



Estate Planning Split-Dollar (Collateral Assignment)

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Concept Analysis

Split-Dollar Life Insurance	1
Scope of Article	1
History	1
Split-Dollar and Gross Income	2
Date “Entered Into”.....	2
Material Modification.....	2
Basic Definitions	3
Split-Dollar Life Insurance.....	3
Collateral Assignment Split-Dollar.....	3
The Two Regimes: “Economic Benefit” and “Loan”	3
“Owner” and the Applicable “Regime”.....	4
Economic Benefit Regime.....	4
Loan Regime.....	4
Collateral Assignment Under Either Regime.....	4
The Economic Benefit Regime	4
Treatment of the Economic Benefit.....	4
Contributory.....	4
Non-Contributory.....	4
Determining Economic Benefit.....	5
Current Life Insurance Protection.....	5
Calculating Cost of Protection.....	5
Death Benefit Taxation.....	5
Termination of Arrangement During Insured’s Life.....	6
The Loan Regime	9
Applicable Loan Rules.....	9
Below-Market Demand Loans.....	9
Below-Market Term Loans.....	10
Imputed Interest Taxation.....	12
Death Benefit Taxation.....	12
Termination of Arrangement During Insured’s Life.....	12
Accrued and Forgiven Interest.....	12
Choice of Regimes	16
Switching Regimes	16
Reasons to Change Regimes.....	16
Split-Dollar Arrangements & ERISA	17
Summary	18

Split-Dollar Life Insurance

A split-dollar life insurance arrangement is an arrangement between two people by which life insurance is written on the life of one, though both share the premium payments.¹ This is a method for funding a life insurance policy, not a type of life insurance protection.

Estate planning split-dollar is an arrangement where the insured has acquired a policy to meet estate planning needs, and is funding the policy under a split-dollar arrangement. The policy may be owned by the insured, a family member, or a trust, depending on the insured’s unique needs. The funding may be provided by the insured’s employer, a corporation of which the insured is a shareholder, or a family member of the insured.

For simplicity, references used in discussion and examples in this article will generally be made in terms of a typical estate planning arrangement where the insured’s trust is the actual owner of the policy, and the insured’s employer is the funding party.

Scope of Article

On September 11, 2003, the IRS issued regulations for the tax treatment of split-dollar life insurance arrangements “entered

into” after September 17, 2003.² This article addresses these arrangements.

Generally, IRS Notice 2002-8 will control the tax treatment of split-dollar arrangements “entered into” before September 18, 2003 (pre-final regulation). These pre-final regulation arrangements are not addressed in any detail in this article, but a brief review of the history of split-dollar is offered as a starting foundation.

History

The split-dollar approach to funding life insurance premiums has developed amidst uncertainty in its income tax consequences. The tax history of the split-dollar approach began in 1955 with the IRS’s release of Revenue Ruling 55-713 where it took the position that split-dollar was an un-taxed, interest-free loan. In the 1961 *Dean* case,³ the IRS changed positions and argued that the interest was taxable. Even though the court ruled against the IRS, this clear change of position brought uncertainty to the planning community. In 1964, the IRS released Revenue Ruling 64-328, revoking Revenue Ruling 55-713 and clarifying income and gift tax consequences by introducing the concept of the economic benefit of life insurance protection.

The early “classic” split-dollar arrangement was based on the employer paying the premium up to the increase in cash surrender value, with the remaining

¹ Black’s Law Dictionary (8th ed. 2004) (under definition for Life Insurance). A more technical, regulation-based discussion of the definition of split-dollar is included later in this article.

² Treas. Reg. §§ 1.61-22, 1.83-1(a)(2), 1.83-3(e), 1.83-6(a)(5), 1.301-1(q), 1.7872-15

³ *Dean v. Commissioner of Internal Revenue*, 35 T.C. 1083 (1961).

premium paid by the policy owner.⁴ Later, the equity split-dollar arrangement⁵ grew more widespread than the classic arrangement. Although very common, there was still concern and debate on whether the equity accumulation in the policy was taxable under the income tax rules (and gift tax rules if there was a third-party owner.)

This debate came to an end with the release of IRS Notices 2001-10 and 2002-8, followed by guidance in proposed and then final treasury regulations. It is now clear from these notices and regulations that equity accumulation can't be built from interest free premium advances while avoiding income taxation.

Split-Dollar and Gross Income

IRC § 61 provides a non-exclusive list of items that are included in a taxpayer's gross income. The treasury regulations under § 61 provide further guidance as to what must be included and have been updated with regulation § 1.61-22 that provides the rules for the tax treatment of split-dollar life insurance arrangements.⁶

⁴ References to a policy owner generally mean the party listed on the contract as owner of the policy. The split-dollar regulations create an extra meaning where another party might be treated as the owner for taxation purposes. Any references in this article to the owner (or non-owner) for split-dollar and tax purposes will be indicated by the use of quotation marks ("owner" or "non-owner") and references to the actual owner will be made explicitly.

⁵ An arrangement whereby the owner of the policy retains the right to all cash value in excess of premiums advanced by the sponsor. This excess amount is considered the owner's equity. The sponsor is the party advancing the premiums; the employer, corporation, or donor.

⁶ Treas. Reg. § 1.61-22, also referred to as the "Final Regulations" for split-dollar arrangements. A pdf version of this regulation is currently available at:

http://a257.q.akamaitech.net/7/257/2422/12feb20041500/edocket.access.gpo.gov/cfr_2004/aprqr/pdf/26cfr1.61-22.pdf

Generally, the Code of Federal Regulations can be accessed at:

<http://www.access.gpo.gov/nara/cfr/cfr-table-search.html>.

Date "Entered Into"

These relatively new rules are applicable to split-dollar life insurance arrangements "entered into" after September 17, 2003.⁷ The date a new arrangement is entered into is the latest of the following:

1. the date on which the life insurance contract under the arrangement is issued,
2. the effective date of the life insurance contract under the arrangement,
3. the date on which the first premium on the life insurance contract under the arrangement is paid,
4. the date on which the parties to the arrangement enter into an agreement with regard to the policy, or
5. the date on which the arrangement satisfies the definition of a split-dollar life insurance arrangement (as defined in the regulation).⁸

Material Modification

A split-dollar arrangement entered into before September 18, 2003 will generally be subject to the rules under IRS Notice 2002-8, but, "material modification" of the arrangement can cause it to be controlled by the current split-dollar regulations because of the definition of "entered into". A pre-existing arrangement⁹ that is "materially modified" after September 17, 2003 is treated as "entered into" on the date of the modification and thus subject to the new regulations.¹⁰ Even though the basic idea of "entered into" seems clear, what constitutes a material modification is not clearly defined in the regulation. Rather, a non-exclusive listing of non-material modifications is provided. The non-material modifications listed in the regulation are:

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

⁷ Treas. Reg. § 1.61-22(j)(1).

⁸ Treas. Reg. § 1.61-22(j)(1)(ii)

⁹ established before September 18, 2003.

¹⁰ Treas. Reg. § 1.61-22(j)(2).

2. a change solely in the beneficiary of the life insurance contract, unless the beneficiary is a party to the arrangement,
3. a change solely in the interest rate payable under the life insurance contract on a policy loan,
4. a change solely necessary to preserve the status of the contract under IRC § 7702,¹¹
5. a change solely to the ministerial provisions of the life insurance contract,
6. 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,
7. a change solely in the owner of the life insurance contract as a result of a transaction to which § 381(a)¹² applies and in which substantially all of the former owner's assets are transferred to the new owner of the policy,
8. 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
9. 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.¹³

This list provides little more than a "feel" for the thinking behind what is considered non-material. From this list, it appears that the universe of changes that would be considered material could be quite large.

¹¹ IRC § 7702 defines "Life Insurance" under the Internal Revenue Code.

¹² IRC § 381(a) provides the general rule for carryovers in certain corporate acquisitions of the assets of another corporation.

¹³ Treas. Reg. § 1.61-22(j)(2)(ii).

Future cases and rulings will almost certainly expand and possibly clarify the definition of “material modification”, but to avoid becoming part of one of those cases or rulings, any contemplated change to a pre-final regulation arrangement should be carefully considered by the parties and their professional advisors.

Basic Definitions

Split-Dollar Life Insurance

The split-dollar regulations provide multiple definitions for exactly what is considered a split-dollar arrangement.

Basic Definition

First, the basic definition of a split-dollar life insurance arrangement is any arrangement between an owner and a non-owner of a life insurance contract where:

1. either party pays all or any portion of the premium,
2. the payment is secured by the life insurance contract,
3. at least one of the parties is entitled to recover payments from or the recovery is secured by the proceeds of the policy, and
4. the arrangement is not part of a group-term life insurance plan under § 79 (unless the plan provides permanent benefits).¹⁴

The regulations then follow the basic definition with a special rule that applies even if the basic definition is not met. This special rule contains two additional, alternate definitions.

Compensatory Arrangements.

An arrangement is a split-dollar arrangement if:

1. it is entered into in connection with the performance of services in a compensatory arrangement (again, not a § 79 group-term life insurance plan),

2. the employer pays any or all of the premiums, and
3. the employee names the beneficiary or has any interest in the policy cash value.¹⁵

Shareholder Arrangements.

An arrangement between a corporation and another person not considering their employer/employee relationship can also be considered a split-dollar arrangement if:

1. it is entered into between a corporation and another person in their capacity as a shareholder in the corporation,
2. the corporation pays any or all of the premiums, and
3. the shareholder names the beneficiary or has any interest in the policy cash value.¹⁶

Collateral Assignment Split-Dollar

A collateral assignment split-dollar arrangement is an arrangement under which the owner of the policy names the beneficiary, but assigns some portion of the policy cash value and/or death benefit as collateral to the party advancing part or all of the premium payments. A collateral assignment split-dollar arrangement can be entered into between various parties: employers and employees, or an employee’s trust (a compensatory arrangement), private parties, (a donative arrangement known as private split-dollar), or a corporation and its shareholder (a shareholder arrangement).

Even though the rules apply generally to all these parties, this article will generally be phrased in terms of arrangements between an employer and its employee, or the employee’s trust.

Equity and Non-Equity Collateral Assignment Split-Dollar

When the fair market value¹⁷ of a policy grows to the point that it exceeds the total premiums advanced by the employer, the amount of that excess is considered the “equity” in the contract. The distinction between an equity and non-equity arrangement is based on who has the rights to that equity, not on whether it exists.

An equity collateral assignment split-dollar arrangement provides the employee the benefit of life insurance protection and rights to at least some portion of the equity in the contract. The employer’s rights are restricted to something less than the full equity in the contract, often only a right to repayment of premiums advanced.

In contrast, a non-equity collateral assignment split-dollar arrangement provides the employee the benefit of life insurance protection only, with no access to any other policy values. All rights beyond the life insurance protection are assigned to the employer.

The Two Regimes: “Economic Benefit” and “Loan”

A split-dollar arrangement is taxed under one of two “regimes”: either the “economic benefit regime”, or the “loan regime”.¹⁸ The regulations provide for the economic benefit regime tax treatment while also specifically carving out split-dollar loans to be taxed under the loan regime of Treasury Regulation § 1.7872-15. The language of the regulations is such that an arrangement can only be taxed under either the economic benefit regime or the loan regime, not both simultaneously.¹⁹

¹⁵ Treas. Reg. § 1.61-22(b)(2)(ii).

¹⁶ Treas. Reg. § 1.61-22(b)(2)(iii).

¹⁴ Treas. Reg. § 1.61-22(b)(1).

¹⁷ The fair market value of a life insurance policy is determined under different rules, depending on the circumstances. In an employment context, Revenue Procedure 2005-25 will generally apply. In a gift tax context, Treas. Reg. § 25.2512-6 will generally apply.

¹⁸ Treas. Reg. § 1.61-22

¹⁹ Treas. Reg. § 1.61-22(b)(3)

“Owner” and the Applicable “Regime”

The “owner” of the policy can be used to determine which regime applies for tax purposes. If the policy is “owned” by the employer, the arrangement will be taxed under the economic benefit regime. If it is “owned” by the employee, or the employee’s trust, the arrangement will be taxed under the loan regime. But remember, these rules are for tax purposes and the regulation provides for the concept of a “deemed”²⁰ owner.

The actual ownership of the policy is first considered, followed by special tests:

1. If the split-dollar arrangement is entered into in connection with the performance of services and if the only economic benefit provided to the employee is current life insurance protection, the employer will be “treated as the owner”.²¹
2. If the split-dollar arrangement is entered into between a donor and donee (private split-dollar) and only current life insurance protection is provided to the donee, the donor will be “treated as the owner”.²²

Economic Benefit Regime

If the policy is actually owned by the employee or the employee’s irrevocable trust, but the employer has all rights in the policy cash value and the employee or the employee’s trust only receives life insurance protection, the employer will be “treated as the owner” for tax purposes and thus this “non-equity” collateral assignment arrangement will be taxed

under the economic benefit regime. The employee’s trust will be responsible for paying for the economic benefit, or the employee will be responsible for deemed income and deemed gifts to the trust based on the trust receiving the economic benefit of the protection.

If the policy is owned by the employer and life insurance protection is all that is provided to the employee, this endorsement arrangement will also be taxed under the economic benefit regime. The employee will be responsible for paying for the economic benefit, or for the income tax consequences of receiving the economic benefit of the protection. Endorsement split-dollar arrangements are covered in a separate article and will not be discussed here in any further detail.

To summarize, both collateral assignment and endorsement arrangements that provide only death benefit protection to the employee or the employee’s trust will be taxed under the economic benefit regime.

Loan Regime

The loan regime in split-dollar arrangements is where the premium payments receive the tax treatment of loans. If the policy is actually owned by the employee or the employee’s irrevocable trust, and the trust also has rights in the policy beyond the life insurance protection, loan regime tax treatment will apply. The employee or the employee’s trust will be responsible for the interest due on the premium loans.

Collateral Assignment Under Either Regime

From the above descriptions, you can see that a collateral assignment split-dollar arrangement can be structured so that its tax treatment can fall under either the economic benefit regime or the loan regime. A non-equity arrangement falls under the economic benefit regime and an equity arrangement falls under the loan regime. This equity vs. non-equity distinction will generally be used for the remainder of the article rather than the

cumbersome actual vs. deemed owner language of the regulations.

The Economic Benefit Regime

Treatment of the Economic Benefit

Under the economic benefit regime, the employee’s trust receives the economic benefit of life insurance protection from the employer. The value of this economic benefit will be treated under the Internal Revenue Code according to the terms of the arrangement, the relationship between the parties, and any other exchange of value.

Contributory

If the employee’s trust actually makes payment to the employer for the economic benefit received, the arrangement is considered contributory. The payment for the economic benefit is made from the after-tax funds of the employee’s trust, thus no additional taxation is required on the benefit received, but the payment does not provide the employee’s trust an investment in the contract (basis).²³

Even though the trust has no further income tax consequences, the payment received by the employer will be treated as taxable income, and to the extent the contribution is used to make premium payment, will be included as part of the employer’s investment (basis).²⁴ This could happen if the employer advances only the balance of the premium due beyond the amount of the economic benefit paid by the employee’s trust. Considering these income tax and basis rules, contributory arrangements may have limited appeal to the employee’s trust and the employee making the arrangement.

Non-Contributory

If the employee’s trust receives the economic benefit of the protection but doesn’t make actual payment for the benefit, the arrangement is considered non-contributory. In this type of

²⁰ **deem**, *vb.* 1. To treat (something) as if (1) it were really something else, or (2) it had qualities that it does not have. Black’s Law Dictionary (8th ed. 2004). " 'Deem' has been traditionally considered to be a useful word when it is necessary to establish a legal fiction either positively by 'deeming' something to be what it is not or negatively by 'deeming' something not to be what it is...." G.C. Thornton, *Legislative Drafting* 99 (4th ed. 1996).

²¹ Treas. Reg. § 1.61-22(c)(1)(ii)(A)(1).

²² Treas. Reg. § 1.61-22(c)(1)(ii)(A)(2).

²³ Treas. Reg. § 1.61-22(f)(2)(i).

²⁴ Treas. Reg. § 1.61-22(f)(2)(ii).

arrangement, the employee's trust is treated as having received the benefit from the employer, through the employee.

Employer/Employee's Irrevocable Trust

If the employee's irrevocable trust is the owner, the economic benefit will be treated as compensation, taxable as income to the employee and deductible as an expense to the employer, plus there will be a deemed gift of the same amount from the employee to the employee's trust, with associated gift tax issues.

Employer/Employee

If the owner is an employee, the economic benefit will be treated as compensation, taxable as income to the employee and deductible as an expense to the employer.

Corporation/Shareholder

If the owner is a shareholder in a corporation that is advancing premiums on the policy, the economic benefit will be treated as a taxable dividend distribution, provided there are no other relationships that may also apply.

Donor/Donee (Private Split-Dollar)

If the owner is a donee (insured or insured's trust), as in a private split-dollar arrangement, the economic benefit will be treated as a gift from the donor to the donee.

Determining Economic Benefit

The value of the economic benefit provided to the owner equals the sum of:

1. The cost of the current life insurance protection provided to the owner,²⁵
2. The amount of cash value to which the owner "has current access", disregarding any surrender charges,²⁶ and

3. The value of any other economic benefit beyond current life insurance protection and cash value access.²⁷

In a true, non-equity collateral assignment arrangement, the only benefit generally provided to the employee's trust is the value of the current life insurance protection. The amount of cash value or other economic benefit available to the employee's trust will be zero.

In an equity collateral assignment arrangement, the employee's trust will have access to cash value, but this type of arrangement is taxed under the loan regime, described below.

Thus, the focus for determination of the economic benefit under a non-equity collateral assignment arrangement will generally be item 1 above, the value of the current life insurance protection.

Current Life Insurance Protection

In a non-equity collateral assignment arrangement, the current life insurance protection provided to the employee's trust is the amount of the death benefit from the policy that exceeds the amount payable to the employer, reduced by any amount actually paid for by the trust.²⁸ This means the economic benefit amount that has to be accounted for will be reduced if the trust pays all or part of the actual premium.

The determination of the amount of life insurance protection and cash value is made on the same date: the last day of the employee's trust's tax year, unless the parties agree to use the policy anniversary date.²⁹ Both parties must use the same date, and the same date must be used throughout all years of the arrangement.³⁰ This is subject to an anti-abuse provision that, in the face of any artifice or device used to understate economic benefit, may cause the use of the value on the date that economic benefit is greatest.³¹

In the year a split-dollar arrangement is terminated, the valuation date will be the date of termination, regardless of the date used in previous years of the arrangement.³²

Calculating Cost of Protection

The cost of current life insurance protection is calculated by multiplying the amount of that protection by a "life insurance premium factor" established by the Internal Revenue Service. Currently, that premium factor is published in IRS Notice 2002-8 in a table titled "Table 2001".³³ This table provides a cost factor for each \$1000 of death benefit protection for different ages.

Death Benefit Taxation

Death benefit proceeds paid to the employee's trust that are attributable to the economic benefit actually accounted for by the trust will be treated as an amount received under a life insurance contract and will be excluded from gross income.³⁴

Any portion of the death benefit paid to the employee's trust that exceeds the amount attributable to the economic benefit accounted for will not be excluded from income and will receive the appropriate tax treatment. For example, if the economic benefit for \$100,000 of death benefit was accounted for during the arrangement, but the beneficiary was paid \$120,000 at the insured's death, the \$20,000 excess will be treated as compensation from the employer to the employee and then a gift from the employee to the trust.³⁵

³² Treas. Reg. § 1.61-22(d)(5).

³³ This table is effective until replaced by "future guidance" from the IRS. No information is currently available regarding potential future guidance. Notice 2002-8 was published January 28, 2002 in Internal Revenue Bulletin 2002-4, currently posted on the IRS web site at: <http://www.irs.gov/pub/irs-irbs/irb02-04.pdf>

³⁴ Treas. Reg. § 1.61-22(f)(3)(i), IRC § 101(a).

³⁵ Treas. Reg. § 1.61-22(f)(3)(iii).

²⁷ Treas. Reg. § 1.61-22(d)(2)(iii).

²⁸ Treas. Reg. § 1.61-22(d)(3)(i).

²⁹ Treas. Reg. § 1.61-22(d)(5).

³⁰ Treas. Reg. § 1.61-22(d)(5)(ii).

³¹ Treas. Reg. § 1.61-22(d)(5)(iii).

²⁵ Treas. Reg. § 1.61-22(d)(2)(i).

²⁶ Treas. Reg. § 1.61-22(d)(2)(ii).

If operating under a private split-dollar arrangement, the excess will be treated as a gift from the donor.

Any death benefit paid to the employer as beneficiary is excluded from income to the extent that the amount is not allocable to the death benefit protection taken into account by the employee's trust.³⁶ For example, if the death benefit paid to an employee's trust is at least the amount attributable to the economic benefit accounted for by the trust, then the portion of the death benefit received by the employer is excluded from income.

Termination of Arrangement During Insured's Life

An estate planning split-dollar arrangement taxed under the economic benefit regime can be terminated by agreement of the parties during the insured's life.

The termination can be structured so that the employee's trust remains the owner after the termination, or so that the employer becomes the owner at termination. The tax results will depend on who is the owner after the termination, the relationship of the parties, and other factors.

If Trust Remains Owner After Termination

If, after the termination, the employee's trust remains the owner and the employer is no longer "treated as the owner", then the employer is treated as *having made a transfer of the entire policy* to the employee and the employee is treated as having made a transfer to the trust.³⁷

This form of termination has been called a "roll-out" and can be accomplished either in a single payment to the employer, or as a series of payments, and can include some degree of forgiveness³⁸ from the obligation by the employer. The employee's trust simply pays back the employer what is owed under the arrangement, the employer

forgives some or all of what is owed, or a combination of payment and forgiveness is used to settle what is owed to the employer.

Any amount that is paid back to the employer by the employee's trust will be non-deductible to the trust, who may use liquid funds already in the trust, funds gifted into the trust by the employee, funds available from policy values, or any combination.

Any amount that is forgiven will have tax consequences, depending on the relationship of the parties.

If the owner is the employee's irrevocable trust, the forgiven amount will be considered compensation to the employee and includible in income taxes, then as a gift from the employee to the trust, subject to the gift tax rules.

If the owner is an employee, the forgiven amount will be considered compensation to the employee and includible in income taxes.³⁹

If the arrangement is private split-dollar, the forgiven amount will be considered a gift from the sponsor⁴⁰ to the owner.

Any amount received by the sponsor will be considered a tax-free return of premium advances, to the extent of actual advances made, and as taxable income to the extent the payment exceeds premium advances. E.g., if the policy fair market value has grown to an amount that exceeds the premium advances, then the amount owed to the sponsor could exceed the actual premium advances.

To the extent that the "transfer" of the policy would be subject to the transfer for value rules, the exception for a transfer to the insured may apply.⁴¹ If the employee is the insured, transfer's from the

employer to the employee will fall under the exception for transfers to the insured. If the policy is owned by the employee's trust, the transfer, for income tax purposes, will still be treated as a transfer to the employee first, followed by a gift to the trust. The transfer to the employee will fall under the exception just mentioned and the gift to the trust is not a transfer for value, but rather a gratuitous transfer.

If Employer Becomes Owner After Termination

If the employer becomes the owner after the termination of the arrangement, there will be no further economic benefit provided to the employee's trust and thus no further income or gift implications for the trust. This type of termination can be called a "roll-in".

The employer will have taken ownership of the policy as a return of the premiums advanced, and to the extent that the policy cash value may exceed the premiums advanced, will also have taxable income.

To aid in understanding an estate planning collateral assignment arrangement taxed under the economic benefit regime, the basic arrangement is shown in diagrams below where the policy is owned by an employee's irrevocable trust, but is treated as owned by the employer for income tax purposes, and the employer advances the premium payments. Two diagrams are shown to help distinguish between a non-contributory and a contributory arrangement.

The diagrams assume the arrangement stays in place until the death of the insured (no roll-out) and policy death proceeds are used to pay the employer.

³⁹ Treas. Reg. § 1.61-2(d)(2)(ii)(A). A pdf version of this regulation is currently available at:

http://a257.g.akamaitech.net/7/257/2422/12feb20041500/edocket.access.gpo.gov/cfr_2004/aprqr/pdf/26cfr1.61-2.pdf.

⁴⁰ see footnote 5.

⁴¹ IRC § 101(a)(2)

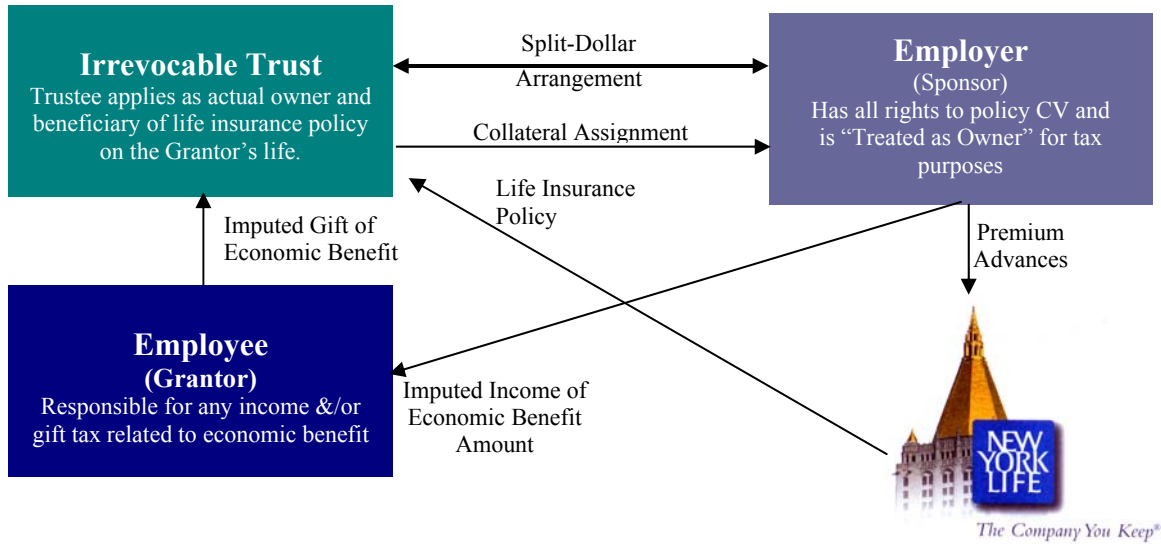
³⁶ Treas. Reg. § 1.61-22(f)(3)(ii).

³⁷ Treas. Reg. § 1.61-22(c)(1)(ii)(B)(2)

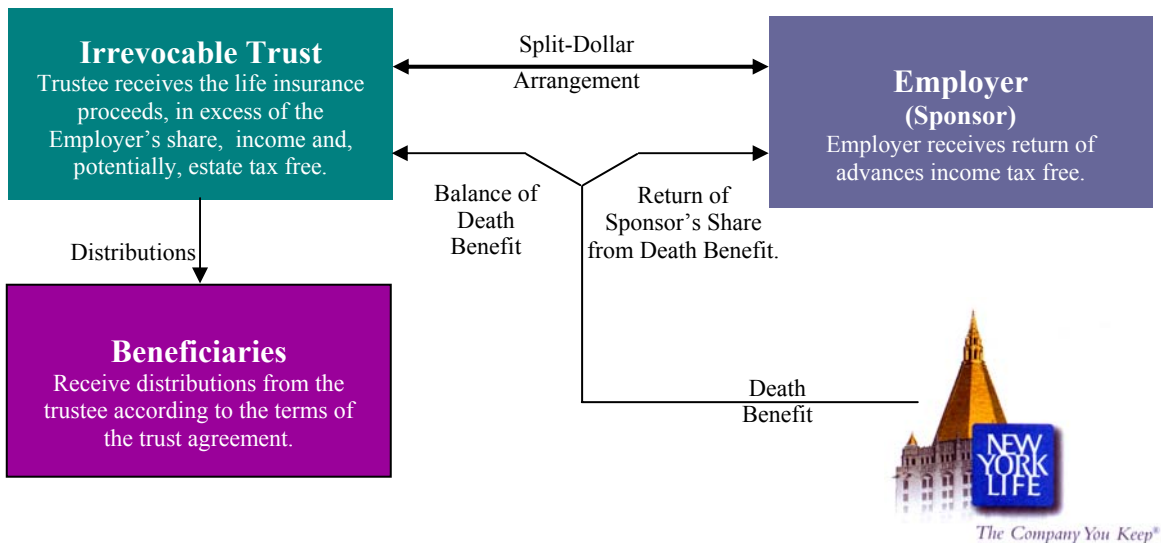
³⁸ The release from a debt obligation.

Economic Benefit Regime: Non-Equity Collateral Assignment
Non-Contributory

During The Life Of The Insured



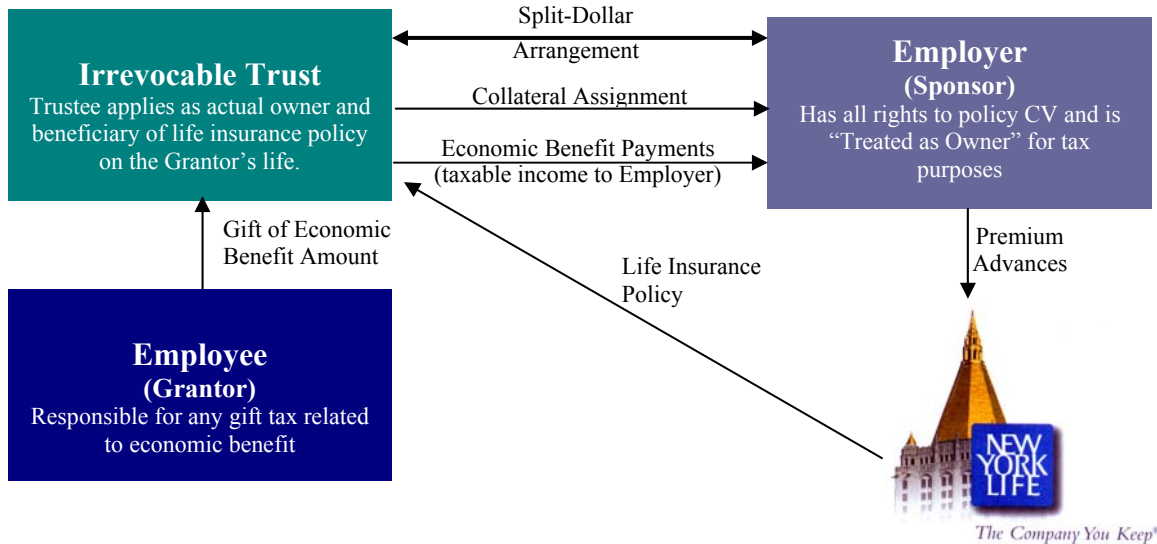
After The Death Of The Insured



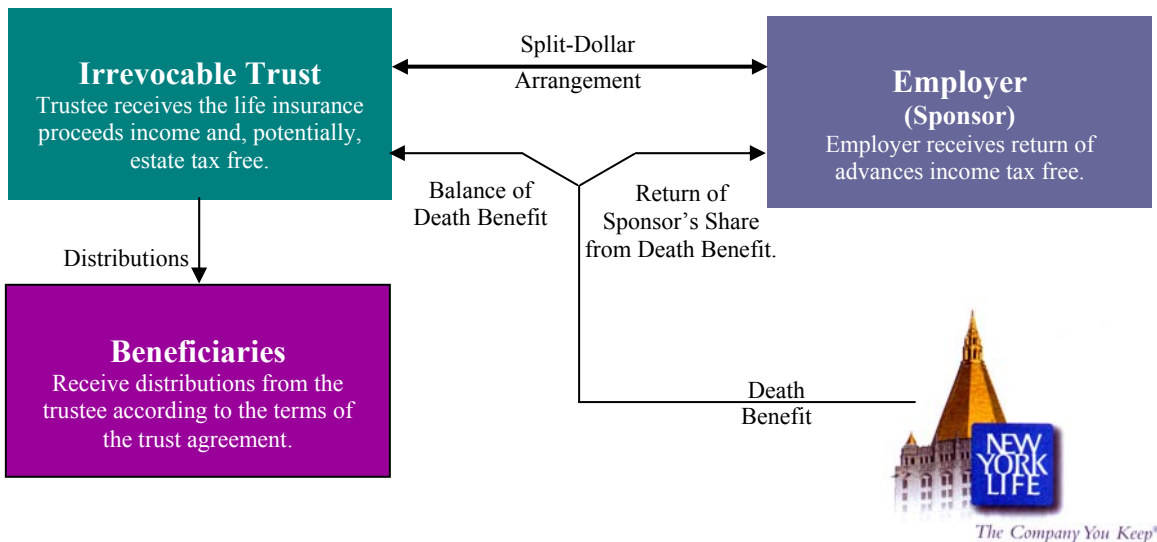
This is New York Life's understanding of the generally applicable rules. Please understand New York Life, its agents or employees may not give legal or tax advice. We recommend everyone seek and rely upon the advice of his or her own professional advisors.

Economic Benefit Regime: Non-Equity Collateral Assignment
Contributory

During The Life Of The Insured



After The Death Of The Insured



The Loan Regime

If a premium payment meets the definition of “split-dollar loan”, the regulations under the economic benefit regime do not apply.⁴² A premium payment made under a split-dollar life insurance arrangement is treated as a loan if:

1. The payment is made by the employer to the employee’s trust (including a payment made to an insurance company on a policy held by the trust),⁴³
2. The payment is a loan under general principles of Federal tax law, or if it is not, a reasonable person would expect it to be repaid in full,⁴⁴ and
3. The repayment is to be made from, or is secured by, the policy’s death benefit proceeds, cash surrender value, or both.⁴⁵

The employee’s trust is treated as the borrower and the employer is treated as the lender. This is what has been called the “loan regime” of split-dollar taxation.

Specifically excluded from this definition and placed under the economic benefit regime already discussed⁴⁶ are arrangements:

- entered into in an employment context where the employer is (or is “treated as”) the owner of the policy,⁴⁷ or
- entered into by a donor and donee (private split-dollar) where the donor is (or is “treated as”) the owner of the policy.⁴⁸

The result is that in an equity collateral assignment arrangement, the premium advances from the employer are treated as

loans and the employee’s trust is responsible for interest on the loans.

Applicable Loan Rules

There are different income tax rules applied to arrangements under the loan regime, depending on whether the loan is a below market loan or not and on whether a demand loan or a term loan is used. A below-market loan is any demand loan with interest payable at a rate less than the blended annual rate published by the IRS in July of each year,⁴⁹ and any term loan where the amount loaned exceeds the present value of all payments due under the loan.⁵⁰

The present value calculation for term loans is accomplished using the Applicable Federal Rate (AFR) appropriate to the term length. The IRS publishes the AFR each month.

A split-dollar loan with adequate stated interest is not a below-market loan and is governed by the general rules for debt instruments (including the rules for original issue discount (OID)).⁵¹

If a split-dollar loan is a below-market loan, it is governed by IRC § 7872 and the related regulations as discussed below. Note that tax issues discussed here are income tax unless specifically identified otherwise.

Below-Market Demand Loans

A demand loan is any loan that is payable in full at any time, on the demand of the lender.⁵² The code also includes in this definition loans where the interest arrangements are non-transferable and conditioned on the future performance of substantial services, or any loan with an indefinite maturity date.

A demand loan is considered a below-market loan if the interest payable is set at a rate less than the blended annual rate for the year,

compounded annually.⁵³ This would include rates set at zero or any other rate less than the blended annual rate.

The blended annual rate is established by the IRS and published each July in an IRS Revenue Ruling.⁵⁴

Employment Context

A below-market demand loan in an employment context will be treated as if there was a transfer of the forgone interest as compensation from the lender (employer) to the borrower (employee), then retransferred by the borrower to the lender as interest.⁵⁵

The amount treated as compensation will be deductible to the employer and included in the income of the employee. The retransferred interest payment is non-deductible to the employee⁵⁶ and will be treated as taxable income to the employer. Thus, the imputed deductible compensation to the employer and the imputed taxable income to the employer will result in a tax neutral transfer and retransfer for the employer, but will cause a net tax burden to the employee.

Private Split-Dollar Context

A below-market demand loan in a private split-dollar context will be treated as if there was a transfer of the forgone interest as a gift from the lender to the borrower, then retransferred by the borrower to the lender as interest.

The amount treated as a gift by the lender to the borrower will be subject to the gift tax laws, depending on the facts of the situation. It may be that the imputed gift will be treated as an annual exclusion gift or as a taxable gift.

The amount received by the borrower should be received with no income tax implications, so long as it is considered a gift.

⁴² Treas. Reg. § 1.61-22(b)(3).

⁴³ Treas. Reg. § 1.7872-15(a)(2)(i)(A).

⁴⁴ Treas. Reg. § 1.7872-15(a)(2)(i)(B).

⁴⁵ Treas. Reg. § 1.7872-15(a)(2)(i)(C).

⁴⁶ Treas. Reg. § 1.61-22(b)(3)(ii).

⁴⁷ Treas. Reg. § 1.61-22(b)(3)(ii)(A). This would be non-equity endorsement and non-equity collateral assignment arrangements where the employee or employee’s trust receives only the economic benefit of life insurance protection.

⁴⁸ Treas. Reg. § 1.61-22(b)(3)(ii)(B). Again, this could be either a non-equity endorsement or non-equity collateral assignment arrangement where the donee receives only the economic benefit of life insurance protection.

⁴⁹ Treas. Reg. § 7872-15(e)(3)(ii).

⁵⁰ I.R.C. § 7872(e)(1)

⁵¹ Treas. Reg. § 1.7872-15(a)(1). OID rules are under § 1271 through 1275 of the Internal Revenue Code.

⁵² IRC § 7872(f)(5).

⁵³ Treas. Reg. § 1.7872-15(e)(3)(ii).

⁵⁴ Current and historical revenue rulings publishing applicable federal rates can be found on the IRS web site at: <http://www.irs.gov/taxpros/lists/0,,id=98042,00.html>

⁵⁵ IRC § 7872(a)(1).

⁵⁶ Treas. Reg. § 1.7872-15(c).

The amount considered retransmitted from the borrower to the lender as interest will be non-deductible to the borrower⁵⁷ and treated as taxable income to the lender.

Corporation/Shareholder Context

A below-market demand loan in a corporation/shareholder context will be treated as if there was a transfer of the forgone interest as a dividend from the lender (corporation) to the borrower (shareholder), then retransferred by the borrower to the lender as interest.

The amount treated as a dividend will be taxed to the corporation according to its status and to the shareholder according to various factors:

A C-Corp will have been taxed on its income at the corporate level, the dividend will not be deductible to the corporation, and the dividend will be included in the income of the borrower as a taxable dividend.

An S-Corp will have had its income taxed under the flow-thru rules of subchapter S⁵⁸ and the dividend will likely be received by the shareholder as a tax-free return of basis, assuming no other tax issues have already reduced the shareholder’s basis.

The amount considered retransmitted from the borrower (shareholder) to the lender (corporation) as interest will be non-deductible to the borrower⁵⁹ and as taxable income to the lender.

Timing of imputed interest transfers

Regardless of the context, the imputed transfers of interest under a below-market demand loan will be treated as if they had occurred on the last day of the calendar year, unless the regulations provide otherwise.⁶⁰

Actual Interest Payments

Any interest that is actually paid by the borrower will not be deductible to the

borrower and will be received as taxable income to the lender.

Below-Market Term Loans

A term loan is any loan that is not a demand loan.⁶¹ The term of the loan can be defined by:

1. a stated maturity date,
2. a period ending no later than the death of an individual,
3. the earlier of the death of an individual or a specified term,
4. the later of the death of an individual or a specified term,
5. a condition of future performance of services, or
6. the later of a term certain or the date when a condition of future performance ends.

Each of these types of term loans is discussed below with examples to illustrate each. Term loans can be made in an employment context, corporate shareholder context, or a private split-dollar context.

Loans with a Stated Maturity Date

A term loan with a stated maturity date is considered a below-market loan if the amount loaned exceeds the present value of all payments due under the loan, calculated using a discount rate equal to the applicable Federal rate,⁶² compounded semiannually.⁶³ The applicable Federal rate is established by IRC § 1274(d). This rate is updated and published each month in an IRS Revenue Ruling.⁶⁴

The appropriate rate is determined by the term of the loan:

<u>Term</u>	<u>AFR</u>
Not over 3 years.....	Short-Term
Over 3 years – not over 9 years.....	Mid-Term
Over 9 years.....	Long-Term

The excess of the amount loaned over the present value of the payments due will be considered Original Issue Discount (OID)⁶⁵ and will be included in the gross income of the borrower.⁶⁶

To illustrate this, consider a 5-year term loan of \$50,000. If the current mid-term AFR is 4% and the amount to be repaid in 5 years is \$55,000, then the calculated present value of that repayment using the 4% AFR discount rate is \$45,119.⁶⁷ The excess of the amount loaned over the present value of the repayment due is \$4,881. This total amount will be considered OID and included in the gross income of the borrower in the year of the loan. Another way to look at it is that the \$45,119 amount is all that should have been loaned at the 4% AFR if all that is to be paid back is \$55,000. The “extra” amount loaned is considered taxable income.

Note that the income tax implications of a below-market term loan with a stated maturity date will be realized in the year that the loan is taken and not spread out over the life of the loan as you could expect with a demand loan. This is one of the “costs” of establishing the terms of the loan for a set period of time.

Loans Payable Not Later Than the Death of an Individual, or at the Earlier of Death of an Individual or a Specified Term

A split-dollar loan that is payable not later than the death of an individual is considered a term loan for purposes of determining whether the loan provides for sufficient interest.⁶⁸

If the loan is payable at the death of an individual, the term of the loan is the life expectancy of the individual as determined under the appropriate table in Treas. Reg. § 1.72-9⁶⁹ on the day the loan is made.

⁵⁷ Treas. Reg. § 1.7872-15(c).

⁵⁸ IRC §§ 1361 - 1379.

⁵⁹ Treas. Reg. § 1.7872-15(c).

⁶⁰ IRC § 7872(a)(2).

⁶¹ IRC § 7872(f)(6).

⁶² IRC § 7872(e)(1)(B).

⁶³ IRC § 7872(f)(2)(A).

⁶⁴ See note 47 above.

⁶⁵ IRC § 7872(b)(2).

⁶⁶ IRC § 1272(a)(1).

⁶⁷ Remember that the calculation is based on semi-annual compounding.

⁶⁸ Treas. Reg. §§ 1.7872-15(e)(4)(iii)(D) and 1.7872(e)(5)(i).

⁶⁹ A pdf version of this regulation is currently available at:

If the loan is payable on the earlier of an individual's death or another specified term, the term of the loan is the shorter of the term provided in the loan, or the individual's life expectancy as determined under the appropriate table in Treas. Reg. § 1.72-9 on the day the loan is made.⁷⁰ This allows the possibility that a term loan for 10 years, as an example, may be treated under the federal mid-term or short-term rate rather than the long-term rate if the individual's life expectancy is 9 years or less.

The loan is tested under the same test as is used on a term loan with a stated maturity as discussed above.

If the loan provides for sufficient interest, it will be subject to the same Internal Revenue Code and regulatory provisions for stated interest and OID as other loans.⁷¹

If the loan does not provide for sufficient interest, IRC § 7872 applies and the loan will be treated as a below market demand loan,⁷² but imputed interest will be calculated each year using the appropriate term AFR rather than the blended annual rate used by "regular" demand loans.

The imputed interest is the excess of the calculated amount using the appropriate AFR for the established term over the amount that accrues or is paid under the terms of the loan.

To illustrate this, consider a 10-year term loan of \$50,000, that is payable at the insured's death if it occurs before the term of the loan. Assume further that the insured is 81 years old, there is stated annual interest of 2%, with a total amount to be repaid of \$61,010⁷³ and the current AFRs are mid-term = 3.6%, long-term = 4.8%, and the blended annual rate is 3.0%.

First, determine if the term loan provides for sufficient interest. The present value of the total amount to be repaid is calculated using

http://a257.g.akamaitech.net/7/257/2422/12feb20041500/edocket.access.gpo.gov/cfr_2004/aprqrtr/pdf/26cfr1.72-9.pdf

⁷⁰ Treas. Reg. § 1.7872-15(e)(5)(ii)(C).

⁷¹ Treas. Reg. § 1.7872-15(f).

⁷² Treas. Reg. § 1.7872-15(e)(5)(ii)(B).

⁷³ Calculated with interest accrued on a semi-annual basis.

the shorter of the insured's life expectancy or 10 years. Using Table V under Treasury Regulation § 1.72-9, the life expectancy of an 81 year old is 8.9 years, thus the term of the loan is 8.9 years and the federal mid-term rate applies.⁷⁴ The present value of the total to be repaid is \$44,409.⁷⁵ Since the loaned amount of \$50,000 exceeds this, the loan is considered a below market loan.

Next, determine the imputed interest of the below market loan. This type of loan is treated as a demand loan except that the appropriate AFR is used rather than the blended annual rate, so, the mid-term rate of 3.6% of this example applies and we ignore the 3% blended rate. The imputed interest is calculated for each year the loan is outstanding and is the excess of the interest calculated using the AFR over the interest under the terms of the loan. With a starting balance of \$50,000 and a 3.6% AFR, the calculated first-year interest would be \$1800 (using annual compounding). The interest provided in the loan at 2% would be \$1000. This produces an imputed first-year interest of \$800 that would be treated as transferred from the lender to the borrower and then retransferred to the lender. See the discussion under *Below Market Demand Loans* above for the tax implications of these imputed interest transfers.

Loans Payable at the Later of the Death of an Individual or a Specified Term

A term loan with a term defined as the later of the death of an individual or a specified term will be tested for adequate stated interest under the same rules that apply to loans with a stated maturity date, using the specified term, ignoring the life expectancy of the individual.⁷⁶ In contrast, the longer of the specified term or the life expectancy of the individual determines the applicable AFR.⁷⁷ If the loan is a below-market term loan, the foregone interest will be calculated the same as a term loan with a stated

⁷⁴ The individual's life expectancy controls so the long-term rate of the 10 year term cannot be used.

⁷⁵ Remember, semi-annual compounding, so, 17.8 periods at 1.8% with a future value of \$61,010.

⁷⁶ Treas. Reg. § 1.7872-15(e)(5)(v)(B)(2).

⁷⁷ Treas. Reg. § 1.7872-15(e)(5)(v)(B)(3).

maturity date described above, using the specified term and AFR used for the testing.

To illustrate this, assume the same facts as the example above under "Loans with Stated Maturity":

- 5-year term loan of \$50,000,
- mid-term AFR is 4%,
- amount to be repaid is \$55,000,
- but assume that the individual is only 60 years old, with a life expectancy of 24 years, and the long-term AFR is 5%.

The term to be used is the 5-year stated term, but the interest rate will be the long-term rate.

The calculated present value of that repayment is \$42,966.⁷⁸ The excess of the amount loaned over the present value of the repayment due is \$7,034. This total amount will be considered OID and included in the gross income of the borrower in the year of the loan.

Loans Payable on Condition of Future Performance of Substantial Services

If split-dollar loan benefits are not transferable and are conditioned on the future performance of substantial services,⁷⁹ it is tested as discussed above as a term loan using the stated term if there is one, or an assumed term of 7 years.⁸⁰

If the loan provides for sufficient interest, it will be subject to the same Internal Revenue Code and regulatory provisions for stated interest and OID as other loans.⁸¹

If the loan does not provide for sufficient interest, it is treated as a below-market

⁷⁸ Remember that the calculation is based on semi-annual compounding.

⁷⁹ See IRC § 83 and Treas. Reg. § 1.83-3 for more on "future performance of substantial services."

⁸⁰ Treas. Reg. § 1.7872-15(e)(5)(iii)(C). But if the loan remains outstanding longer than the assumed term, it will be considered retired and re-issued at the assumed maturity, and tested again for sufficient interest.

⁸¹ Treas. Reg. §§ 1.7872-15(e)(5)(iii)(B) & 1.7872-15(f) (note exception that § 1.1272-1(c), dealing with debt instruments subject to contingencies, does not apply to any split-dollar loan).

demand loan, with the imputed interest determined each year that the loan is outstanding using the current AFR appropriate for the term as was shown in the preceding example.⁸²

Loans Payable Upon the Later of a Term Certain and the end of a Condition of Future Performance

If a split-dollar loan is payable upon the later of a term certain or the date on which a condition to perform substantial future services ends, the loan will be treated as a split-dollar term loan with stated maturity as discussed above, and the term of the loan will be the term certain.⁸³

The appropriate AFR will be either the mid-term or the long-term rate, determined by the longer of the term certain or seven years.

Gift (Private Split-dollar) Term Loans

A gift term loan can arise under a private split-dollar arrangement. It is tested for sufficient interest the same way a non-gift split-dollar term loan is tested, as discussed above under "Loans with a Stated Maturity Date".

If the loan provides for sufficient interest, it will be subject to the same Code and regulatory provisions for stated interest and OID as other loans.⁸⁴

If the loan does not provide for sufficient interest, the regulations provide a special rule for gift (private split-dollar) term loans where the imputed interest is determined annually under the rules for a below-market demand loan,⁸⁵ but the interest rate will be the AFR appropriate to the loan's term rather than the blended rate used for regular demand loans.

⁸² Treas. Reg. § 1.7872-15(e)(5)(iii)(B).

⁸³ Treas. Reg. § 1.7872-15(e)(5)(v)(B). But if the loan remains outstanding longer than the term certain, it will be considered retired and re-issued at maturity, but not tested again for sufficient interest.

⁸⁴ Treas. Reg. §§ 1.7872-15(e)(5)(iv)(B) & 1.7872-15(f) (note exception that § 1.1272-1(c), dealing with debt instruments subject to contingencies, does not apply to any split-dollar loan).

⁸⁵ Treas. Reg. § 1.7872-15(e)(5)(iv)(B).

The term of the loan used to determine the AFR depends upon the details of the arrangement. See the appropriate paragraph above for gift loans with a term defined by:

- a stated maturity date,
- a period ending no later than the death of an individual,
- the earlier of the death of an individual or a specified term, or
- the later of the death of an individual or a specified term.

As a gift loan, there are also gift tax issues to consider. For purposes of the gift tax rules, the loan will be considered a term loan.⁸⁶ This will cause the present value of the imputed gift to be considered in the year that the loan is established.

Imputed Interest Taxation

Regardless of the type of term loan, any unpaid interest that is imputed will have tax consequences.

If the arrangement is made in an employment or shareholder context, the imputed interest will be included in the borrower's gross income.⁸⁷

Death Benefit Taxation

Generally, death benefit payments received by the beneficiary of a life insurance contract subject to a split-dollar arrangement will not be included in the beneficiary's income.⁸⁸

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.⁸⁹ To the extent that split-dollar loans had been made by the lender to the borrower, the amount paid to the lender should be received as payment of any accrued interest and then a tax-free repayment of the loan.⁹⁰

⁸⁶ Treas. Reg. § 1.7872-15(e)(5)(iv)(D).

⁸⁷ Treas. Reg. § 1.7872-15(e)(1)(i) & IRC § 61.

⁸⁸ Treas. Reg. § 1.7872-15(m) and IRC § 101(a).

⁸⁹ Treas. Reg. § 1.7872-15(m).

⁹⁰ Treas. Reg. § 1.7872-15(k).

Termination of Arrangement During Insured's Life

Rather than maintaining a split-dollar arrangement until payment of the death benefit, the arrangement can be terminated by agreement of the parties during the life of the insured. The tax ramifications of a termination at this time will be dependent on the relationship of the parties, and how the obligations under the arrangement are met.

In an employment relationship, the borrower (the employee or employee's trust) has a loan balance that must be satisfied. This can be accomplished by:

- payment of the outstanding loan balance to the lender,
- forgiveness of the outstanding loan balance by the lender, or
- partial payment and partial forgiveness of the remaining balance.

Payment of the loan balance by the borrower can be accomplished using funds available from the policy cash values or funds available from other sources. Funds from the policy will carry the tax attributes any other policy withdrawal or loan would carry. Funds from another source would carry their own unique tax attributes, if any. Regardless of the source of funds, the repayment of the loan is not tax deductible to the borrower⁹¹ and, to the extent funds were loaned, the repayment will be received by the lender as a tax-free repayment of the loan principal. To the extent that accrued interest on the loan is paid, the lender will have taxable income.

If the lender forgives some or all of the loan principal, that amount will be treated as having been transferred from the lender to the borrower and then retransferred to the lender as payment. The amount treated as transferred to the borrower (employee) will be characterized as taxable compensation.

Accrued and Forgiven Interest

If interest is accrued and subsequently waived, cancelled, or forgiven, it is treated as if, on that date, the interest had been paid to the lender and then retransferred by the lender to the borrower. Additionally, the

⁹¹ Treas. Reg. § 1.7872-15(c), IRC §§ 163(h) and 264(a).

amount treated as retransferred to the borrower will be increased by a “deferral charge”.⁹²

The regulation under § 7872 provides a default deferral charge to be used until such time as the Commissioner of the IRS establishes the final charge. The default deferral charge in the regulation depends on whether the loan is treated as a term loan or a demand loan, and is determined by use of the applicable underpayment rate or the highest income tax applicable to the borrower.⁹³

To aid in understanding a collateral assignment arrangement taxed under the loan regime, the basic arrangement is shown in diagrams below, showing arrangements where the policy is owned by an employee’s irrevocable trust. Two diagrams are shown to help distinguish between a loan where interest is accrued and a loan where interest is paid.

The diagrams assume the arrangement stays in place until the death of the insured (no roll-out) and policy death proceeds are used to pay the employer. The employer is also assumed to be a cash basis taxpayer and is actually paid the accrued interest.

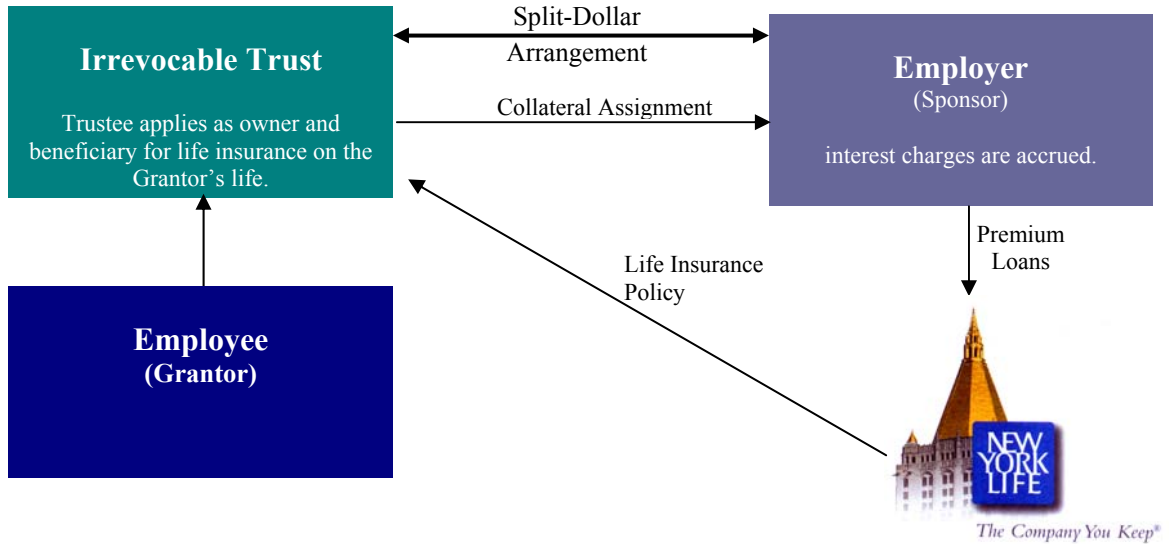
⁹² Treas. Reg. § 1.7872-15(h)(1)(i).

⁹³ Treas. Reg. § 1.7872-15(h)(4).

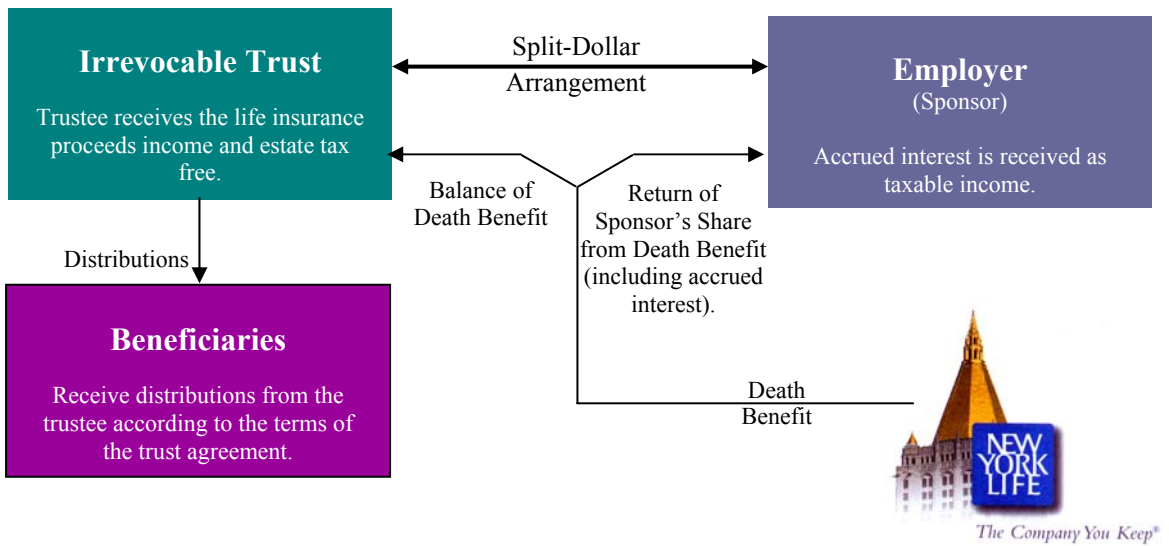
Loan Regime: Equity Collateral Assignment

Interest Accrued

During The Life of The Insured



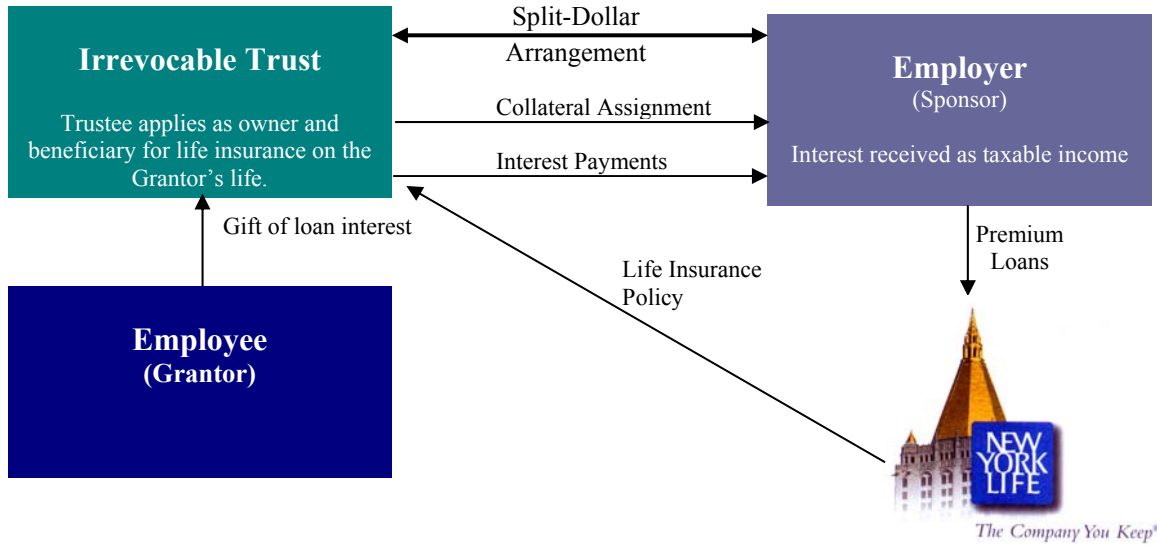
After Death of The Insured



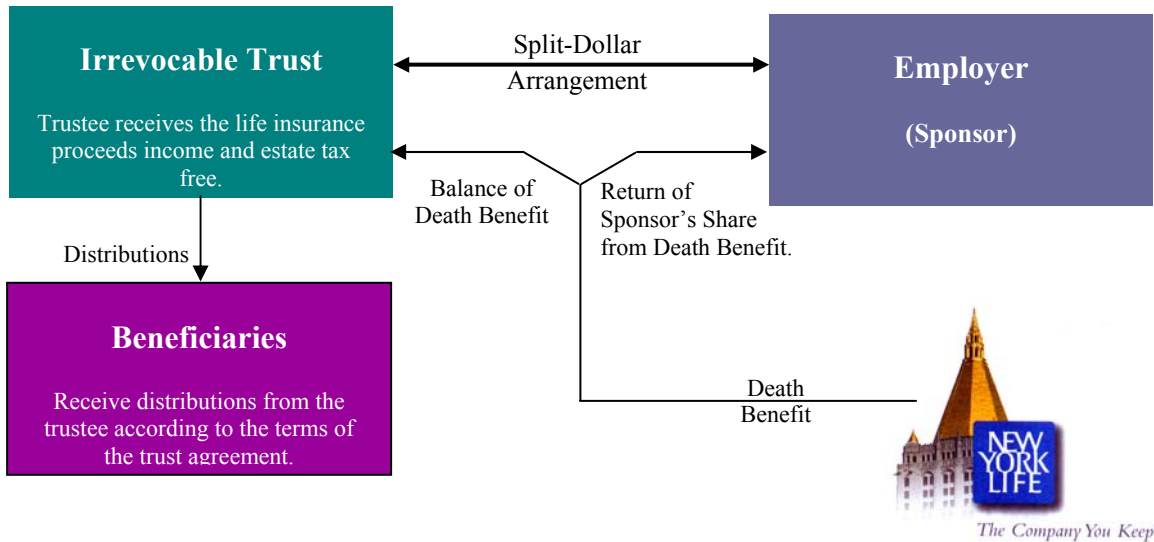
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Loan Regime: Equity Collateral Assignment
Interest Paid

During The Life of The Insured



At Death of The Insured



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Choice of Regimes

Economic considerations, both business and personal, will often be the drivers behind the design of a split-dollar arrangement. Choices made in the design process will determine which of the two taxing regimes will control the arrangement.

The loan regime would apply to any arrangement providing the insured or the insured's trust with access to policy cash values, but the economic benefit regime may result in lower out-of-pocket costs to the insured, at least initially.

Business considerations of the employer may drive the type and amount of benefit to be provided, affecting the choice of regimes.

Often, an estate planning split-dollar arrangement will be entered under the economic benefit regime so as to take advantage of the initially lower out of pocket costs or gifts to a trust possible to many clients under the current life insurance premium factor provided by the IRS.⁹⁴ Of course, the specific facts of a case may produce a different result, e.g., the higher economic benefit costs of an older insured, and/or the lower costs possible during a time of very low interest rates may cause the loan regime to be more attractive from the start.

Switching Regimes

Economic considerations may cause an insured to enter into a split-dollar arrangement under the economic benefit regime, but, as time passes, those same considerations may also create pressures to change the terms of the split-dollar agreement which would cause the taxation of the arrangement to be switched to the loan regime. The exact year of the change can be driven by different considerations.

For example, to avoid taxation of gain of policy cash value, the parties would need to change to the loan regime before the policy develops gain.

Alternatively, if the parties' overriding objective is to minimize annual out-of-pocket costs, the parties might not change to the loan regime until some time after gain has been attained, accepting the tax consequences associated with making the change with gain in the cash value.

Many approaches to the balancing of the cost considerations are possible.

Reasons to Change Regimes

The economics behind a decision to change taxing regimes may be driven by annual cost, income tax, or business considerations. In many cases, a combination of these will influence the final decision.

Annual Cost Considerations

A split-dollar arrangement that is taxed under the economic benefit regime will experience annually increasing economic benefit costs as the insured ages. It is possible that the economic benefit costs will eventually increase to the point that the then-current interest rate could produce a lower cost under the loan regime.

A split-dollar arrangement with a survivorship policy has relatively low economic benefit costs during the lives of both insureds, making the economic benefit regime a very attractive starting point. At the death of the first insured to die, the economic benefit costs increase significantly, possibly causing the economic benefit regime costs to exceed loan regime costs.

The point in time that the annual economic benefit costs would drive a change in regime can be referred to as the cost crossover. If the annual cost of the arrangement is the controlling consideration, changing to the loan regime at the cost crossover might make economic sense. Yet, as important as annual cost considerations are, they are rarely the only consideration.

Income Tax Considerations

An insured may enter a split-dollar arrangement with an initial goal of

minimizing costs and a secondary goal of building cash value in the policy for future needs. Under the economic benefit regime, policy cash values are available only to the employer. Changing the arrangement so that the employee or employee's trust can access policy cash values in the future will cause the arrangement to be taxed under the loan regime.⁹⁵ At the time this change takes place, the policy is treated as having been transferred from the employer to the employee or the employee's trust, and any fair market value⁹⁶ in excess of the premiums advanced by the employer (gain in the cash value) up to that time will be subject to income taxation to the employer.

Avoiding potential income tax costs when changing regimes will require a change at a point in time before the fair market value exceeds the total premiums advanced by the employer. This point in time can be referred to as the equity crossover. It is possible that the equity crossover might occur before the costs crossover. Thus, changing regimes at a time calculated to avoid an income tax event can result in an increase in annual costs, at least for some period of time. Generally, a compromise must be reached between the two sets of considerations, unless there is another, possibly overriding factor.

Business Considerations

In addition to estate planning needs, a collateral assignment split-dollar arrangement may be entered under the economic benefit regime so that the employer will initially have access to the policy cash values. This business need may be specific enough that a certain year can be identified when that need ends. This kind of business consideration may make it appropriate to change to the loan regime at the end of that year so that the insured can access cash values thereafter. This business requirement may also be balanced with, or even override considerations of the cost and equity crossovers.

⁹⁵ Treas. Reg. § 1.61-22(c)(1)(ii)(B).

⁹⁶ Treas. Reg. § 1.61-22(g), and see Rev. Proc. 2005-25

⁹⁴ Table 2001.

Monitoring and Review

Split-dollar arrangements are dynamic, not static. Initial illustrations and projections cannot be relied upon in later years.

The current life insurance premium factor provided by the Internal Revenue Service for computing economic benefit costs are subject to possible future guidance.⁹⁷ Since this premium factor may change, projections related to cost crossovers can't be relied upon to establish future costs or when a regime change should occur.

The economic benefit costs of a survivorship policy will be significantly affected by the death of the first insured to die. This first death will be an unpredictable event that may drive a decision to change regimes.

The cash value of a life insurance policy will grow based on prevailing rates. Since this is subject to change driven by market conditions, projections related to cash value won't remain valid over time.

Regardless of the considerations that will drive an insured's ultimate decision as to a change of regime, it is important to recognize that at the time a split-dollar arrangement is established, it will generally not be possible to know in advance the exact point in time when the change should occur, or even whether it should occur at all. Regular and consistent monitoring and review of the arrangement's goals and economics, from each party's perspective, are necessary to assure the desired results are attained.

Mechanics of Making the Change

Once it has been determined that a change of taxing regime should occur, the change can generally be accomplished by a change in the arrangement that will switch the "owner" for tax purposes from one party to the other.⁹⁸

Remember, under the split-dollar regulations, the "owner" of a policy that is

the subject of a non-equity collateral assignment split dollar arrangement may not be the actual owner of the policy, so changing "owner" does not necessarily involve an actual transfer of the policy.

A new split-dollar arrangement will be required, stating the parties' new rights and obligations, changing from a non-equity arrangement to an equity arrangement. When changing to an equity arrangement to be taxed under the loan regime, a note instrument should also be put in place. The parties' legal and tax advisors should be consulted for the drafting of these new documents.

Tax Implications at the Change

Regardless of the process or the driving factors behind the decision to change regimes, the change will occur before, at, or after the equity crossover.

If the fair market value of the policy is less than or equal to the total premiums advanced by the employer, a change that provides the employee or employee's trust access to the cash value will not be a taxable event. At that point in time, the obligation to the employer will be at least equal, if not greater than the cash value, thus leaving no excess cash value available to the employee or employee's trust.

If the fair market value of the policy exceeds the total premiums advanced by the employer, a change that provides the employee or employee's trust access to the cash value will be a taxable event. At that point in time, the employee or employee's trust will accept a note obligation (loan regime) for the fair market value of the policy at the time of the change. This loan is not taxable to the employee or employee's trust. At the time of the change, the employer will also be considered to have made a complete transfer of the policy, triggering recognition of any gain in the policy to the employer.

Starting Balance of Loan Regime

A collateral assignment split-dollar arrangement taxed under the economic benefit regime provides only life insurance

protection to the employee or employee's trust. The employer holds all rights to policy values other than the death benefit protection going to the employee or employee's trust. Another way to phrase this is that the employer has the right to be repaid the greater of the total of premiums advanced or the policy fair market value.

If the policy fair market value is greater than the total of the premiums advanced, the starting loan balance under a switch to the loan regime will be the policy fair market value.

If the policy fair market value is less than the total of the premiums advanced, the starting loan balance will be the total of the premiums advanced.

Split-Dollar Arrangements & ERISA

Generally, split-dollar arrangements established by employers to provide death benefits for their executives' beneficiaries are welfare benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA) and therefore, subject to Title I of ERISA.⁹⁹ Welfare benefit plans are exempt from ERISA participation, funding and vesting requirements, however they are subject to ERISA fiduciary, claims, reporting and disclosure and prohibited transaction requirements and rules.

A split-dollar arrangement that is unfunded or insured and maintained primarily for a group of select management or highly compensated employees is exempt from the full ERISA reporting and disclosure requirements.¹⁰⁰ There is no requirement to file any notice with the Department of Labor with regards to such arrangements. The phrase "select group of management or highly compensated employees" has not been defined, and there is vagueness in the terms "unfunded or insured." Department of Labor Advisory Opinions imply only that this select group generally consists of an employer's highest paid key employees or management.

⁹⁷ Treas. Reg. 1.61-22(d)(3)(ii).

⁹⁸ Treas. Reg. §§ 1.61-22(c)(1)(ii)(B)(2) & (b)(3).

⁹⁹ DOL Advisory Opinion 77-2.

¹⁰⁰ DOL Reg. §2520.104-24.

Summary

Collateral assignment split-dollar arrangements “entered into” after September 17, 2003 will be taxed under either Treasury Regulation § 1.61-22 (economic benefit regime) or § 1.7872-15 (loan regime).

A collateral assignment split-dollar arrangement structured as a non-equity arrangement will generally be taxed under the economic benefit regime.

A collateral assignment split-dollar arrangement structured as an equity arrangement will generally be taxed under the loan regime.

Various considerations may make it attractive for an arrangement to be initially structured as non-equity and then later changed to an equity arrangement so as to cause the taxing regime to be changed from economic benefit taxation to loan taxation. The tax ramifications of this change will vary over time, depending on the policy fair market value as compared to the total premiums advanced by the employer. Regular monitoring of all relevant values under the arrangement are key to making appropriate decisions over the life of a split-dollar arrangement.



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