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## Background and Explanation of Provisions

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

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

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

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

On May 9, 2003, a notice of proposed rulemaking (REG-164754-01) was published in the **Federal Register** (68 FR 24898) proposing rules for the valuation of economic benefits under an equity split-dollar life insurance arrangement governed by the economic benefit regime (the 2003 proposed regulations). The 2003 proposed regulations provide that, in the case of an equity split-dollar life insurance arrangement, the value of the economic benefits provided to the non-owner under the arrangement for a taxable year equals the cost of any current life insurance protection provided to the non-owner, the amount of policy cash value to which the non-owner has current access (to the extent that such amount was not actually taken into account for a prior taxable year), and the value of any other economic benefits provided to the non-owner (to the extent not actually taken into account for a prior taxable year).

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

### 2. Overview of the Final Regulations

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

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

The final regulations generally define a split-dollar life insurance arrangement as any arrangement between an owner of a life insurance contract and a non-owner of the contract under which either party to the arrangement pays all or part of the premiums, and one of the parties paying the premiums is entitled to recover (either conditionally or

unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the contract. The definition does not cover the purchase of an insurance contract in which the only parties to the arrangement are the policy owner and the life insurance company acting only in its capacity as issuer of the contract.

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

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

#### Mutually Exclusive Regimes

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

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