airplanes that have been modified, altered, or repaired so that the performance of the requirements of this AD is affected, the owner/operator must request approval for an alternative method of compliance in accordance with paragraph (c) of this AD. The request should include an assessment of the effect of the modification, alteration, or repair on the unsafe condition addressed by this AD; and, if the unsafe condition has not been eliminated, the request should include specific proposed actions to address it.

Compliance: Required as indicated, unless accomplished previously.

To prevent forward door escape slides from falling out of their compartments into the airplane interior and inflating, which could impede an evacuation in the event of emergency, accomplish the following:

Hinge Assembly Replacement

(a) Within 24 months after the effective date of this AD, replace the hinge assemblies on the escape slide stowage compartments of the forward doors with new, stronger hinge assemblies, in accordance with Boeing Service Bulletin 737–25–1430, dated February 22, 2001.

Spare Parts

(b) As of the effective date of this AD, no person may install a hinge assembly, part number 65C30431–6 or 65C30431–7, on any airplane.

Alternative Methods of Compliance

(c) An alternative method of compliance or adjustment of the compliance time that provides an acceptable level of safety may be used if approved by the Manager, Seattle Aircraft Certification Office (ACO), FAA. Operators shall submit their requests through an appropriate FAA Principal Maintenance Inspector, who may add comments and then send it to the Manager, Seattle ACO.

Note 2: Information concerning the existence of approved alternative methods of compliance with this AD, if any, may be obtained from the Seattle ACO.

Special Flight Permits

(d) Special flight permits may be issued in accordance with §§ 21.197 and 21.199 of the Federal Aviation Regulations (14 CFR 21.197 and 21.199) to operate the airplane to a location where the requirements of this AD can be accomplished.

Issued in Renton, Washington, on June 28, 2002.

Jeffrey E. Duven,

Acting Manager, Transport Airplane Directorate, Aircraft Certification Service.

[FR Doc. 02–17081 Filed 7–8–02; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 31

[REG–164754–01]

RIN 1545–BA44

Split-Dollar Life Insurance Arrangements

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the income, employment, and gift taxation of split-dollar life insurance arrangements. The proposed regulations will provide needed guidance to persons who enter into split-dollar life insurance arrangements. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written or electronic comments must be received by October 7, 2002. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for October 23, 2002, must be received by October 9, 2002.

ADDRESSES: Send submissions to CC:ITA:RU (REG–164754–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–164754–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC or sent electronically, via the IRS Internet site at *www.irs.gov/regs.* The public hearing will be held in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the section 61 regulations, please contact Elizabeth Kaye at (202) 622–4920; concerning the section 83 regulations, please contact Erinn Madden at (202) 622–6030; concerning the section 301 regulations, please contact Krishna Vallabhaneni at (202) 622–7550; concerning the section 7872 regulations, please contact Rebecca Asta at (202) 622–3940; and concerning the application of these regulations to the Federal gift tax, please contact Lane Damazo at (202) 622–3090. To be placed on the attendance list for the hearing, please contact LaNita M. Vandyke at (202) 622–7180.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S Washington, DC 20224. Comments on the collection of information should be received by September 9, 2002. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collections of information in this proposed regulation are in § 1.7872–15(d)(2)(ii) and (j)(3)(ii). These collections of information are required by the IRS to verify consistent treatment by the borrower and lender of split-dollar loans with nonrecourse or contingent payments. In addition, in the case of a split-dollar loan that provides for nonrecourse payments, the collections of information are required to obtain a benefit. The likely respondents are parties entering into split-dollar loans with nonrecourse or contingent payments.

Estimated total annual reporting and/or recordkeeping burden: 32,500 hours.

Estimated average annual burden hours per respondent and/or recordkeeper: 17 minutes.

Estimated number of respondents and/or recordkeepers: 115,000.

Estimated annual frequency of responses: On occasion.

An agency may not conduct or sponsor, and a person is not required to

respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

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

Background and Explanation of Provisions

1. Current Law

Section 61 provides that gross income includes all income from whatever source derived. Section 1.61–2(d) describes the taxation of premiums paid by an employer or service recipient for life insurance on the life of an employee or independent contractor if the proceeds of the life insurance are payable to the beneficiary of the employee.

Section 83 provides rules for taxing a transfer of property in connection with the performance of services. Generally, if property is transferred to any person other than the service recipient in connection with the performance of services, the excess of the fair market value of such property (determined without regard to lapse restrictions) over the amount paid for such property is included in the gross income of the service provider in the first taxable year in which the service provider's rights in such property are either transferable or not subject to a substantial risk of forfeiture, whichever is applicable. Under § 1.83–1(a)(2), the cost of life insurance protection under a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection generally is taxable under section 61 and the regulations thereunder during the period such contract is substantially nonvested (that is, prior to the time when rights to the contract are either transferable or not subject to a substantial risk of forfeiture). The cost of such life insurance protection is the reasonable net premium cost, as determined by the Commissioner, of the current life insurance protection (as defined in § 1.72–16(b)(3)) provided by such contract. Under § 1.83–3(e), in the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value of the contract is considered property.

Section 163(h) disallows a deduction for personal interest paid or accrued during the taxable year for taxpayers other than corporations. For purposes of section 163(h), personal interest is any interest other than the following: interest paid or accrued on indebtedness properly allocable to a trade or business; any investment interest within the meaning of section 163(d); any interest which is taken into account under section 469 in computing passive income or loss; any qualified residence interest; any interest payable under section 6601 on any unpaid portion of the tax imposed by section 2001 for the period during which an extension of time for payment is in effect; and any interest allowable for deduction under section 221 (relating to interest on education loans).

Section 264(a)(1) provides that no deduction is allowed for premiums on any life insurance policy if the taxpayer is directly or indirectly a beneficiary under the policy. Section 264(a)(2) provides that no deduction is allowed, except as provided in section 264(e), for any interest paid or accrued on indebtedness with respect to a life insurance policy owned by the taxpayer and covering the life of any individual.

Section 301 provides that distributions of property made by a corporation to a shareholder with respect to its stock may constitute a dividend includible in the gross income of the shareholder.

Sections 163(e) and 1271 through 1275 provide rules for the treatment of original issue discount (OID) on debt instruments. In general, the holder and the issuer of a debt instrument take the OID into account as it accrues on the basis of the debt instrument's yield to maturity.

Section 7872 provides rules for certain direct and indirect below-market loans enumerated in section 7872(c)(1). The legislative history of section 7872 states that the term *loan* is to be interpreted broadly for purposes of section 7872, potentially encompassing ''any transfer of money that provides the transferor with a right to repayment.'' H.R. Rep. 98–861, 98th Cong., 2d Sess. 1018 (1984). In general, section 7872 recharacterizes a below-market loan (a loan in which the interest rate charged is less than the applicable Federal rate (AFR)) as an arm's-length transaction in which the lender makes a loan to the borrower at the AFR, coupled with a payment or payments to the borrower sufficient to fund all or part of the interest that the borrower is treated as paying on that loan. The amount, timing, and characterization of the imputed payments to the borrower under a below-market loan depend on the relationship between the borrower and the lender and whether the loan is characterized as a demand loan or a term loan. For example, in the case of a compensation-related below-market loan within the meaning of section 7872(c)(1)(B), the imputed payments are treated as payments of compensation.

Section 7872 generally provides that, in the case of any below-market loan that is a gift or demand loan subject to section 7872, forgone interest is treated as transferred from the lender to the borrower and retransferred from the borrower to the lender as interest on the last day of the calendar year for each year the loan is outstanding.

Section 7872 generally provides that, in the case of any below-market loan that is a term loan subject to section 7872, the lender is treated as having transferred, on the day the loan is made, an amount equal to the excess of the amount loaned over the present value of all payments which are required to be made under the terms of the loan. This amount is treated as retransferred by the borrower to the lender as OID over the term of the loan.

Rev. Rul. 64–328 (1964–2 C.B. 11) and Rev. Rul. 66–110 (1966–1 C.B. 12) address the Federal income tax treatment of a split-dollar life insurance arrangement under which an employer and an employee join in the purchase of a life insurance contract on the life of the employee and provide for the allocation of policy benefits. The rulings conclude that all economic benefits provided by the employer to the employee under such an arrangement are taxed to the employee. Thus, under the rulings, the employee generally must include in compensation income for each taxable year during which the arrangement remains in effect (i) the annual cost of the life insurance protection provided to the employee, reduced by any payments made by the employee for such life insurance protection, (ii) any policy owner dividends or similar distributions provided to the employee under the life insurance contract (including any dividends, as described in Rev. Rul. 66–110, used to provide additional policy benefits), and (iii) any other economic benefits provided to the employee under the arrangement. Neither ruling distinguishes, for tax purposes, between an arrangement in which the employer owns the life insurance contract (as in a so-called endorsement arrangement) and an arrangement in which the employee owns the contract (as in a so-called collateral assignment arrangement).

Rev. Rul. 79–50 (1979–1 C.B. 138) provides that, in a split-dollar life insurance arrangement similar to the one described in Rev. Rul. 64–328 between a corporation and a shareholder, the shareholder must include in income the value of the insurance protection in excess of the premiums paid by the shareholder, and must treat such amounts as provided in section 301(c).

Notice 2001–10 (2001–1 C.B. 459) set forth rules for the taxation of split-dollar life insurance arrangements in which the employee has an interest in the cash surrender value of the life insurance contract (so-called equity split-dollar life insurance arrangements). Notice 2001–10 generally provided, under specified conditions, for the taxation of equity split-dollar life insurance arrangements under either the rules of sections 61 and 83 or the rules of section 7872.

Notice 2002–8 (2002–4 I.R.B. 398), which revoked Notice 2001–10, provides guidance with respect to split-dollar life insurance arrangements entered into before the date final regulations concerning such arrangements are published in the **Federal Register**. The notice indicates that taxpayers may treat current life insurance protection provided under such an arrangement as an economic benefit and that the IRS will not treat the arrangement as having been terminated if the parties continue to treat and report the value of the current life insurance protection in that manner. Notice 2002–8 provides that, alternatively, the parties may treat the premiums or other payments as loans from the sponsor of the arrangement (typically, the employer) to the other party. In these cases, the IRS will not challenge a taxpayer's reasonable efforts to comply with the requirements of sections 1271 through 1275 and section 7872. In addition, all payments by the sponsor from the inception of the arrangement (reduced by any repayments to the sponsor) before the first taxable year in which the payments are treated as loans must be treated as loans entered into at the beginning of such first taxable year.[1]

[1] Notice 2002–8 also provides that an employer and employee may continue to use the P.S. 58 rates set forth in Rev. Rul. 55–747 (1955–2 C.B. 228), which was revoked by Notice 2001–10, only with respect to split-dollar life insurance arrangements entered into before January 28, 2002, in which a contractual arrangement between the employer and employee provides that the P.S. 58 rates will be used to determine the value of the current life insurance protection provided to the employee (or to the employee and one or more additional persons). Taxpayers may not use the P.S. 58 rates for ''reverse'' split-dollar life insurance arrangements or for split-dollar life insurance arrangements outside of the compensatory context.

Notice 2002–8 also describes the anticipated proposed regulations on split-dollar life insurance arrangements. The notice states that the rules would require taxation of a split-dollar life insurance arrangement under one of two mutually exclusive regimes: an economic benefit regime and a loan regime.

2. Overview of the Proposed Regulations

These proposed regulations provide guidance on the taxation of split-dollar life insurance arrangements, including equity split-dollar life insurance arrangements. The proposed regulations apply for purposes of Federal income, employment, and gift taxes. For example, the proposed regulations apply to a split-dollar life insurance arrangement between an employer and an employee, between a corporation and a shareholder, and between a donor and a donee.

Definition of Split-Dollar Life Insurance Arrangement

The proposed regulations generally define a split-dollar life insurance arrangement as any arrangement (that is not part of a group term life insurance plan described in section 79) between an owner of a life insurance contract and a non-owner of the contract under which either party to the arrangement pays all or part of the premiums, and one of the parties paying the premiums is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the contract. This definition is intended to apply broadly and will cover an arrangement, for example, under which the non-owner of a contract provides funds directly to the owner of the contract with which the owner pays premiums, as long as the non-owner is entitled to recover (either conditionally or unconditionally) all or a portion of the funds from the contract proceeds (for example, death benefits) or has an interest in the contract to secure the right of recovery. In addition, the amount to be recovered by the party paying the premiums need not be determined by reference to the amount of those premiums. The definition is not intended to cover the purchase of an insurance contract in which the only parties to the arrangement are the policy owner and the life insurance company acting only in its capacity as issuer of the contract.

A special rule applies in the case of an arrangement entered into in connection with the performance of services. Under this special rule, a split-dollar life insurance arrangement is any arrangement (whether or not described in the general rule) between an owner and a non-owner of a life insurance contract under which the employer or service recipient pays, directly or indirectly, all or any portion of the premiums and the beneficiary of all or any portion of the death benefit is designated by the employee or service provider or is any person whom the employee or service provider would reasonably be expected to name as beneficiary. (Like the general rule, this special rule does not apply to any arrangement covered by section 79.) This special rule also applies to arrangements between a corporation and another person in that person's capacity as a shareholder in the corporation under which the corporation pays, directly or indirectly, all or any portion of the premiums and the beneficiary of all or a portion of the death benefit is a person designated by, or would be reasonably expected to be designated by, the shareholder. As in the case of the general definition, the special rule is not intended to cover the purchase of an insurance contract in which the only parties to the arrangement are the policy owner and the life insurance company acting only in its capacity as issuer of the contract.

Mutually Exclusive Regimes

As indicated in Notice 2002–8, the proposed regulations provide two mutually exclusive regimes for taxing split-dollar life insurance arrangements. A split-dollar life insurance arrangement (as defined in the proposed regulations) is taxed under either the economic benefit regime or the loan regime. The proposed regulations provide rules that determine which tax regime applies to a split-dollar life insurance arrangement.

Under the economic benefit regime (generally set forth in § 1.61–22 of the proposed regulations), the owner of the life insurance contract is treated as providing economic benefits to the non-owner of the contract. The economic benefit regime generally will govern the taxation of endorsement arrangements. In addition, a special rule requires the economic benefit regime to apply (and the loan regime not to apply) to any split-dollar life insurance arrangement if (i) the arrangement is entered into in connection with the performance of services, and the employee or service provider is not the owner of the life insurance contract, or (ii) the

arrangement is entered into between a donor and a donee (for example, a life insurance trust) and the donee is not the owner of the life insurance contract.

Under the loan regime (generally set forth in § 1.7872–15 of the proposed regulations), the non-owner of the life insurance contract is treated as loaning premium payments to the owner of the contract. Except for specified arrangements, the loan regime applies to any split-dollar loan (as defined in the proposed regulations). The loan regime generally will govern the taxation of collateral assignment arrangements.

Thus, in contrast to Rev. Rul. 64–328 and Rev. Rul. 66–110, the proposed regulations generally provide substantially different tax consequences to the parties depending on which party owns the life insurance contract.

The proposed regulations also require both the owner and the non-owner of a life insurance contract that is part of a split-dollar life insurance arrangement (as defined either in the general rule or the special rule) to fully and consistently account for all amounts under the arrangement under the rules of either § 1.61–22 or § 1.7872–15.

For purposes of both the general rule and the special rule, unless the non-owner's payments are certain payments made in consideration for economic benefits, general Federal income, employment, and gift tax principles apply to the arrangement. For example, if an employer pays premiums on a contract owned by an employee and the payments are not split-dollar loans under § 1.7872–15, the employee must include the full amount of the payments in gross income at the time they are paid by the employer to the extent that the employee's rights to the life insurance contract are substantially vested. Also, to the extent an owner's repayment obligation is waived, cancelled, or forgiven at any time under an arrangement that prior to the cancellation of indebtedness was treated as a split-dollar loan, the owner and non-owner must account for the amount waived, cancelled, or forgiven in accordance with the relationship between the parties. Thus, if the arrangement were in a compensatory context, the owner of the contract (the employee) and the non-owner (the employer) would account for the amount as compensation. *See OKC Corp. and Subsidiaries* v. *Commissioner*, 82 T.C. 638 (1984) (whether the cancellation of a debt is ordinary income to the debtor depends upon the nature of the payment); *Newmark* v. *Commissioner,* 311 F.2d 913 (2d Cir. 1962) (discharge of indebtedness constituted a payment for services in an employment situation).

Owners and Non-Owners

The proposed regulations provide rules for determining the owner and the non-owner of the life insurance contract. The owner is the person named as the policy owner. If two or more persons are designated as the policy owners, the first-named person generally is treated as the owner of the entire contract. However, if two or more persons are named as the policy owners and each such person has an undivided interest in every right and benefit of the contract, those persons are treated as owners of separate contracts. For example, if an employer and an employee jointly own a life insurance contract and share equally in all rights and benefits under the contract, they are treated as owning two separate contracts (and, ordinarily, neither contract would be treated as part of a split-dollar life insurance arrangement).

The general rule that the person named as the policy owner is treated as the owner of the life insurance contract is subject to two exceptions involving situations in which the only benefits available under the split-dollar life insurance arrangement would be the value of current life insurance protection (that is, so-called non-equity arrangements). Under the first exception, an employer or service recipient is treated as the owner of the contract under a split-dollar life insurance arrangement that is entered into in connection with the performance of services if, at all times, the only economic benefits available to the employee or service provider under the arrangement would be the value of current life insurance protection. Similarly, a donor is treated as the owner of a life insurance contract under a split-dollar life insurance arrangement that is entered into between a donor and a donee (for example, a life insurance trust) if, at all times, the only economic benefits available to the donee under the arrangement would be the value of current life insurance protection. The proposed regulations reserve on the issue of the consequences of a modification to these arrangements (for example, such as subsequently providing the employee or donee with an interest in the cash value of the life insurance contract). The IRS and the Treasury Department request comments on the rule the final regulations should adopt regarding the consequences of modifying these arrangements.

The non-owner is any person other than the owner of the life insurance contract having any direct or indirect interest in such contract (other than a life insurance company acting solely in its capacity as issuer of a life insurance contract). For example, an employee whose spouse is designated by the employer as the beneficiary of a life insurance contract that is owned by the employer would have an indirect interest in the contract and, therefore, would be treated as a non-owner.

3. Taxation Under the Economic Benefit Regime

a. In General

Section 1.61–22(d) provides that, as a general rule for split-dollar life insurance arrangements that are taxed under the economic benefit regime, the owner of the life insurance contract is treated as providing economic benefits to the non-owner of the contract, and those economic benefits must be accounted for fully and consistently by both the owner and the non-owner. The value of the economic benefits, reduced by any consideration paid by the non-owner to the owner, is treated as transferred from the owner to the non-owner. The tax consequences of that transfer will depend on the relationship between the owner and the non-owner. Thus, the transfer may constitute a payment of compensation, a distribution under section 301, a gift, or a transfer having a different tax character.

Non-Equity Split-Dollar Life Insurance Arrangements

Under a non-equity split-dollar life insurance arrangement, the owner is treated as providing current life insurance protection (including paid-up additions) to the non-owner. The amount of the current life insurance protection provided to the non-owner for a taxable year equals the excess of the average death benefit of the life insurance contract over the total amount payable to the owner under the split-dollar life insurance arrangement. The total amount payable to the owner is increased by the amount of any outstanding policy loan. The cost of the current life insurance protection provided to the non-owner in any year equals the amount of the current life insurance protection provided to the non-owner multiplied by the life insurance premium factor designated or permitted in guidance published in the Internal Revenue Bulletin. For example, assume that employer R is the owner of a $1,000,000 life insurance contract that is part of a split-dollar life insurance arrangement between R and employee E. Under the arrangement, R pays all of the $10,000 annual premiums and is entitled to receive the greater of its

premiums or the cash surrender value of the contract when the arrangement terminates or E dies. Assume that through year 10 of the arrangement R has paid $100,000 of premiums and that in year 10 the cost of term insurance for E is $1.00 for $1,000 of insurance and the cash surrender value of the contract is $200,000. Under § 1.61–22, in year 10, E must include in compensation income $800 ($1,000,000—$200,000, or $800,000 payable to R, multiplied by .001 (E's premium rate factor)). If, however, E paid $300 of the premium, E would include $500 in compensation income.

The Treasury Department and the IRS request comments on whether there is a need for more specific guidance in computing the cost of a death benefit that varies during the course of a taxable year. Comments are requested concerning, for example, whether a convention requiring the amount of the death benefit to be recomputed on a quarterly or semi-annual basis would properly balance the accurate computation of the death benefit against compliance and administrative burdens.

Equity Split-Dollar Life Insurance Arrangements

Under § 1.61–22(d)(3), the owner and the non-owner also must account fully and consistently for any right in, or benefit of, a life insurance contract provided to the non-owner under an equity split-dollar life insurance arrangement. For example, in a compensatory context in which the contract is owned by the employer, the employee must include in gross income the value of any interest in the cash surrender value of the contract provided to the employee during a taxable year.

This result is consistent with the conclusion in Rev. Rul. 66–110 that an employee must include in gross income the value of all economic benefits provided under a split-dollar life insurance arrangement. More broadly, this result is consistent with the fact that a non-owner who has an interest in the cash surrender value of a life insurance contract under an equity split-dollar life insurance arrangement is in a better economic position than a non-owner who has no such interest under a non-equity arrangement.

In general, a mere unfunded, unsecured promise to pay money in the future—as in a standard nonqualified deferred compensation plan covering an employee—does not result in current income. However, a non-owner's interest in a life insurance contract under an equity split-dollar life insurance arrangement is less like that of an employee covered under a standard nonqualified deferred compensation arrangement and more like that of an employee who obtains an interest in a specific asset of the employer (such as where the employer makes an outright purchase of a life insurance contract for the benefit of the employee). The employer's right to a return of its premiums, which characterizes most equity split-dollar life insurance arrangements, affects only the valuation of the employee's interest under the arrangement and, therefore, the amount of the employee's current income.

Specific guidance regarding valuation of economic benefits under an equity split-dollar life insurance arrangement is reserved in § 1.61–22, pending comments from interested parties concerning an appropriate valuation methodology and views on whether such a methodology should be adopted as a substantive rule or as a safe harbor. Any proposal for a specific methodology should be objective and administrable. One potential approach for valuation might involve subtracting from current premium payments made by the contract owner the net present value of the amount to be repaid to the owner in the future.

Other Tax Consequences

Because § 1.61–22(c) treats one party to the split-dollar life insurance arrangement as the owner of the entire contract, the non-owner has no investment in the contract under section 72(e). Thus, no amount paid by the non-owner under a split-dollar life insurance arrangement, whether or not designated as a premium, and no amount included in the non-owner's gross income as an economic benefit, is treated as investment in the contract under section 72(e)(6) for the non-owner. However, as described below, special rules apply in the case of a transfer of the contract from the owner to the non-owner.

Any premium paid by the owner is included in the owner's investment in the contract under section 72(e)(6). However, no premium payment and no economic benefit includible in the non-owner's gross income is deductible by the owner (except as otherwise provided under section 83 when the contract is transferred to the non-owner and the transfer is taxable in accordance with the rules of that section). Any amount paid by the non-owner to the owner for any economic benefit is included in the owner's gross income. Such amount is also included in the owner's investment in the contract (but only to the extent not otherwise so included by reason of having been paid by the owner as a premium or other consideration for the contract).

b. Taxation of Amounts Received Under the Life Insurance Contract

Any amount received under the life insurance contract (other than an amount received by reason of death) and provided, directly or indirectly, to the non-owner is treated as though paid by the insurance company to the owner and then by the owner to the non-owner. This rule applies to a policy owner dividend, the proceeds of a specified policy loan (as defined in § 1.61–22(e)), a withdrawal, or the proceeds of a partial surrender. The owner is taxed on the amount in accordance with the rules of section 72. The non-owner (and the owner for gift tax and employment tax purposes) must take the amount into account as a payment of compensation, a distribution under section 301, a gift, or other transfer depending on the non-owner's relationship to the owner. However, the amount that must be taken into account is reduced by the sum of (i) the value of all economic benefits actually taken into account by the non-owner (and the owner for gift tax and employment tax purposes) reduced (but not below zero) by the amounts that would have been taken into account were the arrangement a non-equity split-dollar life insurance arrangement and (ii) any consideration paid by the non-owner for all economic benefits reduced (but not below zero) by any consideration paid by the non-owner that would have been allocable to economic benefits provided to the non-owner were the arrangement a non-equity split-dollar life insurance arrangement. However, the preceding sentence applies only to the extent such economic benefits were not previously used to reduce an earlier amount received under the contract.

The same result applies in the case of a specified policy loan. A policy loan is a specified policy loan to the extent (i) the proceeds of the loan are distributed directly from the insurance company to the non-owner; (ii) a reasonable person would not expect that the loan will be repaid by the non-owner; or (iii) the non-owner's obligation to repay the loan to the owner is satisfied, or is capable of being satisfied, upon repayment by either party to the insurance company. Because the employee is not the owner of the contract, the specified policy loan will not be treated as a loan to the employee but as a loan to the employer (the owner of the contract), followed by a payment of cash compensation from the employer to the employee.

Amounts received by reason of death are treated differently. Under § 1.61–

22(f), any amount paid to a beneficiary (other than the owner) by reason of the death of the insured is excludable from the beneficiary's gross income under section 101(a) as an amount received under a life insurance contract. This result applies only to the extent that such amount is allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account under the rules set forth in § 1.61–22. Amounts received by a non-owner in its capacity as a lender are generally not amounts received by reason of the death of the insured under section 101(a). Cf. Rev. Rul. 70–254 (1970–1 C.B. 31).

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

Section 1.61–22(g) provides rules for the transfer of a life insurance contract (or an undivided interest therein) from the owner to the non-owner. Consistent with the general rule for determining ownership, § 1.61–22(g) provides that a transfer of a life insurance contract (or an undivided interest therein) underlying a split-dollar life insurance arrangement occurs on the date that the non-owner becomes the owner of the entire contract (or the undivided interest therein). Thus, a transfer of the contract does not occur merely because the cash surrender value of the contract exceeds the premiums paid by the owner or the amount ultimately repayable to the owner on termination of the arrangement or the death of the insured. In addition, there is no transfer of the contract if the owner merely endorses a percentage of the cash surrender value of the contract (or similar rights in the contract) to the non-owner. Unless and until ownership of the contract is formally changed, the owner will continue to be treated as the owner for all Federal income, employment, and gift tax purposes.

At the time of a transfer, there generally must be taken into account for Federal income, employment, and gift tax purposes the excess of the fair market value of the life insurance contract (or the undivided interest therein) transferred to the non-owner (transferee) over the sum of (i) the amount the transferee pays to the owner (transferor) to obtain the contract (or the undivided interest therein), (ii) the value of all economic benefits actually taken into account by the non-owner (and the owner for gift tax and employment tax purposes) reduced (but not below zero) by the amounts that would have been taken into account were the arrangement a non-equity split-dollar life insurance arrangement, and (iii) any consideration paid by the non-owner for all economic benefits reduced (but not below zero) by any consideration paid by the non-owner that would have been allocable to economic benefits provided to the non-owner were the arrangement a non-equity split-dollar life insurance arrangement. However, clauses (ii) and (iii) of the preceding sentence apply only to the extent those economic benefits were not previously used to reduce an earlier amount received under the contract. For this purpose, the fair market value of the life insurance contract is the cash surrender value and the value of all other rights under the contract (including any supplemental agreements, whether or not guaranteed), other than the value of the current life insurance protection. For example, the fair market value of the contract includes the value of a guaranteed right to an above-market rate of return (to the extent not already reflected in the cash surrender value).

In a transfer subject to section 83, fair market value is determined disregarding any lapse restrictions. In addition, the timing of the transferee's inclusion is determined under the rules of section 83. Therefore, a transfer will not give rise to gross income until the transferee's rights to the contract (or undivided interest in the contract) are substantially vested (unless the transferee makes a section 83(b) election). Section 1.83–6(a)(5) of the proposed regulations allows the service recipient's deduction at that time.

Under the general rule, the amount treated as consideration paid to acquire the contract under section 72(g)(1) equals the greater of the fair market value of the contract or the sum of the amount the transferee pays to obtain the contract plus the amount of unrecovered economic benefits previously taken into account or paid for by the transferee. Thus, these amounts become the transferee's investment in the contract under section 72(e) immediately after the transfer.

In the case of a transfer between a donor and a donee, the amount treated as consideration paid by the transferee to acquire the contract under section 72(g)(1) to determine the transferee's investment in the contract under section 72(e) immediately after the transfer is the sum of (i) the amount the transferee pays to obtain the contract, (ii) the aggregate of premiums or other consideration paid or deemed to have been paid by the transferor, and (iii) the amount of unrecovered economic benefits previously either taken into account by the transferee (excluding the amount of those benefits that was excludable from the transferee's gross income at the time of receipt) or paid for by the transferee.

After a transfer of an entire life insurance contract, the transferee becomes the owner for Federal income, employment, and gift tax purposes, including for purposes of the split-dollar life insurance rules. Thus, if the transferor pays premiums after the transfer, the payment of those premiums may be includible in the transferee's gross income if the payments are not split-dollar loans under § 1.7872–15. After the transfer of an undivided interest in a life insurance contract, the transferee is treated as the new owner of a separate contract for all purposes. However, if a transfer of a life insurance contract or an undivided interest in the contract is made in connection with the performance of services and the transfer is not yet taxable under section 83 (because rights to the contract or the undivided interest are substantially nonvested and no section 83(b) election is made), the transferor continues to be treated as the owner of the contract.

4. Taxation Under the Loan Regime

a. In General

Under § 1.7872–15, a payment made pursuant to a split-dollar life insurance arrangement is a split-dollar loan and the owner and non-owner are treated, respectively, as borrower and lender if (i) the payment is made either directly or indirectly by the non-owner to the owner; (ii) the payment is a loan under general principles of Federal tax law or, if not a loan under general principles of Federal tax law, a reasonable person would expect the payment to be repaid in full to the non-owner (whether with or without interest); and (iii) the repayment is to be made from, or is secured by, either the policy's death benefit proceeds or its cash surrender value. The Treasury Department and the IRS recognize that, in the earlier years during which a split-dollar life insurance arrangement is in effect, policy surrender and load charges may significantly reduce the policy's cash surrender value, resulting in under-collateralization of a non-owner's right to be repaid its premium payments. Nevertheless, so long as a reasonable person would expect the payment to be repaid in full, the payment is a split-dollar loan under § 1.7872–15. The Treasury Department and the IRS believe that Congress generally intended that section 7872 would govern the treatment of an arrangement the substance of which is a loan from one

party to another and that there was no congressional intent to make section 7872 inapplicable to split-dollar life insurance arrangements if the arrangements are, in substance, loans.

If a payment on a split-dollar loan is nonrecourse to the borrower and the loan does not otherwise provide for contingent payments, § 1.7872–15 treats the loan as a split-dollar loan that provides for contingent payments unless the parties to the split-dollar life insurance arrangement provide a written representation with respect to the loan to which the payment relates. In general, unless the parties represent that a reasonable person would expect that all payments under the loan will be made, the loan will be treated as a loan that provides for contingent payments. This written representation requirement is intended to help ensure that the parties to the arrangement treat the payments consistently.

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

b. Treatment of Below-Market Split-Dollar Loans

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

For purposes of § 1.7872–15, a below-market split-dollar loan made from a lender to a borrower with a relationship not enumerated in section 7872(c)(1)(A), (B), or (C) is treated as a significant-effect loan under section 7872(c)(1)(E). However, if the effect of a split-dollar loan is attributable to the relationship between the lender or borrower and an indirect participant (for example, when a split-dollar loan is made from an employer to the child of an employee), the below-market split-dollar loan is restructured as two or more successive below-market loans. Any deduction allowable to the indirect participant under section 163(d) for investment interest deemed paid is limited to the amount of investment interest deemed received by the indirect participant.

Split-Dollar Demand Loans

A split-dollar demand loan is any split-dollar loan that is payable in full at any time on the demand of the lender (or within a reasonable time after the lender's demand). Each calendar year that a split-dollar demand loan is outstanding, the loan is tested to determine if the loan provides for sufficient interest. A split-dollar demand loan provides for sufficient interest for the calendar year if the rate (based on annual compounding) at which interest accrues on the loan's adjusted issue price during the year is no lower than the blended annual rate for the year. The use of an annual rate, rather than a semiannual rate, provides a simplified method to determine whether a split-dollar loan provides for sufficient interest and, if the split-dollar loan is below-market, to compute the loan's forgone interest.

In the case of a below-market split-dollar demand loan, the amount of forgone interest for a calendar year is the excess of (i) the amount of interest that would have been payable on the loan for the calendar year if interest accrued on the loan's adjusted issue price at the appropriate AFR and were payable annually over (ii) any interest that accrues on the loan during the year. In general, this excess amount is treated as transferred by the lender to the borrower and retransferred as interest by the borrower to the lender at the end of each calendar year that the loan remains outstanding.

Split-Dollar Term Loans

A split-dollar term loan is any loan that is not a split-dollar demand loan. A split-dollar term loan does not provide for sufficient interest if the amount loaned exceeds the imputed loan amount, which is the present value of all payments due under the loan, determined as of the date the loan is made, using a discount rate equal to the AFR in effect on that date. The AFR used for purposes of the preceding sentence must be appropriate for the loan's term (short-term, mid-term, or long-term) and the compounding period used in computing the present value.

With respect to a below-market split-dollar term loan, the amount of the imputed transfer by the lender to the borrower is the excess of the amount loaned over the imputed loan amount. In general, a split-dollar term loan is treated as having OID equal to the amount of the imputed transfer, in addition to any other OID on the loan (determined without regard to § 1.7872–15).

The term of a split-dollar term loan generally is the term stated in the split-dollar life insurance arrangement. However, special rules apply if the loan is subject to certain borrower or lender options. For purposes of determining a loan's term, the borrower or the lender is projected to exercise or not exercise an option or combination of options in a manner that minimizes the loan's overall yield.

Special rules also are provided for split-dollar term loans payable upon the death of an individual, certain split-dollar term loans that are conditioned on the future performance of substantial services by an individual, and gift split-dollar term loans. Under § 1.7872–15, these split-dollar loans are split-dollar term loans for purposes of determining whether the loan provides for sufficient interest. However, if the loan does not provide for sufficient interest when the loan is made, forgone interest is determined on the loan annually similar to a split-dollar demand loan. The rate used to determine the amount of forgone interest each year is the AFR based on the term of the loan rather than the blended annual rate. A below-market gift split-dollar term loan is treated as a term loan for gift tax purposes.

c. Loans That Provide for Contingent Payments

A split-dollar loan that provides for one or more contingent payments is accounted for by the parties under the contingent split-dollar method, a method similar to the noncontingent bond method described in § 1.1275–4(b). Under this method, the lender prepares a projected payment schedule that includes all of the noncontingent payments and a projected payment for each contingent payment. Any contingent payment provided for under the terms of a split-dollar loan is projected to resolve to its lowest possible value. However, the projected payment schedule must produce a yield that is not less than zero. The projected payment schedule is used to determine

the yield of the split-dollar loan. This yield is then used to determine the accruals of interest (OID) on the loan and to determine whether the loan is a below-market loan for purposes of section 7872 and § 1.7872–15. For example, a split-dollar loan providing for contingent payments is treated as a below-market split-dollar loan if the yield based on the projected payment schedule is less than the appropriate AFR.

If, when a contingency resolves, the actual amount of a contingent payment is different than the projected payment, appropriate adjustments are made by the parties to reflect the difference when the contingency resolves. For example, if a contingent split-dollar loan was treated as a below-market split-dollar loan based on the projected payment schedule and the actual yield on the loan turns out to be greater than the appropriate AFR when the contingency resolves, the parties will take appropriate adjustments into account for any prior imputed transfers under section 7872 and § 1.7872–15 at that time.

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

If a split-dollar loan provides for stated interest that is subsequently waived, cancelled or forgiven, appropriate adjustments are made by the parties to reflect the difference between the interest payable at the stated rate and the interest actually paid by the borrower at that time. An adjustment (for example, an imputed transfer of compensation) may have consequences for the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) if the adjustment represents wages to the borrower.

e. Payment Ordering Rules

Payments made by a borrower to a lender pursuant to a split-dollar life insurance arrangement are applied in the following order: to accrued but unpaid interest (including any OID) on all outstanding split-dollar loans in the order the interest accrued; to principal on the outstanding split-dollar loans in the order in which the loans were made; to payments of amounts previously paid by the lender pursuant to the split-dollar life insurance arrangement that were not reasonably expected to be repaid; and to any other payment with respect to a split-dollar life insurance arrangement. Comments are requested on this rule and other alternative rules, which include applying payments to both the accrued but unpaid interest and principal on each split-dollar loan in the order in which the loans were made, and applying payments pro-rata on all existing split-dollar loan balances.

5. Transfer Tax Treatment of Split-Dollar Life Insurance Arrangements

The proposed regulations will apply for gift tax purposes in situations involving private split-dollar life insurance arrangements. Thus, if, under the proposed regulations, an irrevocable insurance trust is the owner of the life insurance contract underlying the split-dollar life insurance arrangement, and a reasonable person would expect that the donor, or the donor's estate, will recover an amount equal to the donor's premium payments, those premium payments are treated as loans made by the donor to the trust and are subject to § 1.7872–15. In such a case, payment of a premium by the donor is treated as a split-dollar loan to the trust in the amount of the premium payment. If the loan is repayable upon the death of the donor, the term of the loan is the donor's life expectancy determined under the appropriate table under § 1.72–9 as of the date of the payment and the value of the gift is the amount of the premium payment less the present value (determined under section 7872 and § 1.7872–15) of the donor's right to receive repayment. If, however, the donor makes premium payments that are not split-dollar loans, then the premium payments are governed by general gift tax principles. In such a case, with each premium payment, the donor is treated as making a gift to the trust equal to the amount of that payment.

Different rules apply, however, if the donor is treated under § 1.61–22(c) as the owner of the life insurance contract underlying the split-dollar life insurance arrangement and the donor is entitled to recover (either conditionally or unconditionally) all or any portion of the premium payments and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract. Under these circumstances, the donor is treated as making a gift of economic benefits to the irrevocable insurance trust when the donor makes any premium payment on the life insurance contract. For example, assume that under the terms of the split-dollar life insurance arrangement, on termination of the arrangement or the donor's death, the donor or donor's estate is entitled to receive an amount equal to the *greater* of the aggregate premiums paid by the donor or the cash surrender value of the contract. In this case, each time the donor pays a premium, the donor makes a gift to the trust equal to the cost of the current life insurance protection provided to the trust less any premium amount paid by the trustee. On the other hand, if the donor or the donor's estate is entitled to receive an amount equal to the *lesser* of the aggregate premiums paid by the donor, or the cash surrender value of the contract, the amount of the donor's gift to the trust upon the payment of a premium equals the value of the economic benefits attributable to the trust's entire interest in the contract (reduced by any consideration the trustee paid for the interest).

As discussed earlier, § 1.61–22(c) treats the donor as the owner of a life insurance contract even if the donee is named as the policy owner if, under the split-dollar life insurance arrangement, the only amount that would be treated as a transfer by gift by the donor under the arrangement would be the value of current life insurance protection. However, any amount paid by a donee, directly or indirectly, to the donor for such current life insurance protection would generally be included in the donor's gross income.

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

The gift tax consequences of the transfer of an interest in a life insurance contract to a third party will continue to be determined under established gift tax principles notwithstanding who is treated as the owner of the life insurance contract under the proposed regulations. See, for example, Rev. Rul. 81–198 (1981–2 C.B. 188). Similarly, for estate tax purposes, regardless of who is treated as the owner of a life insurance contract under these proposed regulations, the inclusion of the policy proceeds in a decedent's gross estate will continue to be determined under section 2042. Thus, the policy proceeds will be included in the decedent's gross estate under section 2042(1) if receivable by the decedent's executor, or under section 2042(2) if the policy proceeds are receivable by a beneficiary other than the decedent's estate and the decedent possessed any incidents of ownership with respect to the policy.

6. Other Applications of These Regulations

The proposed regulations provide for conforming changes to the definition of wages under sections 3121(a), 3231(e), 3306(b), and 3401(a) and self-employment income under section 1402(a). The rules also apply for purposes of characterizing distributions from a corporation to a shareholder under section 301.

7. Revenue Rulings To Become Obsolete

Concurrent with the publication of final regulations relating to split-dollar life insurance arrangements in the **Federal Register**, the IRS will obsolete the following revenue rulings with respect to split-dollar life insurance arrangements entered into *after* the date the final regulations are published in the **Federal Register:** Rev. Rul. 64–328 (1964–2 C.B. 11); Rev. Rul. 66–110 (1966–1 C.B. 12); Rev. Rul. 78–420 (1978–2 C.B. 68) (with respect to income tax consequences); Rev. Rul. 79–50 (1979–1 C.B. 138); and Rev. Rul. 81–198 (1981–2 C.B. 188) (with respect to income tax consequences). Taxpayers entering into split-dollar life insurance arrangements on or before the date of publication of the final regulations may continue to rely on these revenue rulings to the extent described in Notice 2002–8.

The Treasury Department and the IRS request comments concerning whether any other revenue rulings or guidance published in the Internal Revenue Bulletin should be reconsidered in connection with the publication of final regulations relating to split-dollar life insurance arrangements in the **Federal Register**.

Proposed Effective Date

These proposed regulations are proposed to apply to any split-dollar life insurance arrangement entered into after the date these regulations are published as final regulations in the **Federal Register**. In addition, under the proposed regulations, an arrangement entered into on or before the date final regulations are published in the **Federal Register** and that is materially modified after that date is treated as a new arrangement entered into on the date of the modification. Comments are requested regarding whether certain material modifications should be disregarded in determining whether an arrangement is treated as a new arrangement for purposes of the effective date rule. For example, comments are requested whether an arrangement entered into on or before the effective date should be subject to these rules if the only material modification to the arrangement after that date is an exchange of an insurance policy qualifying for nonrecognition treatment under section 1035.

Taxpayers are reminded that Notice 2002–8 provides guidance with respect to arrangements entered into before the effective date of these regulations.

In addition, taxpayers may rely on these proposed regulations for the treatment of any split-dollar life insurance arrangement entered into on or before the date final regulations are published in the **Federal Register** provided that all parties to the split-dollar life insurance arrangement treat the arrangement consistently. Thus, for example, an owner and a non-owner of a life insurance contract that is part of a split-dollar life insurance arrangement may not rely on these proposed regulations if one party treats the arrangement as subject to the economic benefit rules of § 1.61–22 and the other party treats the arrangement as subject to the loan rules of § 1.7872–15. Moreover, parties to an equity split-dollar life insurance arrangement subject to the economic benefit regime may rely on these proposed regulations only if the value of all economic benefits taken into account by the parties exceeds the value of the economic benefits the parties would have taken into account if the arrangement were a non-equity split-dollar life insurance arrangement (determined using the Table 2001 rates in Notice 2002–8), thereby reflecting the fact that such an arrangement provides the non-owner with economic benefits that are more valuable than current life insurance protection.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written or electronic comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The Treasury Department and IRS specifically request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 23, 2002, beginning at 10 a.m. in room 4718 of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 9, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these proposed regulations are Rebecca Asta of the Office of Associate Chief Counsel (Financial Institutions and Products), Lane Damazo of the Office of Associate Chief Counsel (Passthroughs and Special Industries), Elizabeth Kaye of the Office of Associate Chief Counsel (Income Tax and Accounting), Erinn Madden of the Office of Associate Chief Counsel (Tax-Exempt and Governmental Entities), and Krishna Vallabhaneni of the Office of Associate Chief Counsel

(Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 31

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

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 31 are proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.7872–15 also issued under 26 U.S.C. 1275 and 7872. * * *

Par. 2. Section 1.61–2 is amended by:

1. Redesignating paragraphs (d)(2)(ii)(*a*) and (*b*) as paragraphs (d)(2)(ii)(A) and (B), respectively.

2. Adding two sentences immediately following the second sentence in newly designated paragraph (d)(2)(ii)(A).

The additions read as follows:

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

* * * * *

(d) * * *

(2) * * *

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

* * * * *

Par. 3. Section 1.61–22 is added to read as follows:

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

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

(2) *Overview.* Paragraph (b) of this section defines a split-dollar life insurance arrangement and provides rules to determine whether an arrangement is subject to the rules of paragraphs (d) through (g) of this section, § 1.7872–15, or general tax rules. Paragraph (c) of this section defines certain other terms. Paragraph (d) of this section sets forth rules for the taxation of economic benefits provided under a split-dollar life insurance arrangement. Paragraph (e) of this section sets forth rules for the taxation of amounts received under a life insurance contract that is part of a split-dollar life insurance arrangement. Paragraph (f) of this section provides rules for additional tax consequences of a split-dollar life insurance arrangement, including the treatment of death benefits. Paragraph (g) of this section provides rules for the transfer of a life insurance contract (or an undivided interest in the contract) that is part of a split-dollar life insurance arrangement. Paragraph (h) of this section provides examples illustrating the application of this section. Paragraph (j) of this section provides the effective date of this section.

(b) *Split-dollar life insurance arrangement*— (1) *In general.* A split-dollar life insurance arrangement is any arrangement between an owner and a non-owner of a life insurance contract that satisfies the following criteria—

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

(ii) At least one of the parties to the arrangement paying premiums under paragraph (b)(1)(i) of this section is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract; and

(iii) The arrangement is not part of a group-term life insurance plan described in section 79.

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

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

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

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

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

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

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

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

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

(3) *Determination of whether this section or § 1.7872–15 applies to a split-*

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

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

(A) The arrangement is entered into in connection with the performance of services, and the employee or service provider is not the owner of the life insurance contract (or is not treated as the owner of the contract under paragraph (c)(1)(ii)(A)(*1*) of this section); or

(B) The arrangement is entered into between a donor and a donee (for example, a life insurance trust) and the donee is not the owner of the life insurance contract (or is not treated as the owner of the contract under paragraph (c)(1)(ii)(A)(*2*) of this section).

(4) *Consistency requirement.* Both the owner and the non-owner of a life insurance contract that is part of a split-dollar life insurance arrangement described in paragraph (b)(1) or (2) of this section must fully and consistently account for all amounts under the arrangement under paragraph (b)(5) of this section, paragraphs (d) through (g) of this section, or under § 1.7872–15.

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

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

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

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

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

(*1*) An employer or service recipient is treated as the owner of a life insurance contract under a split-dollar life insurance arrangement that is entered into in connection with the performance of services if, at all times, the arrangement is described in paragraph (d)(2) of this section; and

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

(B) *Modifications.* [Reserved]

(iii) *Attribution rules.* [Reserved]

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

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

(4) *Undivided interest.* An undivided interest in a life insurance contract consists of an identical fractional or percentage interest in each right and benefit under the contract.

(5) *Employment tax.* The term employment tax means the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), the Railroad Retirement Tax Act (RRTA), the Self-Employment Contributions Act of 1954 (SECA), and the Collection of Income Tax at Source on Wages.

(d) *Economic benefits provided under a split-dollar life insurance arrangement*—(1) *In general.* Under a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section, the owner of the life insurance contract is treated as providing economic benefits to the non-owner of the life insurance contract. Those economic benefits must be accounted for fully and consistently by both the owner and the non-owner pursuant to the rules of this paragraph (d). The value of the economic benefits, reduced by any consideration paid by the non-owner to the owner, is treated as transferred from the owner to the non-owner. Depending on the relationship between the owner and the non-owner, the economic benefits may constitute a payment of compensation, a distribution under section 301, a gift, or a transfer having a different tax character. Further, depending on the relationship between or among a non-owner and one or more other persons, the economic benefits may be treated as provided from the owner to the non-owner and as separately provided from the non-owner to such other person or persons (for example, as a payment of compensation from an employer to an employee and as a gift from the employee to the employee's children).

(2) *Non-equity split-dollar life insurance arrangements.* In the case of a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section under which the only economic benefit provided to the non-owner is current life insurance protection (including paid-up additions thereto), the amount of the current life insurance protection provided to the non-owner for a taxable year equals the excess of the average death benefit of the life insurance contract over the total amount payable to the owner under the split-dollar life insurance arrangement. The total amount payable to the owner is increased by the amount of any outstanding policy loan. The cost of the current life insurance protection provided to the non-owner in any year equals the amount of the current life insurance protection provided to the non-owner multiplied by the life insurance premium factor designated or

permitted in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter).

(3) *Equity split-dollar life insurance arrangements*—(i) *In general.* In the case of a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section other than an arrangement described in paragraph (d)(2) of this section, any right in, or benefit of, a life insurance contract (including, but not limited to, an interest in the cash surrender value) provided during a taxable year to a non-owner under a split-dollar life insurance arrangement is an economic benefit for purposes of this paragraph (d).

(ii) *Valuation of economic benefits.* [Reserved]

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

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

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

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

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

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

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

(ii) The amount of all economic benefits described in paragraph (d)(3) of this section actually taken into account under paragraph (d)(1) of this section by the transferee (and the transferor for gift tax and employment tax purposes) reduced (but not below zero) by any amounts that would have been taken into account under paragraph (d)(1) of this section if paragraph (d)(2) of this section were applicable to the arrangement plus any consideration paid by the non-owner for all economic benefits described in paragraph (d)(3) of this section reduced (but not below zero) by any consideration paid by the non-owner that would have been allocable to amounts described in paragraph (d)(2) of this section if paragraph (d)(2) of this section were applicable to the arrangement. The amount determined under the preceding sentence applies only to the extent that neither this paragraph (e)(3)(ii) nor paragraph (g)(1)(ii) of this section previously has applied to such economic benefits.

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

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

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

(3) *To owner.* Any premium paid by an owner under a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section is included in the owner's investment in the contract under section 72(e)(6). No premium or amount described in paragraph (d) of this section is deductible by the owner (except as otherwise provided in § 1.83–6(a)(5)). Any amount paid by a non-owner, directly or indirectly, to the owner of the life insurance contract for current life insurance protection or for any other economic benefit under the life insurance contract is included in the owner's gross income and is included in the owner's investment in the life insurance contract for purposes of section 72(e)(6) (but only to the extent not otherwise so included by reason of having been paid by the owner as a premium or other consideration for the contract).

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

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

(ii) The amount of all economic benefits described in paragraph (d)(3) of this section actually taken into account under paragraph (d)(1) of this section by the transferee (and the transferor for gift tax and employment tax purposes) reduced (but not below zero) by any amounts that would have been taken into account under paragraph (d)(1) of this section if paragraph (d)(2) of this section were applicable to the arrangement plus any consideration paid by the non-owner for all economic benefits described in paragraph (d)(3) of this section reduced (but not below zero) by any consideration paid by the non-owner that would have been allocable to amounts described in paragraph (d)(2) of this section if paragraph (d)(2) of this section were applicable to the arrangement. The amount determined under the preceding sentence applies only to the extent that neither paragraph (e)(3)(ii) of this

section nor this paragraph (g)(1)(ii) previously has applied to such economic benefits.

(2) *Determination of fair market value.* For purposes of paragraph (g)(1) of this section, the fair market value of a life insurance contract is the cash surrender value and the value of all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than the value of current life insurance protection.

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

(4) *Treatment of non-owner after transfer*—(i) *In general.* After a transfer of an entire life insurance contract (except when such transfer is in connection with the performance of services and the transfer is not yet taxable under section 83), the person who previously had been the non-owner is treated as the owner of such contract for all purposes, including for purposes of paragraph (b) of this section and for purposes of § 1.61–2(d)(2)(ii)(A). After the transfer of an undivided interest in a life insurance contract (or, if later, at the time such transfer is taxable under section 83), the person who previously had been the non-owner is treated as the owner of a separate contract consisting of that interest for all purposes, including for purposes of paragraph (b) of this section and for purposes of § 1.61–2(d)(2)(ii)(A). However, such person will continue to be treated as a non-owner with respect to any undivided interest in the contract not so transferred (or not yet taxable under section 83).

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

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

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

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

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

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

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

(ii) E's investment in the contract is $50,000, consisting of the $50,000 of premiums paid by D. The $80,000 of benefits described in paragraph (d)(3) of this section that E received is not included in E's investment in the contract because such amounts were excludable from E's gross income at the time of receipt.

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

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

Example 1. (i) In year 1, R purchases a life insurance contract on the life of E. R is named as the policy owner of the contract. R and E enter into an arrangement under which R will pay all the premiums on the life insurance contract until the termination of the arrangement or E's death. Upon termination of the arrangement or E's death, R is entitled to receive the greater of the aggregate premiums or the cash surrender value of the contract. The balance of the death benefit will be paid to a beneficiary designated by E.

(ii) Because R is designated as the policy owner, R is the owner of the contract under paragraph (c)(1) of this section. E is a non-owner of the contract. Under the arrangement between R and E, a portion of the death benefit is payable to a beneficiary designated by E. The arrangement is a split-dollar life insurance arrangement under paragraph (b)(1) or (2) of this section. For each year that the split-dollar life insurance arrangement is in effect, the arrangement is described in paragraph (d)(2) of this section and E must include in income the value of current life insurance protection, as required by paragraph (d)(2) of this section.

Example 2. (i) The facts are the same as in *Example 1* except that, upon termination of the arrangement or E's death, R is entitled to receive the lesser of the aggregate premiums or the cash surrender value of the contract.

(ii) For each year that the split-dollar life insurance arrangement is in effect, the arrangement is described in paragraph (d)(3) of this section and E must include in gross income the value of the economic benefit attributable to E's interest in the life

insurance contract, as required by paragraph (d)(3) of this section.

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

(ii) In year 5 (and subsequent years), the arrangement is described in paragraph (d)(3) of this section and E must include in gross income the value of the economic benefit attributable to E's interest in the life insurance contract, as required by paragraph (d)(3) of this section. Because the modification made by R and E in year 5 does not involve the transfer (within the meaning of paragraph (c)(3) of this section) of an undivided interest in the life insurance contract from R to E, the modification is not a transfer for purposes of paragraph (g) of this section.

Example 4. (i) The facts are the same as in *Example 2* except that in year 7, R and E modify the split-dollar life insurance arrangement to provide that, upon termination of the arrangement or E's death, R will be paid the lesser of 80 percent of the aggregate premiums or the cash surrender value of the contract.

(ii) The arrangement is described in paragraph (d)(3) of this section. In year 7 (and in subsequent years), E must include in gross income the value of the increased economic benefits described in paragraph (d)(3) of this section resulting from the contract modification under which E obtains rights to a larger amount of the cash value of the contract (attributable to the fact that R will forgo the right to recover 20 percent of the premiums R pays).

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

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

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

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

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

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

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

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

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

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

(i) [Reserved]

(j) *Effective date*—(1) *General rule.* This section applies to any split-dollar life insurance arrangement (as defined in paragraph (b)(1) or (2) of this section) entered into after the date the final regulations are published in the **Federal Register**.

(2) *Early reliance*—(i) *General rule.* Taxpayers may rely on this section for the treatment of any split-dollar life insurance arrangement (as defined in paragraph (b)(1) or (2) of this section) entered into on or before the date described in paragraph (j)(1) of this section, provided that all taxpayers who are parties to the arrangement treat the arrangement consistently under this section and, in the case of an arrangement described in paragraph (d)(3) of this section, also satisfy the requirements in paragraph (j)(2)(ii) of this section.

(ii) *Equity split-dollar life insurance arrangements.* Parties to an arrangement described in paragraph (d)(3) of this section may rely on this section only if the value of all economic benefits taken into account by the parties exceeds the value of the economic benefits the parties would have taken into account if paragraph (d)(2) of this section were applicable to the arrangement (determined using the life insurance premium factor designated in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter)), thereby reflecting the fact that such an arrangement provides the non-owner with economic benefits that are more valuable than current life insurance protection.

(3) *Modified arrangements treated as new arrangements.* An arrangement entered into on or before the date set forth in paragraph (j)(1) of this section that is materially modified after the date set forth in paragraph (j)(1) of this section is treated as a new arrangement entered into on the date of the modification.

Par. 4. Section 1.83–1 is amended by:

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

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

The addition reads as follows:

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

(a) * * *

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

* * * * *

Par. 5. Section 1.83–3 is amended by:

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

2. Revising the penultimate sentence in paragraph (e).

The addition and revision read as follows:

§ 1.83–3 Meaning and use of certain terms.

(a) * * * (1) * * * For special rules applying to the transfer of a life insurance contract (or an undivided interest therein) that is part of a split-dollar life insurance arrangement (as defined in § 1.61–22(b)(1) or (2)), see § 1.61–22(g).

* * * * *

(e) * * * In the case of a transfer of a contract, or any undivided interest therein, providing death benefit protection (including a life insurance contract, retirement contract, or

endowment contract) after the date the final regulations are published in the **Federal Register**, the cash surrender value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than current life insurance protection, are treated as property for purposes of this section.

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Par. 6. Section 1.83–6 is amended as follows:

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

2. Adding a new paragraph (a)(5).

The addition reads as follows:

§ 1.83–6 Deduction by employer.

(a) * * *

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

(ii) *Effective date*—(A) *General rule.* Paragraph (a)(5)(i) of this section applies to any split-dollar life insurance arrangement (as defined in § 1.61–22(b)(1) or (2)) entered into after the date the final regulations are published in the **Federal Register**.

(B) *Early reliance*—(*1*) *General rule.* Taxpayers may rely on this paragraph (a)(5) for the treatment of any split-dollar life insurance arrangement (as defined in § 1.61–22(b)(1) or (2)) entered into on or before the date described in paragraph (a)(5)(ii)(A) of this section, provided that all taxpayers who are parties to the arrangement treat the arrangement consistently under § 1.61–22(d) through (g) and, in the case of an arrangement described in § 1.61–22(d)(3), also satisfy the requirements in paragraph (a)(5)(ii)(B)(*2*) of this section.

(*2*) *Equity split-dollar life insurance arrangements.* Parties to an arrangement described in § 1.61–22(d)(3) may rely on this paragraph (a)(5) only if the value of all economic benefits taken into account by the parties exceeds the value of the economic benefits the parties would have taken into account if § 1.61–22(d)(2) were applicable to the arrangement (determined using the life insurance premium factor designated in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter)), thereby reflecting the fact that such an arrangement provides the non-owner with economic benefits that are more valuable than current life insurance protection.

(C) *Modified arrangements treated as new arrangements.* An arrangement entered into on or before the date set forth in paragraph (a)(5)(ii)(A) of this section that is materially modified after the date set forth in paragraph (a)(5)(ii)(A) of this section is treated as a new arrangement entered into on the date of the modification.

* * * * *

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

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

* * * * *

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

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

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

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

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

(4) *Effective date*—(i) *General rule.* This paragraph (q) applies to split-dollar and other life insurance arrangements entered into after the date the final regulations are published in the **Federal Register**.

(ii) *Early reliance*—(A) *General rule.* Taxpayers may rely on this paragraph (q) for the treatment of any split-dollar life insurance arrangement (as defined in § 1.61–22(b)(1) or (2)) entered into on or before the date described in paragraph (q)(4)(i) of this section, provided that all taxpayers who are parties to the arrangement treat the arrangement consistently under § 1.61–22(d) through (g) and, in the case of an arrangement described in § 1.61–22(d)(3), also satisfy the requirements in paragraph (q)(4)(ii)(B) of this section.

(B) *Equity split-dollar life insurance arrangements.* Parties to an arrangement described in § 1.61–22(d)(3) may rely on this paragraph (q) only if the value of all economic benefits taken into account by the parties exceeds the value of the economic benefits the parties would have taken into account if § 1.61–22(d)(2) were applicable to the arrangement (determined using the life insurance premium factor designated in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter)), thereby reflecting the fact that such an arrangement provides the non-owner with economic benefits that are more valuable than current life insurance protection.

(iii) *Modified arrangements treated as new arrangements.* An arrangement entered into on or before the date set forth in paragraph (q)(4)(i) of this section that is materially modified after the date set forth in paragraph (q)(4)(i) of this section is treated as a new arrangement entered into on the date of the modification.

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

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

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

Par. 9. Section 1.7872–15 is added to read as follows:

§ 1.7872–15 Split-dollar loans.

(a) *General rules*—(1) *Introduction.* This section applies to split-dollar loans as defined in paragraph (b)(1) of this section. If a split-dollar loan is not a below-market loan, then, except as provided in this section, the loan is governed by the general rules for debt

instruments (including the rules for original issue discount (OID) under sections 1271 through 1275 and the regulations thereunder). If a split-dollar loan is a below-market loan, then, except as provided in this section, the loan is governed by section 7872 and the regulations thereunder. The timing, amount, and characterization of the imputed transfers between the lender and borrower of a below-market split-dollar loan depend upon the relationship between the parties and upon whether the loan is a demand loan or a term loan. For additional rules relating to the treatment of split-dollar life insurance arrangements, see § 1.61–22.

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

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

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

(C) The repayment is to be made from, or is secured by, either the policy's death benefit proceeds or its cash surrender value.

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

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

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

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

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

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

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

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

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

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

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

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

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

(2) *Exception for certain loans with respect to which the parties to the split-dollar life insurance arrangement make a representation*—(i) *Requirements.* An otherwise noncontingent payment on a split-dollar loan that is nonrecourse to the borrower is not a contingent payment under this section if the following requirements are satisfied—

(A) The split-dollar loan provides for interest payable at a stated rate that is either a fixed rate or a variable rate described in paragraph (g) of this section; and

(B) The parties to the split-dollar life insurance arrangement represent in writing that a reasonable person would expect that all payments under the loan will be made.

(ii) *Time and manner for providing written representation.* The Commissioner may prescribe the time and manner for providing the written representation required by paragraph (d)(2)(i)(B) of this section. Until the Commissioner prescribes otherwise, the written representation that is required by paragraph (d)(2)(i)(B) of this section must meet the requirements of this paragraph (d)(2)(ii). Both the borrower and the lender must sign the representation not later than the last day (including extensions) for filing the Federal income tax return of the borrower or lender, whichever is earlier, for the taxable year in which the lender makes the first split-dollar loan under the split-dollar life insurance arrangement. This representation must include the names, addresses, and taxpayer identification numbers of the borrower, lender, and any indirect participants. Unless otherwise stated therein, this representation applies to all subsequent split-dollar loans made pursuant to the split-dollar life insurance arrangement. Each party should retain an original of the representation as part of its books and records and should attach a copy of this representation to its Federal income tax return for any taxable year in which the lender makes a loan to which the representation applies.

(e) *Below-market split-dollar loans*—(1) *Scope*—(i) *In general.* This paragraph (e) applies to below-market split-dollar loans enumerated under section 7872(c)(1), which include gift loans, compensation-related loans, and corporation-shareholder loans. The characterization of a split-dollar loan under section 7872(c)(1) and of the

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

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

(2) *Indirect split-dollar loans*—(i) *In general.* If, based on all the facts and circumstances, including the relationship between the borrower or lender and some third person (the indirect participant), the effect of a below-market split-dollar loan is to transfer value from the lender to the indirect participant and from the indirect participant to the borrower, then the below-market split-dollar loan is restructured as two or more successive below-market loans (the deemed loans) as provided in this paragraph (e)(2). The transfers of value described in the preceding sentence include (but are not limited to) a gift, compensation, a capital contribution, and a distribution under section 301 (or, in the case of an S corporation, under section 1368). The deemed loans are—

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(*2*) *Exception for death, liquidation, or termination of the borrower.* In the taxable year in which the borrower dies (in the case of borrower who is a natural person) or is liquidated or otherwise terminated (in the case of a borrower other than a natural person), any forgone interest is treated, for both the

lender and the borrower, as transferred and retransferred on the last day of the borrower's final taxable year.

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

(4) *Split-dollar term loans*—(i) *In general.* Except as provided in paragraph (e)(5) of this section, this paragraph (e)(4) provides rules for testing split-dollar term loans for sufficient interest and, if the loans do not provide for sufficient interest, rules for imputing payments on these loans. See paragraph (g) of this section for additional rules that apply to a split-dollar loan providing for certain variable rates of interest.

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

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

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

(B) *Special rules for certain options*—(*1*) *Payment schedule that minimizes yield.* If a split-dollar term loan is subject to unconditional options that are exercisable at one or more times during the term of the loan and that, if exercised, would require full payment of the loan on a date other than the stated maturity date, then the rules of this paragraph (e)(4)(iii)(B)(*1*) determine the term of the loan. For purposes of determining a split-dollar loan's term, the borrower is projected to exercise or not exercise an option or combination of options in a manner that minimizes the loan's overall yield. Similarly, the lender is projected to exercise or not exercise an option or combination of options in a manner that minimizes the loan's overall yield. If different projected patterns of exercise or non-exercise produce the same minimum yield, the parties are projected to exercise or not exercise an option or combination of options in a manner that produces the longest term.

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

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

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

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

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

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

(D) *Split-dollar loans payable upon the death of an individual.* If a split-dollar term loan is described in paragraph (e)(5)(ii)(A) or (v)(A) of this section, the term of the loan for purposes of paragraph (e)(4)(ii) of this section is determined under paragraph (e)(5)(ii)(C) or (v)(B)(*2*) of this section, whichever is applicable.

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

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

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

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

Example. (i) On July 1, 2009, Corporation *Z* and Shareholder *A* enter into a split-dollar life insurance arrangement under which *A* is named as the policy owner. On July 1, 2009, *Z* makes a $100,000 premium payment, repayable without interest in 15 years. Repayment of the premium payment is fully

recourse to *A*. The premium payment is a split-dollar term loan. Assume the long-term AFR (based on annual compounding) at the time the loan is made is 7 percent.

(ii) Based on a 15-year term and a discount rate of 7 percent, compounded annually (the long-term AFR), the present value of the payments under the loan is $36,244.60, determined as follows: $100,000/[1+(0.07/1)]^{15}. This loan is a below-market split-dollar term loan because the imputed loan amount of $36,244.60 (the present value of the amount required to be repaid to *Z*) is less than the amount loaned ($100,000).

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

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

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

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

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

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

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

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

(B) *Treatment of loan.* A split-dollar loan described in paragraph (e)(5)(iii)(A)(*1*) of this section is tested under paragraph (e)(4)(ii) of this section to determine if the loan provides for sufficient interest. Except as provided in paragraph (e)(5)(iii)(D) of this section, if the loan provides for sufficient interest, then section 7872 does not apply to the loan and the interest on the loan is taken into account under paragraph (f) of this section. If the loan does not provide for sufficient interest, then section 7872 applies to the loan and the loan is treated as a below-market demand loan subject to paragraph (e)(3)(iii) of this section. For each year that the loan is outstanding, however, the AFR used in the determination of forgone interest under paragraph (e)(3)(iii) of this section is not the blended annual rate but rather is the AFR (based on annual compounding) appropriate for the loan's term for the month in which the loan is made. See paragraph (e)(5)(iii)(C) of this section to determine the loan's term.

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

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

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

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

paragraph (e)(5)(iv)(C) of this section to determine the loan's term.

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

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

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

(*1*) The death of an individual; or

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(ii) The loan is subject to this paragraph (g) because the loan is a variable rate debt instrument that bears interest at a qualified floating rate. Because the interest rate is reset each year, under paragraph (g)(3)(ii) of this section, the short-term AFR (based on annual compounding) is the appropriate test rate used to determine whether the loan provides for sufficient interest. Moreover, under paragraph (g)(3)(ii) of this section, to determine whether the loan provides for sufficient interest, the loan is treated as if it provided for a fixed rate of interest equal to 8 percent, compounded annually. Based on a discount rate of 7 percent, compounded annually (the short-term AFR), the present value of the payments under the loan is $109,107.91. The loan provides for sufficient interest because the loan's imputed loan amount of $109,107.91 (the present value of the payments) is more than the amount loaned of $100,000. Therefore, the loan is not a below-market split-dollar term loan, and interest on the loan is taken into account under paragraph (f) of this section.

(h) *Adjustments for interest paid at less than the stated rate*—(1) *In general.* To the extent required by this paragraph (h), if accrued but unpaid interest on a split-dollar loan is subsequently waived, cancelled, or forgiven by the lender, the waiver, cancellation, or forgiveness is treated as if, on that date, the interest had in fact been paid to the lender and then retransferred by the lender to the borrower. To determine the characterization of any retransferred amount, see paragraph (e)(1)(i) of this section. For purposes of this paragraph (h), the amount of interest deemed transferred and retransferred pursuant to this paragraph (h) is determined under paragraph (h)(2) or (3) of this section. See § 1.61–22(b)(6) for the treatment of amounts other than interest on a split-dollar loan that are waived, cancelled, or forgiven by the lender. For purposes of this paragraph (h), a split-dollar term loan described in paragraph (e)(5) of this section (for example, a split-dollar term loan payable not later than the death of an individual) is subject to the rules of paragraph (h)(3) of this section.

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

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

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

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

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

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

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

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

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

(iii) Under paragraph (h)(2) of this section, the waived amount is treated as if, on December 31, 2011, it had in fact been paid to *Y* and was then retransferred by *Y* to *B.* The amount deemed transferred to *Y* and retransferred to *B* equals the excess of the amount of interest payable at the stated rate ($15,762.50) over the interest actually paid ($0), or $15,762.50. Because of the employment relationship between *Y* and *B,* this retransferred amount is treated as compensation paid by *Y* to *B.*

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

(ii) For each year that the split-dollar demand loan was outstanding, the loan was not a below-market loan under paragraph (e)(3)(ii) of this section. Under paragraph (f)

of this section, *Y* was required to accrue compound interest of 7 percent each year the loan remained outstanding. *B,* however, was not entitled to any deduction for this interest under paragraph (c) of this section.

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

(i) [Reserved]

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

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

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

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

(ii) *Insolvency and default.* For purposes of this section, a payment is not contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances. However, if any payment on a split-dollar loan is nonrecourse to the borrower, the payment is a contingent payment for purposes of this paragraph (j) unless the parties to the arrangement make the written representation provided for in paragraph (d)(2) of this section.

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

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

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

(ii) *Projected payment schedule*—(A) *Determination of schedule.* No comparable yield is required to be determined. The projected payment schedule for the loan includes all noncontingent payments and a projected payment for each contingent payment. The projected payment for a contingent payment is the lowest possible value of the payment. The projected payment schedule, however, must produce a yield that is not less than zero. If the projected payment schedule produces a negative yield, the schedule must be reasonably adjusted to produce a yield of zero.

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

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

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

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

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

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

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

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

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

(ii) Under this paragraph (j), the split-dollar loan between *T* and *G* provides for a

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

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

(iv) In accordance with section 7872(b)(1) and paragraph (e)(4)(iv) of this section, on the date the loan is made, *T* is treated as transferring to *G* $23,710.48 (the imputed transfer) as compensation. In addition, *T* must take into account as OID an amount equal to the imputed transfer. See § 1.1272–1 for the treatment of OID.

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

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

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

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

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

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

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

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

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

(l) [Reserved]

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

(n) *Effective date*—(1) *General rule.* This section applies to any split-dollar life insurance arrangement entered into after the date the final regulations are published in the **Federal Register**.

(2) *Early reliance.* Taxpayers may rely on this section for the treatment of any split-dollar life insurance arrangement entered into on or before the date described in paragraph (n)(1) of this section, provided that all taxpayers who are parties to a split-dollar loan described in paragraph (b)(1) of this section treat the arrangement consistently under this section.

(3) *Modified arrangements treated as new arrangements.* An arrangement entered into on or before the date set forth in paragraph (n)(1) of this section that is materially modified after the date set forth in paragraph (n)(1) of this section is treated as a new arrangement entered into on the date of the modification.

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

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

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

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

§ 31.3121(a)–1 Wages.

* * * * *

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

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

§ 31.3231(e)–1 Compensation.

(a) * * *

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

* * * * *

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

§ 31.3306(b)–1 Wages.

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

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

§ 31.3401(a)–1 Wages.

* * * * *

(b) * * *

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

treatment of split-dollar life insurance arrangements.

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David A. Mader,

Acting Deputy Commissioner of Internal Revenue.

[FR Doc. 02–17042 Filed 7–3–02; 9:53 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Bureau of Alcohol, Tobacco and Firearms

27 CFR Part 9

[Notice No. 947]

RIN: 1512–AC62

Establishment of the Oak Knoll District Viticultural Area (2002R–046P)

AGENCY: Bureau of Alcohol, Tobacco and Firearms (ATF), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Bureau of Alcohol, Tobacco and Firearms is proposing the establishment of the ''Oak Knoll District'' viticultural area in Napa County, California. This action is in response to a petition submitted by the Oak Knoll District Committee.

DATES: Written comments must be received by September 9, 2002.

ADDRESSES: Send written comments to: Chief, Regulations Division, Bureau of Alcohol, Tobacco and Firearms, PO Box 50221, Washington, DC 20091–0221 (Attn: Notice No. 947). See the ''Public Participation'' section of this notice for alternative means of commenting.

Copies of the petition, the proposed regulation, the appropriate maps, and any written comments received will be available for public inspection by appointment during normal business hours at the ATF Reading Room, Room 6480, 650 Massachusetts Avenue, NW., Washington, DC 20226; telephone 202–927–7890.

FOR FURTHER INFORMATION CONTACT: Joanne Brady, Specialist, Regulations Division (Philadelphia, PA), Bureau of Alcohol, Tobacco and Firearms, The Curtis Center, Suite 875, Independence Square West, Philadelphia, PA 19106; telephone 215–597–5288 or e-mail *JCBrady@phila.atf.treas.gov.*

SUPPLEMENTARY INFORMATION:

Background

The Federal Alcohol Administration Act (FAA Act) at 27 U.S.C. 205(e) requires that alcohol beverage labels provide the consumer with adequate information regarding a product's identity and prohibits the use of deceptive information on such labels. The FAA Act also authorizes the Bureau of Alcohol, Tobacco and Firearms (ATF) to issue regulations to carry out the Act's provisions.

Regulations in 27 CFR part 4, Labeling and Advertising of Wine, allow the establishment of definitive viticultural areas. The regulations allow the name of an approved viticultural area to be used as an appellation of origin on wine labels and in wine advertisements. A list of approved viticultural areas is contained in 27 CFR part 9, American Viticultural Areas.

Section 4.25a(e)(1) of title 27 CFR defines an American viticultural area as a delimited grape-growing region distinguishable by geographic features, the boundaries of which have been delineated in subpart C of part 9.

Section 4.25a(e)(2) outlines the procedure for proposing an American viticultural area. Any interested person may petition ATF to establish a grape-growing region as a viticultural area. The petition should include:

(a) Evidence that the name of the proposed viticultural area is locally and/or nationally known as referring to the area specified in the petition;

(b) Historical or current evidence that the boundaries of the viticultural area are as specified in the petition;

(c) Evidence relating to the geographical characteristics (climate, soil, elevation, physical features, etc.) which distinguish the viticultural features of the proposed area from surrounding areas;

(d) A description of the specific boundaries of the viticultural area, based on features which can be found on United States Geological Survey (U.S.G.S.) maps of the largest applicable scale; and

(e) A copy (or copies) of the appropriate U.S.G.S. map(s) with the boundaries prominently marked.

Oak Knoll District Petition

The Bureau of Alcohol, Tobacco and Firearms (ATF) has received a petition from the Oak Knoll District Committee proposing a new American viticultural area to be called ''Oak Knoll District.'' As part of its petition, the Committee also submitted reports from historian Charles L. Sullivan and Dr. Deborah L. Elliott-Fisk, a professor at the University of California, Davis, in support of its claims.

The proposed viticultural area is located in the southern end of the Napa Valley in Napa County, California. It includes approximately 9,940 acres, of which 4,040 are plantable to vines. The proposed area would abut the Mt. Veeder viticultural area to the west and the Yountville viticultural area to the north, and would lie entirely within the Napa Valley viticultural area.

Evidence That the Name of the Area is Locally or Nationally Known

According to the Oak Knoll District Committee, the name of the proposed viticultural area is based on both present and historical evidence. The proposed area is the site of the historic Oak Knoll Ranch, which dates from the early days of American settlement in the Napa Valley. The petitioner also provided other examples of the use of the name ''Oak Knoll District'' or ''Oak Knoll'' within the proposed area: the area's former school district was known as the Oak Knoll District, a historic train station was called Oak Knoll Station, and the Oak Knoll Inn and Oak Knoll Cellars vineyard were established within the proposed area.

According to the report submitted by Mr. Charles L. Sullivan, Joseph W. Osborne brought the first fine vinifera varieties to the Napa Valley. His ranch, the Oak Knoll Ranch, became famous when it was named California's best-cultivated farm by the State Agricultural Society in 1854 and 1856. Mr. Sullivan also notes that, according to a local newspaper's extensive article on the Oak Knoll estate in 1886, it was called ''the richest gem in California's golden crown'' and ''one of the fairest spots in California's loveliest valley.''

Mr. Sullivan's report noted that in 1886, the Eshcol Ranch Winery was established on what may have been the Oak Knoll Ranch property. The petition contends that the purchase of the Eshcol estate by the Trefethen family in 1968, and the establishment of Trefethen Vineyards, began to transform Oak Knoll into a world-class wine grape growing area.

The petitioner also supplied evidence in the form of articles from various publications and trade magazines that make reference to the ''Oak Knoll District.'' An excerpt from the Lifestyle section of the August/September 1999 issue of ''Wine News'' magazine states that the Trefethens bought the 600-acre walnut, wheat, grape, and prune ranch in the ''Oak Knoll District of Napa'' in 1968.

An article from the May 1999 ''Inside Napa Valley, a Visitor's Guide,'' states that the ''Yountville, Stag's Leap and Oak Knoll districts near Yountville contain some of the most renown[ed] wineries of Napa Valley.'' An article from the July 16, 1997, Los Angeles Times states, ''Trefethen's 600 acres of vines are in the (not yet legally