurance contract that is part of a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section.

(ii) *To owner.* Any premium paid by an owner under a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section is included in the owner's investment in the contract under section 72(e)(6). No premium or amount

described in paragraph (d) of this section is deductible by the owner (except as otherwise provided in § 1.83-6(a)(5)). Any amount paid by a non-owner, directly or indirectly, to the owner of the life insurance contract for current life insurance protection or for any other economic benefit under the life insurance contract is included in the owner's gross income and is included in the owner's investment in the life insurance contract for purposes of section 72(e)(6) (but only to the extent not otherwise so included by reason of having been paid by the owner as a premium or other consideration for the contract).

(3) *Treatment of death benefit proceeds*—(i) *Death benefit proceeds to beneficiary (other than the owner)*. Any amount paid to a beneficiary (other than the owner) by reason of the death of the insured is excluded from gross income by such beneficiary under section 101(a) as an amount received under a life insurance contract to the extent such amount is allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account pursuant to paragraph (d)(1) of this section.

(ii) *Death benefit proceeds to owner as beneficiary*. Any amount paid or payable to an owner in its capacity as a beneficiary by reason of the death of the insured is excluded from gross income of the owner under section 101(a) as an amount received under a life insurance contract to the extent such amount is not allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account pursuant to paragraph (d)(1) of this section.

(iii) *Transfers of death benefit proceeds*. Death benefit proceeds paid to a party to a split-dollar life insurance arrangement (or the estate or beneficiary of that party) that are not excludable from that party's income under section 101(a) to the extent provided in paragraph (f)(3)(i) or (ii) of this section, are treated as transferred to that party in a separate transaction. The death benefit proceeds treated as so transferred will be taxed in a manner similar to other transfers. For example, if death benefit proceeds paid to an employee, the employee's estate, or the employee's beneficiary are not excludable from the employee's gross income under section 101(a) to the extent provided in paragraph (f)(3)(i) of this section, then

such payment is treated as a payment of compensation by the employer to the employee.

(g) *Transfer of entire contract or undivided interest therein*—(1) *In general*. Upon a transfer within the meaning of paragraph (c)(3) of this section of a life insurance contract (or an undivided interest therein) to a non-owner (transferee), the transferee (and the owner (transferor) for gift tax and employment tax purposes) takes into account the excess of the fair market value of the life insurance contract (or the undivided interest therein) transferred to the transferee at that time over the sum of—

(i) The amount the transferee pays to the transferor to obtain the contract (or the undivided interest therein); and

(ii) The amount of all economic benefits described in paragraph (d)(2)(ii) and (iii) of this section actually taken into account by the transferee (and the transferor for gift tax and employment tax purposes), plus any consideration described in paragraph (d)(1) of this section paid by the transferee for such economic benefits described in paragraphs (d)(2)(ii) and (iii) of this section. The amount determined under the preceding sentence applies only to the extent that neither this paragraph (g)(1)(ii) nor paragraph (e)(3)(ii) of this section previously has applied to such economic benefits.

(2) *Determination of fair market value*. For purposes of paragraph (g)(1) of this section, the fair market value of a life insurance contract is the policy cash value and the value of all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than the value of current life insurance protection. Notwithstanding the preceding sentence, the fair market value of a life insurance contract for gift tax purposes is determined under § 25.2512-6(a) of this chapter.

(3) *Exception for certain transfers in connection with the performance of services*. To the extent the ownership of a life insurance contract (or undivided interest in such contract) is transferred in connection with the performance of services, paragraph (g)(1) of this section does not apply until such contract (or undivided interest in such contract) is taxable under section 83. For purposes of paragraph (g)(1) of this section, fair market value is determined disregarding any lapse restrictions and at the time the transfer of such contract (or undivided interest in such contract) is taxable under section 83.

(4) *Treatment of non-owner after transfer*—(i) *In general*. After a transfer of an entire life insurance contract

(except when such transfer is in connection with the performance of services and the transfer is not yet taxable under section 83), the person who previously had been the non-owner is treated as the owner of such contract for all purposes, including for purposes of paragraph (b) of this section and for purposes of § 1.61-2(d)(2)(ii)(A). After the transfer of an undivided interest in a life insurance contract (or, if later, at the time such transfer is taxable under section 83), the person who previously had been the non-owner is treated as the owner of a separate contract consisting of that interest for all purposes, including for purposes of paragraph (b) of this section and for purposes of § 1.61-2(d)(2)(ii)(A).

(ii) *Investment in the contract after transfer*—(A) *In general*. The amount treated as consideration paid to acquire the contract under section 72(g)(1), in order to determine the aggregate premiums paid by the transferee for purposes of section 72(e)(6)(A) after the transfer (or, if later, at the time such transfer is taxable under section 83), equals the greater of the fair market value of the contract or the sum of the amounts determined under paragraphs (g)(1)(i) and (ii) of this section.

(B) *Transfers between a donor and a donee*. In the case of a transfer of a contract between a donor and a donee, the amount treated as consideration paid by the transferee to acquire the contract under section 72(g)(1), in order to determine the aggregate premiums paid by the transferee for purposes of section 72(e)(6)(A) after the transfer, equals the sum of the amounts determined under paragraphs (g)(1)(i) and (ii) of this section except that—

(1) The amount determined under paragraph (g)(1)(i) of this section includes the aggregate of premiums or other consideration paid or deemed to have been paid by the transferor; and

(2) The amount of all economic benefits determined under paragraph (g)(1)(ii) of this section actually taken into account by the transferee does not include such benefits to the extent such benefits were excludable from the transferee's gross income at the time of receipt.

(C) *Transfers of an undivided interest in a contract*. If a portion of a contract is transferred to the transferee, then the amount to be included as consideration paid to acquire the contract is determined by multiplying the amount determined under paragraph (g)(4)(ii)(A) of this section (as modified by paragraph (g)(4)(ii)(B) of this section, if the transfer is between a donor and a donee) by a fraction, the numerator of which is the fair market value of the

portion transferred and the denominator of which is the fair market value of the entire contract.

(D) *Example.* The following example illustrates the rules of this paragraph (g)(4)(ii):

*Example.* (i) In year 1, donor D and donee E enter into a split-dollar life insurance arrangement as defined in paragraph (b)(1) of this section. D is the owner of the life insurance contract under paragraph (c)(1) of this section. The life insurance contract is not a modified endowment contract as defined in section 7702A. In year 5, D gratuitously transfers the contract, within the meaning of paragraph (c)(3) of this section, to E. At the time of the transfer, the fair market value of the contract is \$200,000 and D had paid \$50,000 in premiums under the arrangement. In addition, by the time of the transfer, E had current access to \$80,000 of policy cash value which was excludable from E's gross income under section 102.

(ii) E's investment in the contract is \$50,000, consisting of the \$50,000 of premiums paid by D. The \$80,000 of policy cash value to which E had current access is not included in E's investment in the contract because such amount was excludable from E's gross income when E had current access to that policy cash value.

(iii) *No investment in the contract for current life insurance protection.* Except as provided in paragraph (g)(4)(ii)(B) of this section, no amount allocable to current life insurance protection provided to the transferee (the cost of which was paid by the transferee or the value of which was provided to the transferee) is treated as consideration paid to acquire the contract under section 72(g)(1) to determine the aggregate premiums paid by the transferee for purposes of determining the transferee's investment in the contract under section 72(e) after the transfer.

(h) *Examples.* The following examples illustrate the rules of this section. Except as otherwise provided, each of the examples assumes that the employer (R) is the owner (as defined in paragraph (c)(1) of this section) of a life insurance contract that is part of a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section, that the employee (E) is not provided any economic benefits described in paragraph (d)(2)(iii) of this section, that the life insurance contract is not a modified endowment contract under section 7702A, that the compensation paid to E is reasonable, and that E makes no premium payments. The examples are as follows:

*Example 1.* (i) In year 1, R purchases a life insurance contract on the life of E. R is named as the policy owner of the contract. R and E enter into an arrangement under

which R will pay all the premiums on the life insurance contract until the termination of the arrangement or E's death. Upon termination of the arrangement or E's death, R is entitled to receive the greater of the aggregate premiums or the policy cash value of the contract. The balance of the death benefit will be paid to a beneficiary designated by E.

(ii) Because R is designated as the policy owner of the contract, R is the owner of the contract under paragraph (c)(1)(i) of this section. In addition, R would be treated as the owner of the contract regardless of whether of R were designated as the policy owner under paragraph (c)(1)(i) of this section because the split-dollar life insurance arrangement is described in paragraph (c)(1)(ii)(A)(1) of this section. E is a non-owner of the contract. Under the arrangement between R and E, a portion of the death benefit is payable to a beneficiary designated by E. The arrangement is a split-dollar life insurance arrangement under paragraph (b)(1) or (2) of this section. Because R pays all the premiums on the life insurance contract, R provides to E the entire amount of the current life insurance protection E receives under the arrangement. Therefore, for each year that the split-dollar life insurance arrangement is in effect, E must include in gross income under paragraph (d)(1) of this section the value of current life insurance protection described in paragraph (d)(2)(i) of this section provided to E in each year.

*Example 2.* (i) The facts are the same as in *Example 1* except that, upon termination of the arrangement or E's death, R is entitled to receive the lesser of the aggregate premiums or the policy cash value of the contract. Under the terms of the arrangement and applicable state law, the policy cash value is fully accessible by R and R's creditors but E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R.

(ii) Because R is designated as the policy owner, R is the owner of the contract under paragraph (c)(1)(i) of this section. E is a non-owner of the contract. For each year that the split-dollar life insurance arrangement is in effect, E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R. Thus, under paragraph (d)(4)(ii) of this section, E has current access to such portion of the policy cash value for each year that the arrangement is in effect. In addition, because R pays all the premiums on the life insurance contract, R provides to E all the economic benefits that E receives under the arrangement. Therefore, for each year that the split-dollar life insurance arrangement is in effect, E must include in gross income under paragraph (d)(1) of this section, the value of all economic benefits described in paragraph (d)(2)(i) and (ii) of this section provided to E in each year.

*Example 3.* (i) The facts are the same as in *Example 1* except that in year 5, R and E modify the split-dollar life insurance arrangement to provide that, upon termination of the arrangement or E's death, R is entitled to receive the greater of the aggregate premiums or one-half the policy

cash value of the contract. Under the terms of the modified arrangement and applicable state law, the policy cash value is fully accessible by R and R's creditors but E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R.

(ii) For each year that the split-dollar life insurance arrangement is in effect, E must include in gross income under paragraph (d)(1) of this section the value of the economic benefits described in paragraph (d)(2)(i) of this section provided to E under the arrangement during that year. In year 5 (and subsequent years), E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R. Thus, under paragraph (d)(4)(ii) of this section, E has current access to such portion of the policy cash value. Thus, in year 5 (and each subsequent year), E must also include in gross income under paragraph (d)(1) of this section the value of the economic benefits described in paragraph (d)(2)(ii) of this section provided to E in each year.

(iii) The arrangement is not described in paragraph (c)(1)(ii)(A)(1) of this section after it is modified in year 5. Because R is the designated owner of the life insurance contract, R continues to be treated as the owner of the contract under paragraph (c)(1)(ii)(B)(1) of this section after the arrangement is modified. In addition, because the modification made by R and E in year 5 does not involve the transfer (within the meaning of paragraph (c)(3) of this section) of an undivided interest in the life insurance contract from R to E, the modification is not a transfer for purposes of paragraph (g) of this section.

*Example 4.* (i) The facts are the same as in *Example 2* except that in year 7, R and E modify the split-dollar life insurance arrangement to provide that, upon termination of the arrangement or E's death, R will be paid the lesser of 80 percent of the aggregate premiums or the policy cash value of the contract. Under the terms of the modified arrangement and applicable state law, the policy cash value is fully accessible by R and R's creditors but E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the lesser of 80 percent of the aggregate premiums paid by R or the policy cash value of the contract.

(ii) Commencing in year 7 (and in each subsequent year), E must include in gross income the economic benefits described in paragraph (d)(2)(ii) of this section as provided in this *Example 4(ii)* rather than as provided in *Example 2(ii)*. Thus, in year 7 (and in each subsequent year) E must include in gross income under paragraph (d) of this section, the excess of the policy cash value over the lesser of 80 percent of the aggregate premiums paid by R or the policy cash value of the contract (to the extent E did not actually include such amounts in gross income for a prior taxable year). In addition, in year 7 (and each subsequent year) E must also include in gross income the value of the

economic benefits described in paragraph (d)(2)(i) of this section provided to E under the arrangement during in each such year.

*Example 5.* (i) The facts are the same as in *Example 3* except that in year 7, E is designated as the policy owner. At that time, E's rights to the contract are substantially vested as defined in § 1.83-3(b).

(ii) In year 7, R is treated as having made a transfer (within the meaning of paragraph (c)(3) of this section) of the life insurance contract to E. E must include in gross income the amount determined under paragraph (g)(1) of this section.

(iii) After the transfer of the contract to E, E is the owner of the contract and any premium payments by R will be included in E's income under paragraph (b)(5) of this section and § 1.61-2(d)(2)(ii)(A) (unless R's payments are split-dollar loans as defined in § 1.7872-15(b)(1)).

*Example 6.* (i) In year 1, E and R enter into a split-dollar life insurance arrangement as defined in paragraph (b)(2) of this section. Under the arrangement, R is required to make annual premium payments of \$10,000 and E is required to make annual premium payments of \$500. In year 5, a \$500 policy owner dividend payable to E is declared by the insurance company. E directs the insurance company to use the \$500 as E's premium payment for year 5.

(ii) For each year the arrangement is in effect, E must include in gross income the value of the economic benefits provided during the year, as required by paragraph (d)(2) of this section, over the \$500 premium payments paid by E. In year 5, E must also include in gross income as compensation the excess, if any, of the \$500 distributed to E from the proceeds of the policy owner dividend over the amount determined under paragraph (e)(3)(ii) of this section.

(iii) R must include in income the premiums paid by E during the years the split-dollar life insurance arrangement is in effect, including the \$500 of the premium E paid in year 5 with proceeds of the policy owner dividend. R's investment in the contract is increased in an amount equal to the premiums paid by E, including the \$500 of the premium paid by E in year 5 from the proceeds of the policy owner dividend. In year 5, R is treated as receiving a \$500 distribution under the contract, which is taxed pursuant to section 72.

*Example 7.* (i) The facts are the same as in *Example 2* except that in year 10, E withdraws \$100,000 from the cash value of the contract.

(ii) In year 10, R is treated as receiving a \$100,000 distribution from the insurance company. This amount is treated as an amount received by R under the contract and taxed pursuant to section 72. This amount reduces R's investment in the contract under section 72(e). R is treated as paying the \$100,000 to E as cash compensation, and E must include that amount in gross income less any amounts determined under paragraph (e)(3)(ii) of this section.

*Example 8.* (i) The facts are the same as in *Example 7* except E receives the proceeds of a \$100,000 specified policy loan directly from the insurance company.

(ii) The transfer of the proceeds of the specified policy loan to E is treated as a loan

by the insurance company to R. Under the rules of section 72(e), the \$100,000 loan is not included in R's income and does not reduce R's investment in the contract. R is treated as paying the \$100,000 of loan proceeds to E as cash compensation. E must include that amount in gross income less any amounts determined under paragraph (e)(3)(ii) of this section.

(i) [Reserved]

(j) *Effective date*—(1) *General rule*—(i) *In general.* This section applies to any split-dollar life insurance arrangement (as defined in paragraph (b)(1) or (2) of this section) entered into after September 17, 2003.

(ii) *Determination of when an arrangement is entered into.* For purposes of paragraph (j) of this section, a split-dollar life insurance arrangement is entered into on the latest of 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 on which the first premium on the life insurance contract under the arrangement is paid;

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

(E) The date on which the arrangement satisfies the definition of a split-dollar life insurance arrangement (as defined in paragraph (b)(1) or (2) of this section).

(2) *Modified arrangements treated as new arrangements*—(i) *In general.* For purposes of paragraph (j)(1) of this section, if an arrangement entered into on or before September 17, 2003 is materially modified after September 17, 2003, the arrangement is treated as a new arrangement entered into on the date of the modification.

(ii) *Non-material modifications.* The following is a non-exclusive list of changes that are not material modifications under paragraph (j)(2)(i) of this section (either alone or in conjunction with other changes listed in paragraphs (j)(2)(ii)(A) through (I) of this section)—

(A) A change solely in the mode of premium payment (for example, a change from monthly to quarterly premiums);

(B) A change solely in the beneficiary of the life insurance contract, unless the beneficiary is a party to the arrangement;

(C) A change solely in the interest rate payable under the life insurance contract on a policy loan;

(D) A change solely necessary to preserve the status of the life insurance contract under section 7702;

(E) A change solely to the ministerial provisions of the life insurance contract (for example, a change in the address to send payment);

(F) A change made solely under the terms of any agreement (other than the life insurance contract) that is a part of the split-dollar life insurance arrangement if the change is non-discretionary by the parties and is made pursuant to a binding commitment (whether set forth in the agreement or otherwise) in effect on or before September 17, 2003;

(G) A change solely in the owner of the life insurance contract as a result of a transaction to which section 381(a) applies and in which substantially all of the former owner's assets are transferred to the new owner of the policy;

(H) A change to the policy solely if such change is required by a court or a state insurance commissioner as a result of the insolvency of the insurance company that issued the policy; or

(I) A change solely in the insurance company that administers the policy as a result of an assumption reinsurance transaction between the issuing insurance company and the new insurance company to which the owner and the non-owner were not a party.

(iii) *Delegation to Commissioner.* The Commissioner, in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin, may provide additional guidance with respect to other modifications that are not material for purposes of paragraph (j)(2)(i) of this section. See § 601.601(d)(2)(ii) of this chapter.

■ **Par. 4.** Section 1.83-1 is amended by:

■ 1. Removing the second sentence of paragraph (a)(2).

■ 2. Adding a sentence at the end of paragraph (a)(2).

The addition reads as follows:

**§ 1.83-1 Property transferred in connection with the performance of services.**

(a) \* \* \*

(2) *Life insurance.* \* \* \* For the taxation of life insurance protection under a split-dollar life insurance arrangement (as defined in § 1.61-22(b)(1) or (2)), see § 1.61-22.

\* \* \* \* \*

■ **Par. 5.** Section 1.83-3 is amended by:

■ 1. Adding a sentence at the end of paragraph (a)(1).

■ 2. Adding a sentence immediately prior to the last sentence in paragraph (e).

The additions read as follows:

**§ 1.83-3 Meaning and use of certain terms.**

(a) \* \* \* (1) \* \* \* For special rules applying to the transfer of a life

insurance contract (or an undivided interest therein) that is part of a split-dollar life insurance arrangement (as defined in § 1.61-22(b)(1) or (2)), see § 1.61-22(g).

\* \* \* \* \*

(e) \* \* \* Notwithstanding the previous sentence, in the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any undivided interest therein, that is part of a split-dollar life insurance arrangement (as defined in § 1.61-22(b)(1) or (2)) that is entered into, or materially modified (within the meaning of § 1.61-22(j)(2)), after September 17, 2003, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than current life insurance protection, are treated as property for purposes of this section. \* \* \*

\* \* \* \* \*

■ **Par. 6.** Section 1.83-6 is amended as follows:

■ 1. Redesignating paragraph (a)(5) as paragraph (a)(6).

■ 2. Adding a new paragraph (a)(5).

The addition reads as follows:

**§ 1.83-6 Deduction by employer.**

(a) \* \* \*

(5) *Transfer of life insurance contract (or an undivided interest therein)*—(i) *General rule.* In the case of a transfer of a life insurance contract (or an undivided interest therein) described in § 1.61-22(c)(3) in connection with the performance of services, a deduction is allowable under paragraph (a)(1) of this section to the person for whom the services were performed. The amount of the deduction, if allowable, is equal to the sum of the amount included as compensation in the gross income of the service provider under § 1.61-22(g)(1) and the amount determined under § 1.61-22(g)(1)(ii).

(ii) *Effective date*—(A) *General rule*—Paragraph (a)(5)(i) of this section applies to any split-dollar life insurance arrangement (as defined in § 1.61-22(b)(1) or (2)) entered into after September 17, 2003. For purposes of this paragraph (a)(5), an arrangement is entered into as determined under § 1.61-22(j)(1)(ii).

(B) *Modified arrangements treated as new arrangements.* If an arrangement entered into on or before September 17, 2003 is materially modified (within the meaning of § 1.61-22(j)(2)) after September 17, 2003, the arrangement is

treated as a new arrangement entered into on the date of the modification.

\* \* \* \* \*

■ **Par. 7.** In § 1.301-1, paragraph (q) is added to read as follows:

**§ 1.301-1 Rules applicable with respect to distributions of money and other property.**

\* \* \* \* \*

(q) *Split-dollar and other life insurance arrangements*—(1) *Split-dollar life insurance arrangements*—(i) *Distribution of economic benefits.* The provision by a corporation to its shareholder pursuant to a split-dollar life insurance arrangement, as defined in § 1.61-22(b)(1) or (2), of economic benefits described in § 1.61-22(d) or of amounts described in § 1.61-22(e) is treated as a distribution of property, the amount of which is determined under § 1.61-22(d) and (e), respectively.

(ii) *Distribution of entire contract or undivided interest therein.* A transfer (within the meaning of § 1.61-22(c)(3)) of the ownership of a life insurance contract (or an undivided interest therein) that is part of a split-dollar life insurance arrangement is a distribution of property, the amount of which is determined pursuant to § 1.61-22(g)(1) and (2).

(2) *Other life insurance arrangements.* A payment by a corporation on behalf of a shareholder of premiums on a life insurance contract or an undivided interest therein that is owned by the shareholder constitutes a distribution of property, even if such payment is not part of a split-dollar life insurance arrangement under § 1.61-22(b).

(3) *When distribution is made*—(i) *In general.* Except as provided in paragraph (q)(3)(ii) of this section, paragraph (b) of this section shall apply to determine when a distribution described in paragraph (q)(1) or (2) of this section is taken into account by a shareholder.

(ii) *Exception.* Notwithstanding paragraph (b) of this section, a distribution described in paragraph (q)(1)(ii) of this section shall be treated as made by a corporation to its shareholder at the time that the life insurance contract, or an undivided interest therein, is transferred (within the meaning of § 1.61-22(c)(3)) to the shareholder.

(4) *Effective date*—(i) *General rule.* This paragraph (q) applies to split-dollar and other life insurance arrangements entered into after September 17, 2003. For purposes of this paragraph (q)(4), a split-dollar life insurance arrangement is entered into as determined under § 1.61-22(j)(1)(ii).

(ii) *Modified arrangements treated as new arrangements.* If a split-dollar life

insurance arrangement entered into on or before September 17, 2003 is materially modified (within the meaning of § 1.61-22(j)(2)) after September 17, 2003, the arrangement is treated as a new arrangement entered into on the date of the modification.

■ **Par. 8.** Section 1.1402(a)-18 is added to read as follows:

**§ 1.1402(a)-18 Split-dollar life insurance arrangements.**

See §§ 1.61-22 and 1.7872-15 for rules relating to the treatment of split-dollar life insurance arrangements.

■ **Par. 9.** Section 1.7872-15 is added to read as follows:

**§ 1.7872-15 Split-dollar loans.**

(a) *General rules*—(1) *Introduction.* This section applies to split-dollar loans as defined in paragraph (b)(1) of this section. If a split-dollar loan is not a below-market loan, then, except as provided in this section, the loan is governed by the general rules for debt instruments (including the rules for original issue discount (OID) under sections 1271 through 1275 and the regulations thereunder). If a split-dollar loan is a below-market loan, then, except as provided in this section, the loan is governed by section 7872. The timing, amount, and characterization of the imputed transfers between the lender and borrower of a below-market split-dollar loan depend upon the relationship between the parties and upon whether the loan is a demand loan or a term loan. For additional rules relating to the treatment of split-dollar life insurance arrangements, see § 1.61-22.

(2) *Loan treatment*—(i) *General rule.* A payment made pursuant to a split-dollar life insurance arrangement is treated as a loan for Federal tax purposes, and the owner and non-owner are treated, respectively, as the borrower and the lender, if—

(A) The payment is made either directly or indirectly by the non-owner to the owner (including a premium payment made by the non-owner directly or indirectly to the insurance company with respect to the policy held by the owner);

(B) The payment is a loan under general principles of Federal tax law or, if it is not a loan under general principles of Federal tax law (for example, because of the nonrecourse nature of the obligation or otherwise), a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest); and

(C) The repayment is to be made from, or is secured by, the policy's death

benefit proceeds, the policy's cash surrender value, or both.

(ii) *Payments that are only partially repayable.* For purposes of § 1.61-22 and this section, if a non-owner makes a payment pursuant to a split-dollar life insurance arrangement and the non-owner is entitled to repayment of some but not all of the payment, the payment is treated as two payments: One that is repayable and one that is not. Thus, paragraph (a)(2)(i) of this section refers to the repayable payment.

(iii) *Treatment of payments that are not split-dollar loans.* See § 1.61-22(b)(5) for the treatment of payments by a non-owner that are not split-dollar loans.

(iv) *Examples.* The provisions of this paragraph (a)(2) are illustrated by the following examples:

*Example 1.* Assume an employee owns a life insurance policy under a split-dollar life insurance arrangement, the employer makes premium payments on this policy, there is a reasonable expectation that the payments will be repaid, and the repayments are secured by the policy. Under paragraph (a)(2)(i) of this section, each premium payment is a loan for Federal tax purposes.

*Example 2.* (i) Assume an employee owns a life insurance policy under a split-dollar life insurance arrangement and the employer makes premium payments on this policy. The employer is entitled to be repaid 80 percent of each premium payment, and the repayments are secured by the policy. Under paragraph (a)(2)(ii) of this section, the taxation of 20 percent of each premium payment is governed by § 1.61-22(b)(5). If there is a reasonable expectation that the remaining 80 percent of a payment will be repaid in full, then, under paragraph (a)(2)(i) of this section, the 80 percent is a loan for Federal tax purposes.

(ii) If less than 80 percent of a premium payment is reasonably expected to be repaid, then this paragraph (a)(2) does not cause any of the payment to be a loan for Federal tax purposes. If the payment is not a loan under general principles of Federal tax law, the taxation of the entire premium payment is governed by § 1.61-22(b)(5).

(3) *No de minimis exceptions.* For purposes of this section, section 7872 is applied to a split-dollar loan without regard to the *de minimis* exceptions in section 7872(c)(2) and (3).

(4) *Certain interest provisions disregarded—(i) In general.* If a split-dollar loan provides for the payment of interest and all or a portion of the interest is to be paid directly or indirectly by the lender (or a person related to the lender), then the requirement to pay the interest (or portion thereof) is disregarded for purposes of this section. All of the facts and circumstances determine whether a payment to be made by the lender (or a person related to the lender) is

sufficiently independent from the split-dollar loan for the payment to not be an indirect payment of the interest (or a portion thereof) by the lender (or a person related to the lender).

(ii) *Examples.* The provisions of this paragraph (a)(4) are illustrated by the following examples:

*Example 1—* (i) On January 1, 2009, Employee *B* issues a split-dollar term loan to Employer *Y*. The split-dollar term loan provides for five percent interest, compounded annually. Interest and principal on the split-dollar term loan are due at maturity. On January 1, 2009, *B* and *Y* also enter into a fully vested non-qualified deferred compensation arrangement that will provide a payment to *B* in an amount equal to the accrued but unpaid interest due at the maturity of the split-dollar term loan.

(ii) Under paragraph (a)(4)(i) of this section, *B*'s requirement to pay interest on the split-dollar term loan is disregarded for purposes of this section, and the split-dollar term loan is treated as a loan that does not provide for interest for purposes of this section.

*Example 2—* (i) On January 1, 2004, Employee *B* and Employer *Y* enter into a fully vested non-qualified deferred compensation arrangement that will provide a payment to *B* equal to *B*'s salary in the three years preceding the retirement of *B*. On January 1, 2009, *B* and *Y* enter into a split-dollar life insurance arrangement and, under the arrangement, *B* issues a split-dollar term loan to *Y* on that date. The split-dollar term loan provides for five percent interest, compounded annually. Interest and principal on the split-dollar term loan are due at maturity. Over the period in which the non-qualified deferred compensation arrangement is effective, the terms and conditions of *B*'s non-qualified deferred compensation arrangement do not change in a way that indicates that the payment of the non-qualified deferred compensation is related to *B*'s requirement to pay interest on the split-dollar term loan. No other facts and circumstances exist to indicate that the payment of the non-qualified deferred compensation is related to *B*'s requirement to pay interest on the split-dollar term loan.

(ii) The facts and circumstances indicate that the payment by *Y* of non-qualified deferred compensation is independent from *B*'s requirement to pay interest under the split-dollar term loan. Under paragraph (a)(4)(i) of this section, the fully vested non-qualified deferred compensation does not cause *B*'s requirement to pay interest on the split-dollar term loan to be disregarded for purposes of this section. For purposes of this section, the split-dollar term loan is treated as a loan that provides for stated interest of five percent, compounded annually.

(b) *Definitions.* For purposes of this section, the terms *split-dollar life insurance arrangement*, *owner*, and *non-owner* have the same meanings as provided in § 1.61-22(b) and (c). In addition, the following definitions apply for purposes of this section:

(1) A *split-dollar loan* is a loan described in paragraph (a)(2)(i) of this section.

(2) A *split-dollar demand loan* is any split-dollar loan that is payable in full at any time on the demand of the lender (or within a reasonable time after the lender's demand).

(3) A *split-dollar term loan* is any split-dollar loan other than a split-dollar demand loan. See paragraph (e)(5) of this section for special rules regarding certain split-dollar term loans payable on the death of an individual, certain split-dollar term loans conditioned on the future performance of substantial services by an individual, and gift split-dollar term loans.

(c) *Interest deductions for split-dollar loans.* The borrower may not deduct any qualified stated interest, OID, or imputed interest on a split-dollar loan. See sections 163(h) and 264(a). In certain circumstances, an indirect participant may be allowed to deduct qualified stated interest, OID, or imputed interest on a deemed loan. See paragraph (e)(2)(iii) of this section (relating to indirect loans).

(d) *Treatment of split-dollar loans providing for nonrecourse payments—*

(1) *In general.* Except as provided in paragraph (d)(2) of this section, if a payment on a split-dollar loan is nonrecourse to the borrower, the payment is a contingent payment for purposes of this section. See paragraph (j) of this section for the treatment of a split-dollar loan that provides for one or more contingent payments.

(2) *Exception for certain loans with respect to which the parties to the split-dollar life insurance arrangement make a representation—(i) Requirement.* An otherwise noncontingent payment on a split-dollar loan that is nonrecourse to the borrower is not a contingent payment under this section if the parties to the split-dollar life insurance arrangement represent in writing that a reasonable person would expect that all payments under the loan will be made.

(ii) *Time and manner for providing written representation.* The Commissioner may prescribe the time and manner for providing the written representation required by paragraph (d)(2)(i) of this section. Until the Commissioner prescribes otherwise, the written representation that is required by paragraph (d)(2)(i) of this section must meet the requirements of this paragraph (d)(2)(ii). Both the borrower and the lender must sign the representation not later than the last day (including extensions) for filing the Federal income tax return of the borrower or lender, whichever is earlier, for the taxable year in which the lender

makes the first split-dollar loan under the split-dollar life insurance arrangement. This representation must include the names, addresses, and taxpayer identification numbers of the borrower, lender, and any indirect participants. Unless otherwise stated therein, this representation applies to all subsequent split-dollar loans made pursuant to the split-dollar life insurance arrangement. Each party should retain an original of the representation as part of its books and records and should attach a copy of this representation to its Federal income tax return for any taxable year in which the lender makes a loan to which the representation applies.

(e) *Below-market split-dollar loans*—(1) *Scope*—(i) *In general*. This paragraph (e) applies to below-market split-dollar loans enumerated under section 7872(c)(1), which include gift loans, compensation-related loans, and corporation-shareholder loans. The characterization of a split-dollar loan under section 7872(c)(1) and of the imputed transfers under section 7872(a)(1) and (b)(1) depends upon the relationship between the lender and the borrower or the lender, borrower, and any indirect participant. For example, if the lender is the borrower's employer, the split-dollar loan is generally a compensation-related loan, and any imputed transfer from the lender to the borrower is generally a payment of compensation. The loans covered by this paragraph (e) include indirect loans between the parties. See paragraph (e)(2) of this section for the treatment of certain indirect split-dollar loans. See paragraph (f) of this section for the treatment of any stated interest or OID on split-dollar loans. See paragraph (j) of this section for additional rules that apply to a split-dollar loan that provides for one or more contingent payments.

(ii) *Significant-effect split-dollar loans*. If a direct or indirect below-market split-dollar loan is not enumerated in section 7872(c)(1)(A), (B), or (C), the loan is a significant-effect loan under section 7872(c)(1)(E).

(2) *Indirect split-dollar loans*—(i) *In general*. If, based on all the facts and circumstances, including the relationship between the borrower or lender and some third person (the indirect participant), the effect of a below-market split-dollar loan is to transfer value from the lender to the indirect participant and from the indirect participant to the borrower, then the below-market split-dollar loan is restructured as two or more successive below-market loans (the deemed loans) as provided in this paragraph (e)(2). The transfers of value

described in the preceding sentence include (but are not limited to) a gift, compensation, a capital contribution, and a distribution under section 301 (or, in the case of an S corporation, under section 1368). The deemed loans are—

(A) A deemed below-market split-dollar loan made by the lender to the indirect participant; and

(B) A deemed below-market split-dollar loan made by the indirect participant to the borrower.

(ii) *Application*. Each deemed loan is treated as having the same provisions as the original loan between the lender and borrower, and section 7872 is applied to each deemed loan. Thus, for example, if, under a split-dollar life insurance arrangement, an employer (lender) makes an interest-free split-dollar loan to an employee's child (borrower), the loan is restructured as a deemed compensation-related below-market split-dollar loan from the lender to the employee (the indirect participant) and a second deemed gift below-market split-dollar loan from the employee to the employee's child. In appropriate circumstances, section 7872(d)(1) may limit the interest that accrues on a deemed loan for Federal income tax purposes. For loan arrangements between husband and wife, see section 7872(f)(7).

(iii) *Limitations on investment interest for purposes of section 163(d)*. For purposes of section 163(d), the imputed interest from the indirect participant to the lender that is taken into account by the indirect participant under this paragraph (e)(2) is not investment interest to the extent of the excess, if any, of—

(A) The imputed interest from the indirect participant to the lender that is taken into account by the indirect participant; over

(B) The imputed interest to the indirect participant from the borrower that is recognized by the indirect participant.

(iv) *Examples*. The provisions of this paragraph (e)(2) are illustrated by the following examples:

*Example 1.* (i) On January 1, 2009, Employer X and Individual A enter into a split-dollar life insurance arrangement under which A is named as the policy owner. A is the child of B, an employee of X. On January 1, 2009, X makes a \$30,000 premium payment, repayable upon demand without interest. Repayment of the premium payment is fully recourse to A. The payment is a below-market split-dollar demand loan. A's net investment income for 2009 is \$1,100, and there are no other outstanding loans between A and B. Assume that the blended annual rate for 2009 is 5 percent, compounded annually.

(ii) Based on the relationships among the parties, the effect of the below-market split-dollar loan from X to A is to transfer value from X to B and then to transfer value from B to A. Under paragraph (e)(2) of this section, the below-market split-dollar loan from X to A is restructured as two deemed below-market split-dollar demand loans: a compensation-related below-market split-dollar loan between X and B and a gift below-market split-dollar loan between B and A. Each of the deemed loans has the same terms and conditions as the original loan.

(iii) Under paragraph (e)(3) of this section, the amount of forgone interest deemed paid to B by A in 2009 is \$1,500 ( $[\$30,000 \times 0.05] - 0$ ). Under section 7872(d)(1), however, the amount of forgone interest deemed paid to B by A is limited to \$1,100 (A's net investment income for the year). Under paragraph (e)(2)(iii) of this section, B's deduction under section 163(d) in 2009 for interest deemed paid on B's deemed loan from X is limited to \$1,100 (the interest deemed received from A).

*Example 2.* (i) The facts are the same as the facts in *Example 1*, except that T, an irrevocable life insurance trust established for the benefit of A (B's child), is named as the policy owner. T is not a grantor trust.

(ii) Based on the relationships among the parties, the effect of the below-market split-dollar loan from X to T is to transfer value from X to B and then to transfer value from B to T. Under paragraph (e)(2) of this section, the below-market split-dollar loan from X to T is restructured as two deemed below-market split-dollar demand loans: a compensation-related below-market split-dollar loan between X and B and a gift below-market split-dollar loan between B and T. Each of the deemed loans has the same terms and conditions as the original loan.

(iii) Under paragraph (e)(3) of this section, the amount of forgone interest deemed paid to B by T in 2009 is \$1,500 ( $[\$30,000 \times 0.05] - 0$ ). Section 7872(d)(1) does not apply because T is not an individual. The amount of forgone interest deemed paid to B by T is \$1,500. Under paragraph (e)(2)(iii) of this section, B's deduction under section 163(d) in 2009 for interest deemed paid on B's deemed loan from X is \$1,500 (the interest deemed received from T).

(3) *Split-dollar demand loans*—(i) *In general*. This paragraph (e)(3) provides rules for testing split-dollar demand loans for sufficient interest, and, if the loans do not provide for sufficient interest, rules for the calculation and treatment of forgone interest on these loans. See paragraph (g) of this section for additional rules that apply to a split-dollar loan providing for certain variable rates of interest.

(ii) *Testing for sufficient interest*. Each calendar year that a split-dollar demand loan is outstanding, the loan is tested to determine if the loan provides for sufficient interest. A split-dollar demand loan provides for sufficient interest for the calendar year if the rate (based on annual compounding) at

which interest accrues on the loan's adjusted issue price during the year is no lower than the blended annual rate for the year. (The Internal Revenue Service publishes the blended annual rate in the Internal Revenue Bulletin in July of each year (see § 601.601(d)(2)(ii) of this chapter.) If the loan does not provide for sufficient interest, the loan is a below-market split-dollar demand loan for that calendar year. See paragraph (e)(3)(iii) of this section to determine the amount and treatment of forgone interest for each calendar year the loan is below-market.

(iii) *Imputations*—(A) *Amount of forgone interest*. For each calendar year, the amount of forgone interest on a split-dollar demand loan is treated as transferred by the lender to the borrower and as retransferred as interest by the borrower to the lender. This amount is the excess of—

(1) The amount of interest that would have been payable on the loan for the calendar year if interest accrued on the loan's adjusted issue price at the blended annual rate (determined in paragraph (e)(3)(ii) of this section) and were payable annually on the day referred to in paragraph (e)(3)(iii)(B) of this section; over

(2) Any interest that accrues on the loan during the year.

(B) *Timing of transfers of forgone interest*—(1) *In general*. Except as provided in paragraphs (e)(3)(iii)(B)(2) and (3) of this section, the forgone interest (as determined under paragraph (e)(3)(iii)(A) of this section) that is attributable to a calendar year is treated as transferred by the lender to the borrower (and retransferred as interest by the borrower to the lender) on the last day of the calendar year and is accounted for by each party to the split-dollar loan in a manner consistent with that party's method of accounting.

(2) *Exception for death, liquidation, or termination of the borrower*. In the taxable year in which the borrower dies (in the case of a borrower who is a natural person) or is liquidated or otherwise terminated (in the case of a borrower other than a natural person), any forgone interest is treated, for both the lender and the borrower, as transferred and retransferred on the last day of the borrower's final taxable year.

(3) *Exception for repayment of below-market split-dollar loan*. Any forgone interest is treated, for both the lender and the borrower, as transferred and retransferred on the day the split-dollar loan is repaid in full.

(4) *Split-dollar term loans*—(i) *In general*. Except as provided in paragraph (e)(5) of this section, this paragraph (e)(4) provides rules for

testing split-dollar term loans for sufficient interest and, if the loans do not provide for sufficient interest, rules for imputing payments on these loans. See paragraph (g) of this section for additional rules that apply to a split-dollar loan providing for certain variable rates of interest.

(ii) *Testing a split-dollar term loan for sufficient interest*. A split-dollar term loan is tested on the day the loan is made to determine if the loan provides for sufficient interest. A split-dollar term loan provides for sufficient interest if the imputed loan amount equals or exceeds the amount loaned. The imputed loan amount is the present value of all payments due under the loan, determined as of the date the loan is made, using a discount rate equal to the AFR in effect on that date. The AFR used for purposes of the preceding sentence must be appropriate for the loan's term (short-term, mid-term, or long-term) and for the compounding period used in computing the present value. See section 1274(d)(1). If the split-dollar loan does not provide for sufficient interest, the loan is a below-market split-dollar term loan subject to paragraph (e)(4)(iv) of this section.

(iii) *Determining loan term*. This paragraph (e)(4)(iii) provides rules to determine the term of a split-dollar term loan for purposes of paragraph (e)(4)(ii) of this section. The term of the loan determined under this paragraph (e)(4)(iii) (other than paragraph (e)(4)(iii)(C) of this section) applies to determine the split-dollar loan's term, payment schedule, and yield for all purposes of this section.

(A) *In general*. Except as provided in paragraph (e)(4)(iii)(B), (C), (D) or (E) of this section, the term of a split-dollar term loan is based on the period from the date the loan is made until the loan's stated maturity date.

(B) *Special rules for certain options*—(1) *Payment schedule that minimizes yield*. If a split-dollar term loan is subject to one or more unconditional options that are exercisable at one or more times during the term of the loan and that, if exercised, require payments to be made on the split-dollar loan on an alternative payment schedule (for example, an option to extend or an option to call a split-dollar loan), then the rules of this paragraph (e)(4)(iii)(B)(1) determine the term of the loan. However, this paragraph (e)(4)(iii)(B)(1) applies only if the timing and amounts of the payments that comprise each payment schedule are known as of the issue date. For purposes of determining a split-dollar loan's term, the borrower is projected to exercise or not exercise an option or combination of

options in a manner that minimizes the loan's overall yield. Similarly, the lender is projected to exercise or not exercise an option or combination of options in a manner that minimizes the loan's overall yield. If different projected patterns of exercise or non-exercise produce the same minimum yield, the parties are projected to exercise or not exercise an option or combination of options in a manner that produces the longest term.

(2) *Change in circumstances*. If the borrower (or lender) does or does not exercise the option as projected under paragraph (e)(4)(iii)(B)(1) of this section, the split-dollar loan is treated for purposes of this section as retired and reissued on the date the option is or is not exercised for an amount of cash equal to the loan's adjusted issue price on that date. The reissued loan must be retested using the appropriate AFR in effect on the date of reissuance to determine whether it is a below-market loan.

(3) *Examples*. The following examples illustrate the rules of this paragraph (e)(4)(iii)(B):

*Example 1*. Employee *B* issues a 10-year split-dollar term loan to Employer *Y*. *B* has the right to prepay the loan at the end of year 5. Interest is payable on the split-dollar loan at 1 percent for the first 5 years and at 10 percent for the remaining 5 years. Under paragraph (e)(4)(iii)(B)(1) of this section, this arrangement is treated as a 5-year split-dollar term loan from *Y* to *B*, with interest payable at 1 percent.

*Example 2*. The facts are the same as the facts in *Example 1*, except that *B* does not in fact prepay the split-dollar loan at the end of year 5. Under paragraph (e)(4)(iii)(B)(2) of this section, the first loan is treated as retired at the end of year 5 and a new 5-year split-dollar term loan is issued at that time, with interest payable at 10 percent.

*Example 3*. Employee *A* issues a 10-year split-dollar term loan on which the lender, Employer *X*, has the right to demand payment at the end of year 2. Interest is payable on the split-dollar loan at 7 percent each year that the loan is outstanding. Under paragraph (e)(4)(iii)(B)(1) of this section, this arrangement is treated as a 10-year split-dollar term loan because the exercise of *X*'s put option would not reduce the yield of the loan (the yield of the loan is 7 percent, compounded annually, whether or not *X* demands payment).

(C) *Split-dollar term loans providing for certain variable rates of interest*. If a split-dollar term loan is subject to paragraph (g) of this section (a split-dollar loan that provides for certain variable rates of interest), the term of the loan for purposes of paragraph (e)(4)(ii) of this section is determined under paragraph (g)(3)(ii) of this section.

(D) *Split-dollar loans payable upon the death of an individual*. If a split-

dollar term loan is described in paragraph (e)(5)(ii)(A) or (v)(A) of this section, the term of the loan for purposes of paragraph (e)(4)(ii) of this section is determined under paragraph (e)(5)(ii)(C) or (v)(B)(2) of this section, whichever is applicable.

(E) *Split-dollar loans conditioned on the future performance of substantial services by an individual.* If a split-dollar term loan is described in paragraph (e)(5)(iii)(A)(1) or (v)(A) of this section, the term of the loan for purposes of paragraph (e)(4)(ii) of this section is determined under paragraph (e)(5)(iii)(C) or (v)(B)(2) of this section, whichever is applicable.

(iv) *Timing and amount of imputed transfer in connection with below-market split-dollar term loans.* If a split-dollar term loan is a below-market loan, then the rules applicable to below-market term loans under section 7872 apply. In general, the loan is recharacterized as consisting of two portions: an imputed loan amount (as defined in paragraph (e)(4)(ii) of this section) and an imputed transfer from the lender to the borrower. The imputed transfer occurs at the time the loan is made (for example, when the lender makes a premium payment on a life insurance policy) and is equal to the excess of the amount loaned over the imputed loan amount.

(v) *Amount treated as OID.* In the case of any below-market split-dollar term loan described in this paragraph (e)(4), for purposes of applying sections 1271 through 1275 and the regulations thereunder, the issue price of the loan is the amount determined under § 1.1273-2, reduced by the amount of the imputed transfer described in paragraph (e)(4)(iv) of this section. Thus, the loan is generally treated as having OID in an amount equal to the amount of the imputed transfer described in paragraph (e)(4)(iv) of this section, in addition to any other OID on the loan (determined without regard to section 7872(b)(2)(A) or this paragraph (e)(4)).

(vi) *Example.* The provisions of this paragraph (e)(4) are illustrated by the following example:

*Example.* (i) On July 1, 2009, Corporation Z and Shareholder A enter into a split-dollar life insurance arrangement under which A is named as the policy owner. On July 1, 2009, Z makes a \$100,000 premium payment, repayable without interest in 15 years. Repayment of the premium payment is fully recourse to A. The premium payment is a split-dollar term loan. Assume the long-term AFR (based on annual compounding) at the time the loan is made is 7 percent.

(ii) Based on a 15-year term and a discount rate of 7 percent, compounded annually (the long-term AFR), the present value of the

payments under the loan is \$36,244.60, determined as follows:  $\$100,000/[1+(0.07/1)]^{15}$ . This loan is a below-market split-dollar term loan because the imputed loan amount of \$36,244.60 (the present value of the amount required to be repaid to Z) is less than the amount loaned (\$100,000).

(iii) In accordance with section 7872(b)(1) and paragraph (e)(4)(iv) of this section, on the date that the loan is made, Z is treated as transferring to A \$63,755.40 (the excess of \$100,000 (amount loaned) over \$36,244.60 (imputed loan amount)). Under section 7872 and paragraph (e)(1)(i) of this section, Z is treated as making a section 301 distribution to A on July 1, 2009, of \$63,755.40. Z must take into account as OID an amount equal to the imputed transfer. See § 1.1272-1 for the treatment of OID.

(5) *Special rules for certain split-dollar term loans—(i) In general.* This paragraph (e)(5) provides rules for split-dollar loans payable on the death of an individual, split-dollar loans conditioned on the future performance of substantial services by an individual, and gift term loans. These split-dollar loans are split-dollar term loans for purposes of determining whether the loan provides for sufficient interest. If, however, the loan is a below-market split-dollar loan, then, except as provided in paragraph (e)(5)(v) of this section, forgone interest is determined annually, similar to a demand loan, but using an AFR that is appropriate for the loan's term and that is determined when the loan is issued.

(ii) *Split-dollar loans payable not later than the death of an individual—(A) Applicability.* This paragraph (e)(5)(ii) applies to a split-dollar term loan payable not later than the death of an individual.

(B) *Treatment of loan.* A split-dollar loan described in paragraph (e)(5)(ii)(A) of this section is tested under paragraph (e)(4)(ii) of this section to determine if the loan provides for sufficient interest. If the loan provides for sufficient interest, then section 7872 does not apply to the loan, and the interest on the loan is taken into account under paragraph (f) of this section. If the loan does not provide for sufficient interest, then section 7872 applies to the loan, and the loan is treated as a below-market demand loan subject to paragraph (e)(3)(iii) of this section. For each year that the loan is outstanding, however, the rate used in the determination of forgone interest under paragraph (e)(3)(iii) of this section is not the blended annual rate but rather is the AFR (based on annual compounding) appropriate for the loan's term as of the month in which the loan is made. See paragraph (e)(5)(ii)(C) of this section to determine the loan's term.

(C) *Term of loan.* For purposes of paragraph (e)(5)(ii)(B) of this section, the term of a split-dollar loan payable on the death of an individual (including the death of the last survivor of a group of individuals) is the individual's life expectancy as determined under the appropriate table in § 1.72-9 on the day the loan is made. If a split-dollar loan is payable on the earlier of the individual's death or another term determined under paragraph (e)(4)(iii) of this section, the term of the loan is whichever term is shorter.

(D) *Retirement and reissuance of loan.* If a split-dollar loan described in paragraph (e)(5)(ii)(A) of this section remains outstanding longer than the term determined under paragraph (e)(5)(ii)(C) of this section because the individual outlived his or her life expectancy, the split-dollar loan is treated for purposes of this section as retired and reissued as a split-dollar demand loan at that time for an amount of cash equal to the loan's adjusted issue price on that date. However, the loan is not retested at that time to determine whether the loan provides for sufficient interest. For purposes of determining forgone interest under paragraph (e)(5)(ii)(B) of this section, the appropriate AFR for the reissued loan is the AFR determined under paragraph (e)(5)(ii)(B) of this section on the day the loan was originally made.

(iii) *Split-dollar loans conditioned on the future performance of substantial services by an individual—(A) Applicability—(1) In general.* This paragraph (e)(5)(iii) applies to a split-dollar term loan if the benefits of the interest arrangements of the loan are not transferable and are conditioned on the future performance of substantial services (within the meaning of section 83) by an individual.

(2) *Exception.* Notwithstanding paragraph (e)(5)(iii)(A)(1) of this section, this paragraph (e)(5)(iii) does not apply to a split-dollar loan described in paragraph (e)(5)(v)(A) of this section (regarding a split-dollar loan that is payable on the later of a term certain and the date on which the condition to perform substantial future services by an individual ends).

(B) *Treatment of loan.* A split-dollar loan described in paragraph (e)(5)(iii)(A)(1) of this section is tested under paragraph (e)(4)(ii) of this section to determine if the loan provides for sufficient interest. Except as provided in paragraph (e)(5)(iii)(D) of this section, if the loan provides for sufficient interest, then section 7872 does not apply to the loan and the interest on the loan is taken into account under paragraph (f) of this section. If the loan does not

provide for sufficient interest, then section 7872 applies to the loan and the loan is treated as a below-market demand loan subject to paragraph (e)(3)(iii) of this section. For each year that the loan is outstanding, however, the rate used in the determination of forgone interest under paragraph (e)(3)(iii) of this section is not the blended annual rate but rather is the AFR (based on annual compounding) appropriate for the loan's term as of the month in which the loan is made. See paragraph (e)(5)(iii)(C) of this section to determine the loan's term.

(C) *Term of loan.* The term of a split-dollar loan described in paragraph (e)(5)(iii)(A)(1) of this section is based on the period from the date the loan is made until the loan's stated maturity date. However, if a split-dollar loan described in paragraph (e)(5)(iii)(A)(1) of this section does not have a stated maturity date, the term of the loan is presumed to be seven years.

(D) *Retirement and reissuance of loan.* If a split-dollar loan described in paragraph (e)(5)(iii)(A)(1) of this section remains outstanding longer than the term determined under paragraph (e)(5)(iii)(C) of this section because of the continued performance of substantial services, the split-dollar loan is treated for purposes of this section as retired and reissued as a split-dollar demand loan at that time for an amount of cash equal to the loan's adjusted issue price on that date. The loan is retested at that time to determine whether the loan provides for sufficient interest.

(iv) *Gift split-dollar term loans—(A) Applicability.* This paragraph (e)(5)(iv) applies to gift split-dollar term loans.

(B) *Treatment of loan.* A split-dollar loan described in paragraph (e)(5)(iv)(A) of this section is tested under paragraph (e)(4)(ii) of this section to determine if the loan provides for sufficient interest. If the loan provides for sufficient interest, then section 7872 does not apply to the loan and the interest on the loan is taken into account under paragraph (f) of this section. If the loan does not provide for sufficient interest, then section 7872 applies to the loan and the loan is treated as a below-market demand loan subject to paragraph (e)(3)(iii) of this section. For each year that the loan is outstanding, however, the rate used in the determination of forgone interest under paragraph (e)(3)(iii) of this section is not the blended annual rate but rather is the AFR (based on annual compounding) appropriate for the loan's term as of the month in which the loan is made. See paragraph (e)(5)(iv)(C) of this section to determine the loan's term.

(C) *Term of loan.* For purposes of paragraph (e)(5)(iv)(B) of this section, the term of a gift split-dollar term loan is the term determined under paragraph (e)(4)(iii) of this section.

(D) *Limited application for gift split-dollar term loans.* The rules of paragraph (e)(5)(iv)(B) of this section apply to a gift split-dollar term loan only for Federal income tax purposes. For purposes of Chapter 12 of the Internal Revenue Code (relating to the gift tax), gift below-market split-dollar term loans are treated as term loans under section 7872(b) and paragraph (e)(4) of this section. See section 7872(d)(2).

(v) *Split-dollar loans payable on the later of a term certain and another specified date—(A) Applicability.* This paragraph (e)(5)(v) applies to any split-dollar term loan payable upon the later of a term certain or—

(1) The death of an individual; or

(2) For a loan described in paragraph (e)(5)(iii)(A)(1) of this section, the date on which the condition to perform substantial future services by an individual ends.

(B) *Treatment of loan—(1) In general.* A split-dollar loan described in paragraph (e)(5)(v)(A) of this section is a split-dollar term loan, subject to paragraph (e)(4) of this section.

(2) *Term of the loan.* The term of a split-dollar loan described in paragraph (e)(5)(v)(A) of this section is the term certain.

(3) *Appropriate AFR.* The appropriate AFR for a split-dollar loan described in paragraph (e)(5)(v)(A) of this section is based on a term of the longer of the term certain or the loan's expected term as determined under either paragraph (e)(5)(ii) or (iii) of this section, whichever is applicable.

(C) *Retirement and reissuance.* If a split-dollar loan described in paragraph (e)(5)(v)(A) of this section remains outstanding longer than the term certain, the split-dollar loan is treated for purposes of this section as retired and reissued at the end of the term certain for an amount of cash equal to the loan's adjusted issue price on that date. The reissued loan is subject to paragraph (e)(5)(ii) or (iii) of this section, whichever is applicable. However, the loan is not retested at that time to determine whether the loan provides for sufficient interest. For purposes of paragraph (e)(3)(iii) of this section, the appropriate AFR for the reissued loan is the AFR determined under paragraph (e)(5)(v)(B)(3) of this section on the day the loan was originally made.

(vi) *Example.* The provisions of this paragraph (e)(5) are illustrated by the following example:

*Example.* (i) On January 1, 2009, Corporation Y and Shareholder B, a 65 year-old male, enter into a split-dollar life insurance arrangement under which B is named as the policy owner. On January 1, 2009, Y makes a \$100,000 premium payment, repayable, without interest, from the death benefits of the underlying contract upon B's death. The premium payment is a split-dollar term loan. Repayment of the premium payment is fully recourse to B. Assume the long-term AFR (based on annual compounding) at the time of the loan is 7 percent. Both Y and B use the calendar year as their taxable years.

(ii) Based on Table 1 in § 1.72-9, the expected term of the loan is 15 years. Under paragraph (e)(5)(ii)(C) of this section, the long-term AFR (based on annual compounding) is the appropriate test rate. Based on a 15-year term and a discount rate of 7 percent, compounded annually (the long-term AFR), the present value of the payments under the loan is \$36,244.60, determined as follows:  $\$100,000/[1+(0.07/1)]^{15}$ . Under paragraph (e)(5)(ii)(B) of this section, this loan is a below-market split-dollar term loan because the imputed loan amount of \$36,244.60 (the present value of the amount required to be repaid to Y) is less than the amount loaned (\$100,000).

(iii) Under paragraph (e)(5)(ii)(B) of this section, the amount of forgone interest for 2009 (and each subsequent full calendar year that the loan remains outstanding) is \$7,000, which is the amount of interest that would have been payable on the loan for the calendar year if interest accrued on the loan's adjusted issue price (\$100,000) at the long-term AFR (7 percent, compounded annually). Under section 7872 and paragraph (e)(1)(i) of this section, on December 31, 2009, Y is treated as making a section 301 distribution to B of \$7,000. In addition, Y has \$7,000 of imputed interest income for 2009.

(f) *Treatment of stated interest and OID for split-dollar loans—(1) In general.* If a split-dollar loan provides for stated interest or OID, the loan is subject to this paragraph (f), regardless of whether the split-dollar loan has sufficient interest. Except as otherwise provided in this section, split-dollar loans are subject to the same Internal Revenue Code and regulatory provisions for stated interest and OID as other loans. For example, the lender of a split-dollar loan that provides for stated interest must account for any qualified stated interest (as defined in § 1.1273-1(c)) under its regular method of accounting (for example, an accrual method or the cash receipts and disbursements method). See § 1.446-2 to determine the amount of qualified stated interest that accrues during an accrual period. In addition, the lender must account under § 1.1272-1 for any OID on a split-dollar loan. However,

§ 1.1272-1(c) does not apply to any split-dollar loan. See paragraph (h) of this section for a subsequent waiver, cancellation, or forgiveness of stated interest on a split-dollar loan.

(2) *Term, payment schedule, and yield.* The term of a split-dollar term loan determined under paragraph (e)(4)(iii) of this section (other than paragraph (e)(4)(iii)(C) of this section) applies to determine the split-dollar loan's term, payment schedule, and yield for all purposes of this section.

(g) *Certain variable rates of interest—(1) In general.* This paragraph (g) provides rules for a split-dollar loan that provides for certain variable rates of interest. If this paragraph (g) does not apply to a variable rate split-dollar loan, the loan is subject to the rules in paragraph (j) of this section for split-dollar loans that provide for one or more contingent payments.

(2) *Applicability—(i) In general.* Except as provided in paragraph (g)(2)(ii) of this section, this paragraph (g) applies to a split-dollar loan that is a variable rate debt instrument (within the meaning of § 1.1275-5) and that provides for stated interest at a qualified floating rate (or rates).

(ii) *Interest rate restrictions.* This paragraph (g) does not apply to a split-dollar loan if, as a result of interest rate restrictions (such as an interest rate cap), the expected yield of the loan taking the restrictions into account is significantly less than the expected yield of the loan without regard to the restrictions. Conversely, if reasonably symmetric interest rate caps and floors or reasonably symmetric governors are fixed throughout the term of the loan, these restrictions generally do not prevent this paragraph (g) from applying to the loan.

(3) *Testing for sufficient interest—(i) Demand loan.* For purposes of paragraph (e)(3)(ii) of this section (regarding testing a split-dollar demand loan for sufficient interest), a split-dollar demand loan is treated as if it provided for a fixed rate of interest for each accrual period to which a qualified floating rate applies. The projected fixed rate for each accrual period is the value of the qualified floating rate as of the beginning of the calendar year that contains the last day of the accrual period.

(ii) *Term loan.* For purposes of paragraph (e)(4)(ii) of this section (regarding testing a split-dollar term loan for sufficient interest), a split-dollar term loan subject to this paragraph (g) is treated as if it provided for a fixed rate of interest for each accrual period to which a qualified floating rate applies. The projected fixed rate for each accrual

period is the value of the qualified floating rate on the date the split-dollar term loan is made. The term of a split-dollar loan that is subject to this paragraph (g)(3)(ii) is determined using the rules in § 1.1274-4(c)(2). For example, if the loan provides for interest at a qualified floating rate that adjusts at varying intervals, the term of the loan is determined by reference to the longest interval between interest adjustment dates. See paragraph (e)(5) of this section for special rules relating to certain split-dollar term loans, such as a split-dollar term loan payable not later than the death of an individual.

(4) *Interest accruals and imputed transfers.* For purposes of paragraphs (e) and (f) of this section, the projected fixed rate or rates determined under paragraph (g)(3) of this section are used for purposes of determining the accrual of interest each period and the amount of any imputed transfers. Appropriate adjustments are made to the interest accruals and any imputed transfers to take into account any difference between the projected fixed rate and the actual rate.

(5) *Example.* The provisions of this paragraph (g) are illustrated by the following example:

*Example.* (i) On January 1, 2010, Employer V and Employee F enter into a split-dollar life insurance arrangement under which F is named as the policy owner. On January 1, 2010, V makes a \$100,000 premium payment, repayable in 15 years. The premium payment is a split-dollar term loan. Under the arrangement between the parties, interest is payable on the split-dollar loan each year on January 1, starting January 1, 2011, at a rate equal to the value of 1-year LIBOR as of the payment date. The short-term AFR (based on annual compounding) at the time of the loan is 7 percent. Repayment of both the premium payment and the interest due thereon is nonrecourse to F. However, the parties made a representation under paragraph (d)(2) of this section. Assume that the value of 1-year LIBOR on January 1, 2010, is 8 percent, compounded annually.

(ii) The loan is subject to this paragraph (g) because the loan is a variable rate debt instrument that bears interest at a qualified floating rate. Because the interest rate is reset each year, under paragraph (g)(3)(ii) of this section, the short-term AFR (based on annual compounding) is the appropriate test rate used to determine whether the loan provides for sufficient interest. Moreover, under paragraph (g)(3)(ii) of this section, to determine whether the loan provides for sufficient interest, the loan is treated as if it provided for a fixed rate of interest equal to 8 percent, compounded annually. Based on a discount rate of 7 percent, compounded annually (the short-term AFR), the present value of the payments under the loan is \$109,107.91. The loan provides for sufficient interest because the loan's imputed loan amount of \$109,107.91 (the present value of

the payments) is more than the amount loaned of \$100,000. Therefore, the loan is not a below-market split-dollar term loan, and interest on the loan is taken into account under paragraph (f) of this section.

(h) *Adjustments for interest paid at less than the stated rate—(1)*

*Application—(i) In general.* To the extent required by this paragraph (h), if accrued but unpaid interest on a split-dollar loan is subsequently waived, cancelled, or forgiven by the lender, then the waiver, cancellation, or forgiveness is treated as if, on that date, the interest had in fact been paid to the lender and retransferred by the lender to the borrower. The amount deemed transferred and retransferred is determined under paragraph (h) (2) or (3) of this section. Except as provided in paragraph (h)(1)(iv) of this section, the amount treated as retransferred by the lender to the borrower under paragraph (h) (2) or (3) of this section is increased by the deferral charge determined under paragraph (h)(4) of this section. To determine the character of any retransferred amount, see paragraph (e)(1)(i) of this section. See § 1.61-22(b)(6) for the treatment of amounts other than interest on a split-dollar loan that are waived, cancelled, or forgiven by the lender.

(ii) *Certain split-dollar term loans.* For purposes of this paragraph (h), a split-dollar term loan described in paragraph (e)(5) of this section (for example, a split-dollar term loan payable not later than the death of an individual) is subject to the rules of paragraph (h)(3) of this section.

(iii) *Payments treated as a waiver, cancellation, or forgiveness.* For purposes of this paragraph (h), if a payment by the lender (or a person related to the lender) to the borrower is, in substance, a waiver, cancellation, or forgiveness of accrued but unpaid interest, the payment by the lender (or person related to the lender) is treated as an amount retransferred to the borrower by the lender under this paragraph (h) and is subject to the deferral charge in paragraph (h)(4) of this section to the extent that the payment is, in substance, a waiver, cancellation, or forgiveness of accrued but unpaid interest.

(iv) *Treatment of certain nonrecourse split-dollar loans.* For purposes of this paragraph (h), if the parties to a split-dollar life insurance arrangement make the representation described in paragraph (d)(2) of this section and the interest actually paid on the split-dollar loan is less than the interest required to be accrued on the split-dollar loan, the excess of the interest required to be accrued over the interest actually paid

is treated as waived, cancelled, or forgiven by the lender under this paragraph (h). However, the amount treated as retransferred under paragraph (h)(1)(i) of this section is not increased by the deferral charge in paragraph (h)(4) of this section.

(2) *Split-dollar term loans.* In the case of a split-dollar term loan, the amount of interest deemed transferred and retransferred for purposes of paragraph (h)(1) of this section is determined as follows:

(i) If the loan's stated rate is less than or equal to the appropriate AFR (the AFR used to test the loan for sufficient interest under paragraph (e) of this section), the amount of interest deemed transferred and retransferred pursuant to this paragraph (h) is the excess of the amount of interest payable at the stated rate over the interest actually paid.

(ii) If the loan's stated rate is greater than the appropriate AFR (the AFR used to test the loan for sufficient interest under paragraph (e) of this section), the amount of interest deemed transferred and retransferred pursuant to this paragraph (h) is the excess, if any, of the amount of interest payable at the AFR over the interest actually paid.

(3) *Split-dollar demand loans.* In the case of a split-dollar demand loan, the amount of interest deemed transferred and retransferred for purposes of paragraph (h)(1) of this section is equal to the aggregate of—

(i) For each year that the split-dollar demand loan was outstanding in which the loan was a below-market split-dollar demand loan, the excess of the amount of interest payable at the stated rate over the interest actually paid allocable to that year; plus

(ii) For each year that the split-dollar demand loan was outstanding in which the loan was not a below-market split-dollar demand loan, the excess, if any, of the amount of interest payable at the appropriate rate used for purposes of imputation for that year over the interest actually paid allocable to that year.

(4) *Deferral charge.* The Commissioner may prescribe the method for determining the deferral charge treated as retransferred by the lender to the borrower under paragraph (h)(1) of this section. Until the Commissioner prescribes otherwise, the deferral charge is determined under paragraph (h)(4)(i) of this section for a split-dollar term loan subject to paragraph (h)(2) of this section and under paragraph (h)(4)(ii) of this section for a split-dollar demand loan subject to paragraph (h)(3) of this section.

(i) *Split-dollar term loan.* The deferral charge for a split-dollar term loan subject to paragraph (h)(2) of this

section is determined by multiplying the hypothetical underpayment by the applicable underpayment rate, compounded daily, for the period from the date the split-dollar loan was made to the date the interest is waived, cancelled, or forgiven. The hypothetical underpayment is equal to the amount determined under paragraph (h)(2) of this section, multiplied by the highest rate of income tax applicable to the borrower (for example, the highest rate in effect under section 1 for individuals) for the taxable year in which the split-dollar term loan was made. The applicable underpayment rate is the average of the quarterly underpayment rates in effect under section 6621(a)(2) for the period from the date the split-dollar loan was made to the date the interest is waived, cancelled, or forgiven.

(ii) *Split-dollar demand loan.* The deferral charge for a split-dollar demand loan subject to paragraph (h)(3) of this section is the sum of the following amounts determined for each year the loan was outstanding (other than the year in which the waiver, cancellation, or forgiveness occurs): For each year the loan was outstanding, multiply the hypothetical underpayment for the year by the applicable underpayment rate, compounded daily, for the applicable period. The hypothetical underpayment is equal to the amount determined under paragraph (h)(3) of this section for each year, multiplied by the highest rate of income tax applicable to the borrower for that year (for example, the highest rate in effect under section 1 for individuals). The applicable underpayment rate is the average of the quarterly underpayment rates in effect under section 6621(a)(2) for the applicable period. The applicable period for a year is the period of time from the last day of that year until the date the interest is waived, cancelled, or forgiven.

(5) *Examples.* The provisions of this paragraph (h) are illustrated by the following examples:

*Example 1.* (i) On January 1, 2009, Employer Y and Employee B entered into a split-dollar life insurance arrangement under which B is named as the policy owner. On January 1, 2009, Y made a \$100,000 premium payment, repayable on December 31, 2011, with interest of 5 percent, compounded annually. The premium payment is a split-dollar term loan. Assume the short-term AFR (based on annual compounding) at the time the loan was made was 5 percent. Repayment of both the premium payment and the interest due thereon was fully recourse to B. On December 31, 2011, Y is repaid \$100,000 but Y waives the remainder due on the loan (\$15,762.50). Both Y and B use the calendar year as their taxable years.

(ii) When the split-dollar term loan was made, the loan was not a below-market loan under paragraph (e)(4)(ii) of this section. Under paragraph (f) of this section, Y was required to accrue compound interest of 5 percent each year the loan remained outstanding. B, however, was not entitled to any deduction for this interest under paragraph (c) of this section.

(iii) Under paragraph (h)(1) of this section, the waived amount is treated as if, on December 31, 2011, it had in fact been paid to Y and was then retransferred by Y to B. The amount deemed transferred to Y and retransferred to B equals the excess of the amount of interest payable at the stated rate (\$15,762.50) over the interest actually paid (\$0), or \$15,762.50. In addition, the amount deemed retransferred to B is increased by the deferral charge determined under paragraph (h)(4) of this section. Because of the employment relationship between Y and B, the total retransferred amount is treated as compensation paid by Y to B.

*Example 2.* (i) On January 1, 2009, Employer Y and Employee B entered into a split-dollar life insurance arrangement under which B is named as the policy owner. On January 1, 2009, Y made a \$100,000 premium payment, repayable on the demand of Y, with interest of 7 percent, compounded annually. The premium payment is a split-dollar demand loan. Assume the blended annual rate (based on annual compounding) in 2009 was 5 percent and in 2010 was 6 percent. Repayment of both the premium payment and the interest due thereon was fully recourse to B. On December 31, 2010, Y demands repayment and is repaid its \$100,000 premium payment in full; however, Y waives all interest due on the loan. Both Y and B use the calendar year as their taxable years.

(ii) For each year that the split-dollar demand loan was outstanding, the loan was not a below-market loan under paragraph (e)(3)(ii) of this section. Under paragraph (f) of this section, Y was required to accrue compound interest of 7 percent each year the loan remained outstanding. B, however, was not entitled to any deduction for this interest under paragraph (c) of this section.

(iii) Under paragraph (h)(1) of this section, a portion of the waived interest is treated as if, on December 31, 2010, it had in fact been paid to Y and was then retransferred by Y to B. The amount of interest deemed transferred to Y and retransferred to B equals the excess, if any, of the amount of interest payable at the blended annual rate for each year the loan is outstanding over the interest actually paid with respect to that year. For 2009, the interest payable at the blended annual rate is \$5,000 (\$100,000 × 0.05). For 2010, the interest payable at the blended annual rate is \$6,000 (\$100,000 × 0.06). Therefore, the amount of interest deemed transferred to Y and retransferred to B equals \$11,000. In addition, the amount deemed retransferred to B is increased by the deferral charge determined under paragraph (h)(4) of this section. Because of the employment relationship between Y and B, the total retransferred amount is treated as compensation paid by Y to B.

(i) [Reserved]

(j) *Split-dollar loans that provide for contingent payments*—(1) *In general.* Except as provided in paragraph (j)(2) of this section, this paragraph (j) provides rules for a split-dollar loan that provides for one or more contingent payments. This paragraph (j), rather than § 1.1275-4, applies to split-dollar loans that provide for one or more contingent payments.

(2) *Exceptions*—(i) *Certain contingencies.* For purposes of this section, a split-dollar loan does not provide for contingent payments merely because—

(A) The loan provides for options described in paragraph (e)(4)(iii)(B) of this section (for example, certain call options, put options, and options to extend); or

(B) The loan is described in paragraph (e)(5) of this section (relating to certain split-dollar term loans, such as a split-dollar term loan payable not later than the death of an individual).

(ii) *Insolvency and default.* For purposes of this section, a payment is not contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances.

However, if any payment on a split-dollar loan is nonrecourse to the borrower, the payment is a contingent payment for purposes of this paragraph (j) unless the parties to the arrangement make the written representation provided for in paragraph (d)(2) of this section.

(iii) *Remote and incidental contingencies.* For purposes of this section, a payment is not a contingent payment merely because of a contingency that, as of the date the split-dollar loan is made, is either remote or incidental (within the meaning of § 1.1275-2(h)).

(iv) *Exceptions for certain split-dollar loans.* This paragraph (j) does not apply to a split-dollar loan described in § 1.1272-1(d) (certain debt instruments that provide for a fixed yield) or a split-dollar loan described in paragraph (g) of this section (relating to split-dollar loans providing for certain variable rates of interest).

(3) *Contingent split-dollar method*—(i) *In general.* If a split-dollar loan provides for one or more contingent payments, then the parties account for the loan under the contingent split-dollar method. In general, except as provided in this paragraph (j), this method is the same as the noncontingent bond method described in § 1.1275-4(b).

(ii) *Projected payment schedule*—(A) *Determination of schedule.* No comparable yield is required to be determined. The projected payment schedule for the loan includes all

noncontingent payments and a projected payment for each contingent payment. The projected payment for a contingent payment is the lowest possible value of the payment. The projected payment schedule, however, must produce a yield that is not less than zero. If the projected payment schedule produces a negative yield, the schedule must be reasonably adjusted to produce a yield of zero.

(B) *Split-dollar term loans payable upon the death of an individual.* If a split-dollar term loan described in paragraph (e)(5)(ii)(A) or (v)(A)(1) of this section provides for one or more contingent payments, the projected payment schedule is determined based on the term of the loan as determined under paragraph (e)(5)(ii)(C) or (v)(B)(2) of this section, whichever is applicable.

(C) *Certain split-dollar term loans conditioned on the future performance of substantial services by an individual.* If a split-dollar term loan described in paragraph (e)(5)(iii)(A)(1) or (v)(A)(2) of this section provides for one or more contingent payments, the projected payment schedule is determined based on the term of the loan as determined under paragraph (e)(5)(iii)(C) or (v)(B)(2) of this section, whichever is applicable.

(D) *Demand loans.* If a split-dollar demand loan provides for one or more contingent payments, the projected payment schedule is determined based on a reasonable assumption as to when the lender will demand repayment.

(E) *Borrower/lender consistency.* Contrary to § 1.1275-4(b)(4)(iv), the lender rather than the borrower is required to determine the projected payment schedule and to provide the schedule to the borrower and to any indirect participant as described in paragraph (e)(2) of this section. The lender's projected payment schedule is used by the lender, the borrower, and any indirect participant to compute interest accruals and adjustments.

(iii) *Negative adjustments.* If the issuer of a split-dollar loan is not allowed to deduct interest or OID (for example, because of section 163(h) or 264), then the issuer is not required to include in income any negative adjustment carryforward determined under § 1.1275-4(b)(6)(iii)(C) on the loan, except to the extent that at maturity the total payments made over the life of the loan are less than the issue price of the loan.

(4) *Application of section 7872*—(i) *Determination of below-market status.* The yield based on the projected payment schedule determined under paragraph (j)(3) of this section is used to determine whether the loan is a below-

market split-dollar loan under paragraph (e) of this section.

(ii) *Adjustment upon the resolution of a contingent payment.* To the extent that interest has accrued under section 7872 on a split-dollar loan and the interest would not have accrued under this paragraph (j) in the absence of section 7872, the lender is not required to recognize income under § 1.1275-4(b) for a positive adjustment and the borrower is not treated as having interest expense for a positive adjustment. To the same extent, there is a reversal of the tax consequences imposed under paragraph (e) of this section for the prior imputed transfer from the lender to the borrower. This reversal is taken into account in determining adjusted gross income.

(5) *Examples.* The following examples illustrate the rules of this paragraph (j). For purposes of this paragraph (j)(5), assume that the contingent payments are neither remote nor incidental. The examples are as follows:

*Example 1.* (i) On January 1, 2010, Employer *T* and Employee *G* enter into a split-dollar life insurance arrangement under which *G* is named as the policy owner. On January 1, 2010, *T* makes a \$100,000 premium payment. On December 31, 2013, *T* will be repaid an amount equal to the premium payment plus an amount based on the increase, if any, in the price of a specified commodity for the period the loan is outstanding. The premium payment is a split-dollar term loan. Repayment of both the premium payment and the interest due thereon is recourse to *G*. Assume that the appropriate AFR for this loan, based on annual compounding, is 7 percent. Both *T* and *G* use the calendar year as their taxable years.

(ii) Under this paragraph (j), the split-dollar term loan between *T* and *G* provides for a contingent payment. Therefore, the loan is subject to the contingent split-dollar method. Under this method, the projected payment schedule for the loan provides for a noncontingent payment of \$100,000 and a projected payment of \$0 for the contingent payment (because it is the lowest possible value of the payment) on December 31, 2013.

(iii) Based on the projected payment schedule and a discount rate of 7 percent, compounded annually (the appropriate AFR), the present value of the payments under the loan is \$76,289.52. Under paragraphs (e)(4) and (j)(4)(i) of this section, the loan does not provide for sufficient interest because the loan's imputed loan amount of \$76,289.52 (the present value of the payments) is less than the amount loaned of \$100,000. Therefore, the loan is a below-market split-dollar term loan and the loan is recharacterized as consisting of two portions: an imputed loan amount of \$76,289.52 and an imputed transfer of \$23,710.48 (amount loaned of \$100,000 minus the imputed loan amount of \$76,289.52).

(iv) In accordance with section 7872(b)(1) and paragraph (e)(4)(iv) of this section, on the

date the loan is made, *T* is treated as transferring to *G* \$23,710.48 (the imputed transfer) as compensation. In addition, *T* must take into account as OID an amount equal to the imputed transfer. See § 1.1272-1 for the treatment of OID.

*Example 2.* (i) Assume, in addition to the facts in *Example 1*, that on December 31, 2013, *T* receives \$115,000 (its premium payment of \$100,000 plus \$15,000).

(ii) Under the contingent split-dollar method, when the loan is repaid, there is a \$15,000 positive adjustment (\$15,000 actual payment minus \$0 projected payment). Under paragraph (j)(4) of this section, because *T* accrued imputed interest under section 7872 on this split-dollar loan to *G* and this interest would not have accrued in the absence of section 7872, *T* is not required to include the positive adjustment in income, and *G* is not treated as having interest expense for the positive adjustment. To the same extent, *T* must include in income, and *G* is entitled to deduct, \$15,000 to reverse their respective prior tax consequences imposed under paragraph (e) of this section (*T*'s prior deduction for imputed compensation deemed paid to *G* and *G*'s prior inclusion of this amount). *G* takes the reversal into account in determining adjusted gross income. That is, the \$15,000 is an "above-the-line" deduction, whether or not *G* itemizes deductions.

*Example 3.* (i) Assume the same facts as in *Example 2*, except that on December 31, 2013, *T* receives \$127,000 (its premium payment of \$100,000 plus \$27,000).

(ii) Under the contingent split-dollar method, when the loan is repaid, there is a \$27,000 positive adjustment (\$27,000 actual payment minus \$0 projected payment). Under paragraph (j)(4) of this section, because *T* accrued imputed interest of \$23,710.48 under section 7872 on this split-dollar loan to *G* and this interest would not have accrued in the absence of section 7872, *T* is not required to include \$23,710.48 of the positive adjustment in income, and *G* is not treated as having interest expense for the positive adjustment. To the same extent, in 2013, *T* must include in income, and *G* is entitled to deduct, \$23,710.48 to reverse their respective prior tax consequences imposed under paragraph (e) of this section (*T*'s prior deduction for imputed compensation deemed paid to *G* and *G*'s prior inclusion of this amount). *G* and *T* take these reversals into account in determining adjusted gross income. Under the contingent split-dollar method, *T* must include in income \$3,289.52 upon resolution of the contingency (\$27,000 positive adjustment minus \$23,710.48).

(k) *Payment ordering rule.* For purposes of this section, a payment made by the borrower to or for the benefit of the lender pursuant to a split-dollar life insurance arrangement is applied to all direct and indirect split-dollar loans in the following order—

(1) A payment of interest to the extent of accrued but unpaid interest (including any OID) on all outstanding split-dollar loans in the order the interest accrued;

(2) A payment of principal on the outstanding split-dollar loans in the order in which the loans were made;

(3) A payment of amounts previously paid by a non-owner pursuant to a split-dollar life insurance arrangement that were not reasonably expected to be repaid by the owner; and

(4) Any other payment with respect to a split-dollar life insurance arrangement, other than a payment taken into account under paragraphs (k)(1), (2), and (3) of this section.

(l) [Reserved]

(m) *Repayments received by a lender.* Any amount received by a lender under a life insurance contract that is part of a split-dollar life insurance arrangement is treated as though the amount had been paid to the borrower and then paid by the borrower to the lender. Any amount treated as received by the borrower under this paragraph (m) is subject to other provisions of the Internal Revenue Code as applicable (for example, sections 72 and 101(a)). The lender must take the amount into account as a payment received with respect to a split-dollar loan, in accordance with paragraph (k) of this section. No amount received by a lender with respect to a split-dollar loan is treated as an amount received by reason of the death of the insured.

(n) *Effective date—(1) General rule.* This section applies to any split-dollar life insurance arrangement entered into after September 17, 2003. For purposes of this section, an arrangement is entered into as determined under § 1.61-22(j)(1)(ii).

(2) *Modified arrangements treated as new arrangements.* If an arrangement entered into on or before September 17, 2003 is materially modified (within the meaning of § 1.61-22(j)(2)) after September 17, 2003, the arrangement is treated as a new arrangement entered into on the date of the modification.

**PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE**

■ **Par. 10.** The authority citation for part 31 continues to read in part as follows:

Authority: 26 U.S.C. 7805. \* \* \*

■ **Par. 11.** In § 31.3121(a)-1, paragraph (k) is added to read as follows:

**§ 31.3121(a)-1 Wages.**

\* \* \* \* \*

(k) *Split-dollar life insurance arrangements.* Except as otherwise provided under section 3121(v), see §§ 1.61-22 and 1.7872-15 of this chapter for rules relating to the treatment of split-dollar life insurance arrangements.

■ **Par. 12.** In § 31.3231(e)-1, paragraph (a)(6) is added to read as follows:

**§ 31.3231(e)-1 Compensation.**

(a) \* \* \*

(6) *Split-dollar life insurance arrangements.* See §§ 1.61-22 and 1.7872-15 of this chapter for rules relating to the treatment of split-dollar life insurance arrangements.

\* \* \* \* \*

■ **Par. 13.** In § 31.3306(b)-1, paragraph (l) is added to read as follows:

**§ 31.3306(b)-1 Wages.**

\* \* \* \* \*

(l) *Split-dollar life insurance arrangements.* Except as otherwise provided under section 3306(r), see §§ 1.61-22 and 1.7872-15 of this chapter for rules relating to the treatment of split-dollar life insurance arrangements.

■ **Par. 14.** In § 31.3401(a)-1, paragraph (b)(15) is added to read as follows:

**§ 31.3401(a)-1 Wages.**

\* \* \* \* \*

(b) \* \* \*

(15) *Split-dollar life insurance arrangements.* See § 1.61-22 of this chapter for rules relating to the treatment of split-dollar life insurance arrangements.

\* \* \* \* \*

**PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT**

■ **Par. 15.** The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805. \* \* \*

■ **Par. 16.** In section 602.101, paragraph (b) is amended by adding an entry in numerical order for § 1.7872-15 to read as follows:

**§ 602.101 OMB Control numbers.**

\* \* \* \* \*

(b) \* \* \*

CFR part or section where identified and described	Current OMB control No.
* * * * *	* * * * *
1.7872-15 .....	1545-1792
* * * * *	* * * * *

Robert E. Wenzel,

Deputy Commissioner for Services and Enforcement.

Approved: September 11, 2003.

Pamela F. Olson,

Assistant Secretary of the Treasury.

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