PART X: SPLIT DOLLAR PLAN

3898. What is a split dollar plan?

Split dollar insurance is an arrangement that often is between an employer and an employee under which policy benefits are split and the premiums may be split. Split dollar plans also can be set up between corporations and shareholders ("shareholder split dollar") or between parents and their children ("private split dollar").

For years, the premium was often split, with the employer paying the cost of annual term coverage, and the employee paying the balance. Under this arrangement, the employer received from the proceeds an amount equal to the cash value of the policy or at least its premium payments, and the employee's beneficiary received the balance of the proceeds.

From this basic concept, hybrid plans evolved. For example, there are "employer pay all" plans under which an employer pays the entire premium and "level contribution" plans under which an employee pays a level amount each year. There also are reverse split dollar plans (Q 3905) and charitable split dollar plans (Q 116).

A split dollar arrangement may be in the form of an endorsement plan where an employer owns a policy and the benefit-split is provided by endorsement, or a collateral assignment plan under which an employee owns the policy and the employer's interest is secured by collateral assignment of the policy.

The Sarbanes-Oxley Act of 2002[1] generally prohibits direct or indirect loans to certain executive officers and directors of public companies.

After passage of the Sarbanes-Oxley Act, there is now a question of whether it is legal for a publicly traded company to set up a split dollar plan or to continue paying premiums on an already existing plan. Many publicly traded companies have stopped paying premiums on split dollar plans.

Planning Point: Most practitioners are comfortable that endorsement plans whereby the employee merely rents current death benefit converge does not violate the Sarbanes-Oxley Act's prohibition against indirect loans. However, collateral assignment arrangements are regarded as more problematic. Some companies are instead paying bonuses to employees covered by split dollar plans so that the employees can pay the premiums themselves.

Plans Entered Into After September 17, 2003

Treasury regulations issued in 2003 define a split dollar life insurance arrangement as any arrangement between an owner and a non-owner of a life insurance contract satisfying the following criteria:

1. P.L. 107-204.

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(1) either party to the arrangement pays all or a portion of the premiums on the life insurance contract, including payment by means of a loan to the other party that is secured by the life insurance contract;

(2) at least one of the parties to the arrangement that is paying premiums is entitled to recover all or a portion of the premiums and the recovery is to be made from or secured by the proceeds of the life insurance contract; and

(3) the arrangement is not part of a group term life insurance plan unless the plan provides permanent benefits.[1]

Certain compensatory arrangements and shareholder arrangements are treated as split dollar arrangements even if they do not meet the general definition of a split dollar arrangement. A compensatory arrangement is one where:

(1) the arrangement is entered into in connection with the performance of services and is not part of a group term life insurance plan;

(2) the employer pays all or a portion of the premiums; and

(3) either (x) the beneficiary of any portion of the death benefit is designated by the employee or is a person the employee would reasonably be expected to designate as a beneficiary, or (y) the employee has any interest in the cash value of the policy.

The definition of a shareholder agreement is similar, but with corporation substituted for employer and shareholder for employee.[2]

These definitions are effective for split dollar arrangements entered into after September 17, 2003, or split dollar arrangements entered into before September 18, 2003, that are materially modified after September 17, 2003 (Q 3899).[3]

Plans Entered into Before September 18, 2003

The following applies to split dollar plans entered into before September 18, 2003.

If a transaction is cast in a form that results in similar benefits to an employee as in a traditional split dollar plan, it will be treated as a split dollar plan.[4] Thus, an arrangement dividing interests in a policy on an employee between the employer and the insured employee's wife was ruled a split dollar plan providing a taxable economic benefit to the employee (Q 3903, Q 503).

Similarly, where an insured was the employee's father, the plan was held to provide a benefit to the employee taxable as a split dollar plan.[5]

1. Treas. Reg. §1.61-22(b)(1).
2. Treas. Reg. §1.61-22(b)(2).
3. Treas. Reg. §1.61-22(j).
4. Rev. Rul. 64-328, 1964-2 CB 11.
5. Rev. Rul. 78-420, 1978-2 CB 67.

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A split dollar plan between a corporation and an insured non-employee shareholder was ruled to provide a taxable dividend to the shareholder.[1]

Other Considerations

A split dollar arrangement offered as a fringe benefit to employees of an S corporation in which the employer agreed to pay the total premium less the term insurance cost did not violate the one class of stock restriction applicable to S corporations under IRC Section 1361(b)(1)(D).[2]

Similarly, a split dollar arrangement for shareholders in which the employer agreed to pay the full premium and the shareholders agreed to reimburse the employer for the economic benefit amount did not violate the one class of stock restriction.[3]

The cash values of policies in an endorsement-type split dollar plan that made use of an independent fiduciary to select the policies were not considered plan assets for purposes of ERISA.[4]

The IRS has issued guidance regarding the application of IRC Section 409A to split dollar life insurance arrangements. The notice also provides that certain modifications of split dollar life insurance arrangements necessary to comply with, or avoid application of, IRC Section 409A will not be treated as a material modification.[5]

3899. What are the income tax results of a split dollar plan entered into, or materially modified, after September 17, 2003?

The tax treatment of a split dollar arrangement depends on when the arrangement is entered into. For split dollar arrangements entered into after September 17, 2003, the taxation of the arrangement generally is governed by regulations issued in 2003. Split dollar arrangements entered into before September 18, 2003, generally are governed by revenue rulings and other guidance issued by the IRS between 1964 and the issuance of the final regulations (Q 3903).

For split dollar arrangements entered into after September 17, 2003, the tax treatment will be governed by one of two mutually exclusive regimes. The arrangement will be treated either as (1) one in which the life insurance policy owner provides economic benefits to the non-owner (Q 3900) or (2) one in which the non-owner makes loans to the owner (Q 3901).[6] The person named on the policy as the owner generally is considered the owner of the policy. A non-owner is any person other than the owner who has an interest in a policy except for a life insurance company acting only as the issuer of the policy.[7]

1. Rev. Rul. 79-50, 1979-1 CB 138.
2. Let. Rul. 9248019.
3. Let. Rul. 9318007, Let. Rul. 9331009.
4. DOL Adv. Op. 92-22A.
5. Notice 2007-34, 2007-17 IRB 996. See, also, T.D. 9321, 73 Fed. Reg. 19234, 19249 (4-17-2007) (IRC Sec. 409A final regulations).
6. Treas. Reg. §1.61-22(b)(3).
7. Treas. Reg. §1.61-22(c).

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3900. When is a split dollar plan that was entered into or materially modified after September 17, 2003 governed by the economic benefit theory and what are the tax consequences?

If a split dollar arrangement is not treated as a loan, the contract's owner is treated as providing economic benefits to the non-owner. For gift and employment tax purposes, the non-owner and the owner must take into account the full value of the economic benefits provided to the non-owner by the owner, reduced by any consideration paid by the non-owner. Depending on the relationship between the owner and the non-owner, the economic benefits may consist of compensation income, a dividend, a gift, or some other transfer under the IRC.[1]

The value of the economic benefits is equal to:

(1) the cost of life insurance protection provided to the non-owner;

(2) the amount of any cash value the non-owner has current access to, to the extent that these amounts were not taken into account in previous years; and

(3) the value of other benefits provided to the non-owner.

The cost of life insurance protection may be determined by a life insurance premium factor issued by the IRS.[2] Presumably, Table 2001 will be used until the IRS issues another table.[3] In addition, in Notice 2002-8, the IRS found that an insurer's renewable term rate could be used to measure the annual cost of life insurance protection if the insurer generally makes the availability of the product known to those who apply for term insurance, the insurer's product is regularly sold through normal distribution channels, and the product otherwise meets the IRS' previously stated requirements for such use.[4]

Under the economic benefit regime, a non-owner has no any investment in the contract with respect to a life insurance policy subject to a split dollar arrangement. Premiums paid by the owner will be included in the owner's investment in the contract. Any amount the non-owner pays toward a policy will be included in the income of the owner and increase the owner's investment in the contract.[5]

Death benefits paid to a beneficiary other than the owner of the policy by reason of the death of an insured will be excluded from income to the extent that the amount of the death benefit is allocable to current life insurance protection provided to the non-owner, the cost of which was paid by the non-owner or the benefit of which the non-owner took into account for income tax purposes.[6]

1. Treas. Reg. §1.61-22(d)(1).
2. Treas. Reg. §1.61-22(d)(2)-(3).
3. See Notice 2002-8, 2002-1 CB 398.
4. See also Rev. Rul. 66-110, 1966-1 CB 12; PLR 8547006; and Rev. Rul. 67-154, 1967-1 CB 11.
5. Treas. Reg. §1.61-22(f).
6. Treas. Reg. §1.61-22(f)(3).

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Planning Point: In other words, failure to pay or recognize as taxable income the cost of the life insurance economic benefit can make the insurance death benefit taxable to the recipient.

On the transfer of a policy to a non-owner, the non-owner generally is considered to receive the cash value of the policy and the value of all other rights in the policy minus any amounts paid for the policy and any benefits that previously were included in the non-owner's income. Amounts that were previously included in income due to the value of current life insurance protection that was provided to the non-owner may not be used to reduce the amount the non-owner is considered to receive on roll-out. Thus, the taxation on the value of current life insurance protection will not provide the non-owner with any basis in the policy, although taxation for a previous increase in cash value will add basis for the non-owner.[1]

3901. When is a split dollar plan that was entered into or materially modified after September 17, 2003 treated as a loan and what are the tax consequences?

A split dollar arrangement will be treated as a loan if:

(1) payment is made by the non-owner to the owner;

(2) payment is a loan under general principles of federal tax law or a reasonable person would expect the payment to be repaid to the non-owner; and

(3) repayment is made from, or secured by, either the policy's death benefit, cash value, or both.[2]

If a split dollar arrangement is treated as a loan, the owner is considered the borrower and the non-owner is considered the lender.[3] If a split dollar loan is a below market loan, then interest will be imputed at the applicable federal rate ("AFR"), with the owner and the non-owner of the policy considered to transfer imputed amounts to each other.[4]

In a split dollar arrangement between an employer and employee, the lender is the employer and the borrower is the employee. Each payment under a split dollar arrangement will be treated as a separate loan. The employer is considered to transfer the imputed interest to the employee. This amount is considered taxable compensation, and generally will be deductible by the employer, although no deduction will be allowed in a corporation-shareholder arrangement. The employee then is treated as paying the imputed interest back to the employer, which will be taxable income to the employer. This imputed interest payment by the employee generally will be considered personal interest and therefore not deductible.

Planning Point: If the policy is owned by a third party, such as an irrevocable trust in a collateral assignment structure, the economic benefit is treated as a gift by the employee to the trust.

1. Treas. Reg. §1.61-22(g).
2. Treas. Reg. §1.7872-15(a)(2).
3. Treas. Reg. §1.7872-15(a)(2).
4. See IRC Sec. 7872.

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The calculation of the amount of imputed interest differs depending on the type of below market loan involved. A below market loan is either a demand loan or a term loan. A demand loan is a loan that is payable in full on the demand of the lender.[1] All other below market loans are term loans.[2] A split dollar term loan generally will cause more interest to be imputed in the early years of the arrangement, with the amount of imputed interest decreasing each year. In a split dollar demand loan, imputed interest will be smaller in the early years of the arrangement but will increase each year the arrangement is in place.

3902. When will a split dollar plan that is entered into before September 17, 2003 found to be "materially modified" so that it is governed by the 2003 regulations?

The 2003 regulations apply to split dollar arrangements entered into after September 17, 2003, and arrangements entered into on or before September 17, 2003, that are materially modified after September 17, 2003.[3] The final regulations provide a non-exclusive list of changes that will not be considered material modifications. This list includes:

(1) a change solely in premium payment method, for example, from monthly to quarterly;

(2) a change solely of beneficiary, unless the beneficiary is a party to the arrangement;

(3) a change solely in the interest rate payable on a policy loan;

(4) a change solely necessary to preserve the status of the life insurance contract under IRC Section 7702;

(5) a change solely to the ministerial provisions of the life insurance contract such as a change in the address to send premiums; and

(6) a change made solely under the terms of a split dollar agreement other than the life insurance contract if the change is dictated by the arrangement, is non-discretionary to the parties, and was made under a binding commitment in effect on or before September 17, 2003.[4]

An exchange of policies under IRC Section 1035 is not on the list of non-material modifications. The IRS will not issue rulings or determination letters on whether a modification is material.[5]

The IRS has released guidance regarding the application of IRC Section 101(j) and Section 264(f) to life insurance contracts that are subject to split dollar life insurance arrangements. According to the IRS, if parties to a split dollar life insurance arrangement modify the terms

1. IRC Sec. 7872(f)(5).
2. IRC Sec. 7872(f)(6).
3. Treas. Regs. §§1.61-22(j), 1.7872-15(n).
4. Treas. Reg. §1.61-22(j)(2).
5. Rev. Proc. 2012-3, 2012-1 IRB 113; Sec. 3.01(2), 2007-1 IRB 108, as superseded by Rev. Proc. 2014-3, 2014-1 IRB 11.

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of the arrangement but do not modify the terms of the life insurance contract underlying the arrangement, the modification will not be treated as a material change in the life insurance contract for purposes of IRC Section 101(j) and Section 264(f) even if the modification is treated as a material modification of the split dollar arrangement for purposes of Treasury Regulation Section 1.61-22(j). In other words, the contract will not lose its grandfathered status.[1]

The final regulations also contain rules on when a split dollar arrangement is considered to be entered into. A split dollar arrangement is entered into on the latest of the following dates:

(1) the date the life insurance contract is issued;

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

(3) the date the first premium on the life insurance contract is paid;

(4) the date 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.[2]

3903. What are the income tax results of a split dollar plan entered into before September 18, 2003?

Split dollar arrangements that were entered into before September 18, 2003, are governed by various rulings and other guidance that were issued by the IRS between 1964 and the issuance of final regulations on split dollar arrangements in 2003. This guidance includes Notice 2002-8,[3] which provides transition rules for arrangements not subject to split dollar regulations. No inference is to be drawn, however, from Notice 2002-8 or the proposed or final regulations regarding the appropriate tax treatment of split dollar arrangements entered into before September 18, 2003.

For the treatment of split dollar arrangements entered into after September 17, 2003, see Q 3899.

Notice 2002-8

For split dollar arrangements entered into before September 18, 2003:

(1) The IRS will not treat an employer as having made a transfer of a portion of the cash value of a life policy to an employee for purposes of Section 83 solely because the interest or other earnings credited to the cash value of the policy cause the cash value to exceed the portion payable to an employer;

1. Notice 2008-42, 2008-15 IRB 747.
2. Treas. Reg. §1.61-22(j)(1)(ii).
3. 2002-1 CB 398.

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(2) Where the value of current life insurance protection is treated as an economic benefit provided by an employer to an employee, the IRS will not treat the arrangement as having been terminated, and thus will not assert that there has been a transfer of property to the employee by reason of termination of the arrangement, as long as the parties to the arrangement continue to treat and report the value of the life insurance protection as an economic benefit provided to the employee. This treatment will be accepted without regard to the level of the remaining economic interest that the employer has in the life insurance contract; and

(3) The parties to the arrangement may treat premium or other payments by an employer as loans. The IRS will not challenge reasonable efforts to comply with the rules regarding original issue discount and below-market loans. All payments by an employer from the beginning of the arrangement, reduced by any repayments to the employer, before the first taxable year in which payments are treated as loans for tax purposes must be treated as loans entered into at the beginning of the first year in which payments are treated as loans.

For split dollar arrangements entered into before January 28, 2002, under which an employer has made premium or other payments under the arrangement and has received or is entitled to receive full repayment, the IRS will not assert that there has been a taxable transfer of property to an employee on termination of the arrangement if (1) the arrangement is terminated before January 1, 2004, or (2) for all periods beginning on or after January 1, 2004, all payments by an employer from the beginning of the arrangement, reduced by any repayments to the employer, are treated as loans for tax purposes and the parties to the arrangement report the tax treatment in a manner consistent with this loan treatment, including the rules for original issue discount and below-market loans. Any payments by an employer before the first taxable year in which payments are treated as loans for tax purposes must be treated as loans entered into at the beginning of the first year in which payments are treated as loans.

Notice 2001-10

Notice 2001-10 was revoked by Notice 2002-8. For split dollar arrangements entered into before September 18, 2003, taxpayers may rely on the guidance contained in Notice 2001-10. Under Notice 2001-10, the IRS generally will accept the parties' characterization of an employer's payments under a split dollar plan, provided that:

(1) the characterization is not clearly inconsistent with the substance of the arrangement;

(2) the characterization has been consistently followed by the parties from the inception of the agreement; and

(3) the parties fully account for all economic benefits conferred on the employee in a manner consistent with that characterization.[1]

1. Notice 2001-10, 2001-1 CB 459.

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Under Notice 2001-10, there are three different ways that a split dollar plan may be characterized.

First, a plan can be characterized as a loan subject to the below market loan rules.

Second, a plan can be characterized so as to be governed under the traditional split dollar rules of Revenue Ruling 64-328.[1]

Finally, a plan can be characterized in such a way so that the employer's payments are treated as compensation.

Value of Economic Benefit

The employee is taxed on the value of the economic benefit he or she receives from his or her employer's participation in the split dollar arrangement.[2] One of the benefits an employee receives is current life insurance protection under the basic policy. The value of this benefit to an employee may be calculated by using government premium rates. For many years, P.S. 58 rates were used to calculate the value of the protection,[3] but the IRS revoked Revenue Ruling 55-747 and provided new Table 2001 rates. P.S. 58 rates generally may be used prior to 2002; Table 2001 rates generally may be used starting in 2001.[4] Notice 2002-8 provides for some grandfathering of P.S. 58 rates. For split dollar arrangements entered into before January 28, 2002, in which a contractual agreement between an employer and employee provides that P.S. 58 rates will be used to determine the value of current life insurance protection provided to an employee or to an employee and one or more additional persons, the employer and employee may continue to use P.S. 58 rates.[5]

If an insurer publishes rates for individual, initial issue, one year term policies (available to all standard risks) and these rates are lower than the P.S. 58 or Table 2001 rates, as applicable, these insurer rates may be substituted.[6] Only standard rates may be substituted, not preferred rates (such as those offered to non-smoking individuals).[7] The substituted rate must be a rate charged for initial issue insurance and must be available to all standard risks.[8]

For arrangements entered into before September 18, 2003, taxpayers may use an insurer's lower published premium rates available to all standard risks for initial issue one year term insurance. For arrangements entered into after January 28, 2002, and before September 18, 2003, for periods after December 31, 2003, however, an insurer's rates may not be used unless (1) the insurer generally makes the availability of the rates known to those who apply for term insurance coverage from the insurer, and (2) the insurer regularly sells term insurance at those rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels.[9]

1. 1964-2 CB 11.
2. See Rev. Rul. 64-328, 1964-2 CB 11.
3. See Rev. Rul. 55-747, 1955-2 CB 228.
4. Notice 2002-8, 2002-1 CB 398.
5. Notice 2002-8, 2002-1 CB 398.
6. See Rev. Rul. 66-110, 1966-1 CB 12.
7. Let. Rul. 8547006.
8. Rev. Rul. 67-154, 1967-1 CB 11.
9. Notice 2002-8, 2002-2 CB 398.

The IRS has said that taxpayers should make appropriate adjustments to premium rates if life insurance protection covers more than one life.[1] Where a policy death benefit is payable at the second death, rates for single lives should be used to measure the survivor's economic benefit (Appendix G).

Employer's Premiums Nondeductible

An employer cannot take a business expense deduction for its share of the annual premium because the employer is a beneficiary under the policy, within the meaning of IRC Section 264(a)(1).[2] Moreover, it appears that an employer cannot deduct the value of the economic benefit, that is, the Table 2001 or P.S. 58 cost that is taxable to an employee because the employer has not paid or incurred any expense other than nondeductible premium expense.[3]

Death Proceeds

On the death of an employee, both the portion of the proceeds received by the employer and the portion of the proceeds received by the employee's beneficiary are ordinarily exempt from federal income tax under IRC Section 101(a) as life insurance proceeds received by reason of the insured's death.[4] Death proceeds of split dollar life insurance payable to a corporation may affect the calculation of the alternative minimum tax (Q 300).

Stockholder-Employees

Although the issue was not litigated, the IRS treated the P.S. 58 benefit of a substantial stockholder-employee as a dividend in *Johnson v. Commissioner*.[5] The IRS already had ruled that in the case of a split dollar arrangement between a nonemployee stockholder and the corporation, the economic benefit flowing from the corporation to the insured stockholder is taxed as a corporate distribution or dividend.[6]

3904. What are the income tax consequences of the transfer or rollout of a policy subject to a split dollar arrangement?

Under the split dollar regulations, on the transfer of a policy to a non-owner, the non-owner generally is considered to receive the cash value of the policy and the value of all other rights in the policy minus any amounts paid for the policy and any benefits that were previously included in the non-owner's income. Amounts that previously were included in income due to the value of current life insurance protection that was provided to a non-owner may not be used to reduce the amount the non-owner is considered to receive on roll-out. Thus, the taxation on the value of current life insurance protection will not provide a non-owner with any basis in the policy, although taxation for a previous increase in cash value will add basis for a non-owner.[7]

1. Notice 2002-8, 2002-4 CB 398.
2. See Rev. Rul. 64-328 above.
3. See IRC Sec. 162.
4. Rev. Rul. 64-328, supra.
5. 74 TC 1316 (1980).
6. Rev. Rul. 79-50, 1979-1 CB 138.
7. Treas. Reg. §1.61-22(g).

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No inference is to be drawn regarding the tax treatment of split dollar arrangements entered into before September 18, 2003 (Q 3903).[1]

Arrangements Entered into before September 18, 2003

The following discusses rollout from a split dollar arrangement entered into before September 18, 2003.

The IRS considered this issue in two private letter rulings. In the first private letter ruling, the split dollar plan provided that the insured employee would be entitled to a portion of the life insurance policy's cash surrender value annual increase equal to the employee's share of the annual premium. The employee's portion of the annual premium was determined by a payment schedule which entitled the employee to a portion of the cash surrender value of the policy. The plan's rollout provision stated that if the employee remained employed for a specified time, the policy then would be transferred to the employee without cost. The net cash value of the policy transferred to the employee at that time would equal the employee's cumulative premium, or if greater, the cash surrender value less the employer's cumulative premiums.

The IRS concluded that when the policy is transferred to the employee, the employee would have taxable income to the extent the cash value in the policy exceeded the amounts the employee contributed. The IRS reasoned that the cash surrender value would be property transferred in connection with the performance of services and therefore the amount exceeding the employee's basis, that is, the employee's contributions, immediately would be taxable under IRC Section 83. Under IRC Section 83(h), the employer would be entitled to a deduction equal to the amount included in the employee's income. This deduction would be offset by the employer's recognition of a gain equal to the amount received in excess of its basis. Further, the insured employee must include in income each year the annual P.S. 58 cost of life insurance protection the employee received, to the extent paid for by the employer.[2]

The employee was not entitled to use the employee's contributions to offset the employer-provided insurance protection. The ruling does not indicate how the amount of protection provided by the employer is calculated, but it has been suggested that the calculation should be made in a manner consistent with Revenue Ruling 64-328.[3]

The second private letter ruling involved an endorsement arrangement in which the employer owned all the cash values but was to receive death benefits limited to its premium contributions. At the eighth policy year, the employer borrowed an amount equal to its premium contribution from the policy, leaving some amount of cash value in the policy, which then was rolled out to the employee. The IRS, once again, applied IRC Section 83 and found that in the year of the rollout the employer recognized gain in the policy to the extent the cash value exceeded its cumulative premium basis.[4] The employer was entitled to an IRC Section 162 business deduction equal to the total cash value less the employee's premium contributions.

1. See Notice 2002-8, 2002-1 CB 398.
2. Let. Rul. 7916029.
3. 1964-2 CB 11.
4. Treas. Reg. §1.83-6(b).

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The employee likewise must include under IRC Section 83 the full amount of the policy cash value less the premiums the employee paid over the first seven years.[1]

The IRS has provided little or no guidance on the more customary split dollar plan in which an employer's interest is limited to its aggregate premium outlay both during lifetime and at death. Under these circumstances an employer's contractual rights to cash values are limited to the premiums it has paid, which the amount is borrowed from or withdrawn out of the policy in the year of rollout. Typically, the employee pays premiums to offset the economic benefit and contractually owns cash values in excess of the employer's aggregate premium outlay. The 1979 ruling suggested an employee's premium outlay could not be used to offset both the economic benefits and serve as the employee's basis in mitigating the tax on the cash values. The 1983 ruling does not clearly respond to this issue. Neither ruling considered the policy loan in measuring the value transferred to the employee.

In *Neff v Commissioner*,[2] the Tax Court looked at a case involving the termination of a pre-final regulation equity collateral assignment split dollar arrangement. Unfortunately, the case provided little guidance on most issues. The opinion did confirm that at least the amount of corporate premiums was taxable income to the employee when the employment arrangement was terminated and the collateral assignment was released. The court rejected the taxpayer argument that the compensation to the employer was limited to the present value of the premiums discounted to the insured's life expectancy.

Although there are no IRS rulings on point, whether a policy has failed the seven pay test of IRC Section 7702A(b) and therefore is classified as a modified endowment contract should be considered in determining the income tax consequences of a split dollar rollout. Any policy distributions, including policy loans, generally may be taxed less favorably if a policy is a modified endowment contract than if it is not (Q 13).

Where a split dollar arrangement provides a permanent benefit (Q 238) to a member of a group covered by group term life insurance issued by the same insurer or an affiliate, the arrangement may be considered part of a policy providing group term life insurance and its taxation subject to rules discussed in Q 237.

3905. What is reverse split dollar and how is it taxed?

Reverse split dollar is a variation on the split dollar arrangement (Q 3898) in which the ownership of the policy cash value and death proceeds is split between a corporation and an insured employee, but the traditional roles of the two parties to the arrangement are reversed. In the typical reverse split dollar plan, an employer pays a portion of the policy premium equal to the annual P.S. 58 cost or the Table 2001 cost each year while the difference between this cost and the full premium is contributed by the employee. Notice 2002-59[3] is believed to have ended the viability of reverse split dollar.

1. Let. Rul. 8310027.
2. T.C. Memo 2012-244.
3. 2002-2 CB 481.

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In Notice 2002-59, the IRS stated that a party to a split dollar arrangement may use Table 2001 or an insurer's rates only for the purpose of valuing current life insurance protection when the protection is conferred as an economic benefit by one party on another party, determined without regard to consideration or premiums paid by the other party. Thus, if one party has the right to current life insurance protection, neither Table 2001 nor an insurer's rates can be used to value that party's insurance protection for purposes of establishing the value of policy benefits to which another party may be entitled.

Notice 2002-59 provides one example where the premium rates are properly used and one where they are not properly used. In the first example, a donor is assumed to pay the premiums on a life insurance policy that is part of a split dollar arrangement between the donor and a trust, with the trust having the right to the current life insurance protection. The current life insurance protection has been conferred as an economic benefit by the donor on the trust and the donor is permitted to value the life insurance protection using either Table 2001 or an insurer's lower term rates.

In the second example, if the donor or the donor's estate has the right to the current life insurance protection, neither Table 2001 nor an insurer's lower term rates may be used to value the donor's current life insurance protection to establish the value of economic benefits conferred on the trust. Results will be similar if the trust pays for all or a portion of its share of benefits provided under the life insurance arrangement.

Planning Point: Notice 2002-59 does not contain an effective date, which indicates that the IRS does not consider it new guidance but a restatement by the IRS of current law. If that is the case, it will affect reverse split dollar arrangements that were in place before the notice was issued.

3906. What is private split dollar and how is it taxed?

Private split dollar is yet another variation on the traditional split dollar arrangement (Q 3898). The label of private comes from the fact that this type of split dollar arrangement does not include the participation of an employer. Rather, a private split dollar arrangement is typically between two family members or one family member and a trust. When two family members are involved the label "family split dollar" often is used. A common example of family split dollar involves a father assisting his son in setting up a policy insuring the son's life.

The IRS has said that the same principles that govern the tax treatment of employer-employee split dollar plans (Q 3899, Q 3903) also should govern arrangements that provide benefits in gift contexts, which presumably would include private split dollar plans.[1]

The regulations regarding split dollar also apply to private split dollar arrangements (Q 3899). For the estate tax consequences of private split dollar, see Q 308 (under "Non-Employer-Employee Relationship"). For gift tax implications, see Q 503.

1. See Notice 2002-8, 2002-1 CB 398.

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