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Split-Dollar Spotlight: Economic Benefit Versus Loan Regime

This excerpt comes from *The Comprehensive Guide to Split Dollar Life Insurance*. In this chart, each parenthetical reference under the regulation refers to a question or series of questions answered in *The Comprehensive Guide*.

	Economic Benefit	Loan
Rules Governing Taxation	Reg. § 1.61-22 (D.8; D.10-D.34)	Reg. § 1.7872-15 (D.8; D.35-D.60)
Policyowner (Determines Regime Application)	Business (D.5-D.8)	Insured or Insured's Irrevocable Life Insurance Trust (ILIT) (D.5-D.8)
Typical Documentation Method	Endorsement or collateral assignment (non-equity only) (B.2-B.5; D.61-D.64)	Collateral assignment (B.2-B.5; D.65-D.68)
Amounts Taxed Annually to Insured	Value of 1) term cost of current life insurance protection, 2) current access to policy cash value and 3) any other economic benefits under the arrangement. (D.10-D.34)	Demand and hybrid loans: If below market, insured taxed on forgone interest on loan each year. **Term loans:** If below market, insured recognizes all forgone interest for entire loan term in first year of loan. (D.35-D.60)
Insured Taxed on Access to Policy Equity/Cash Value	Current taxation of any entitlement or access to policy cash value. (D.20-D.23)	No (D.36)
Impact on Insured's Contributions/Payments Under Arrangement	Offsets taxable annual economic benefit to insured. Business **is taxed** on contribution. Business (**not insured**) receives tax basis in policy for contributions. (D.24-D.25)	Applied first to outstanding interest on all loans and then to principal. Offsets any taxable forgone/imputed interest to insured. Business recognizes interest income (whether paid or accrued). (D.54)
Tax Basis in Policy During Arrangement	Basis in policy accrues solely for the benefit of the business, as policy owner, regardless of insured's contributions. (D.25)	Basis in policy accrues for the benefit of insured (or ILIT), as policy owner. (D.55)

	Economic Benefit	Loan
Income Taxation of Policy Death Benefits (assumes no transfer for value under IRC §10(a) and compliance with IRC §101(j))	**Business and Insured:** Exempt under IRC § 101(a) (but, for insured, only to extent s/he has reported/paid annual cost of insurance protection; otherwise, benefits treated as received tax-free by business and transferred to insured as income). (D.28)	**Insured:** Exempt under IRC § 101(a). **Business:** Not exempt under IRC §101(a), but to extent received as a recovery of principal, not taxable. (D.54)
Taxation on Exit/Rollout	If the policy is transferred to insured, s/he must recognize as income the fair market value of the policy, less consideration paid for the transfer, and any economic benefits previously paid for or recognized by insured other than the cost of current life insurance protection. Insured takes an equivalent tax basis in the policy. Business can take a corresponding deduction for amounts included in insured's income, plus all amounts previously included in insured's gross income as economic benefits (other than for current life insurance protection). (D.29)	For any outstanding loans, if the business forgives or waives repayment of interest, **the interest amount, plus a deferral charge based on the underpayment of tax penalty rate,** is taxable to the insured. Any forgiveness or waiver of principal due also will be taxed to the insured. (D.52-D.53)
Imputed Gifts if Policy Held by Third Party/ILIT	Yes, based on amounts taxed to insured under the arrangement (e.g., annual economic benefits, transfer of contract). (D.33-D.34)	Yes, based on amounts taxed to insured (e.g., forgone interest, any amount waived or forgiven under loan). (D.60)
When to Consider	• Young insured or a survivorship arrangement (very low annual term insurance costs initially). • Parties want a non-equity arrangement or expect delay in policy equity buildup, and then will switch to loan regime (economic benefit regime unfavorably taxes equity arrangements). • Insured wants predictability regarding annual taxable economic benefits (loans subject to interest rate fluctuations). • Business wants to own or control the policy. (D.71)	• Insured is older or after the first death occurs in a survivorship arrangement, particularly if interest rates are low (annual term insurance rates can be high for older insureds and will spike upon the death of the first insured under a survivorship policy). • Parties want to provide the insured (or ILIT) with tax-free access to policy equity (only loan regime allows insured or ILIT to have current or future access to policy cash values without current taxation). • Parties are entering a compensatory equity arrangement (split-dollar loans should not be taxed as nonqualified deferred compensation arrangements under IRC § 409A). (D.60)

The hypothetical case study results are for illustrative purposes only and should not be deemed a representation of past or future results. No representation is made as to the accurateness of the analysis.

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