

The regulations generally treat only one person as the owner of the life insurance contract. Because only the owner of a life insurance contract can have an investment in that contract, a non-owner employee cannot have basis in the contract for any of the costs of current life insurance protection. In addition, such costs should not be included in the non-owner's basis or investment in the contract if and when the non-owner becomes the owner of the contract because those payments were made for annual life insurance protection, which protection was exhausted prior to the non-owner's acquisition of the contract. Similarly, the fact that the split-dollar life insurance arrangement may require the non-owner to reimburse the owner for the cost of the death benefit protection provided to the non-owner does not mean that such payment is not income to the owner. In these cases, the owner is "renting" out part of the benefit of the life insurance contract to the non-owner for consideration; such consideration constitutes income to the owner.

b. Taxation of Amounts Received Under the Life Insurance Contract

The final regulations retain the rule in the 2002 proposed regulations that 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. As under the 2002 proposed regulations, this rule applies to certain policy loans (referred to in the regulations as "specified policy loans"). Although several commentators objected to this treatment of policy loans, the IRS and Treasury believe that the rule is necessary to ensure that parties to a split-dollar life insurance arrangement do not avoid current taxation of the non-owner with respect to amounts provided to the non-owner through the contract.

The final regulations retain the rule that section 101(a) applies to exclude death benefit proceeds paid to a beneficiary (other than the owner of the life insurance policy) from the gross income of the beneficiary only to the extent such amount is allocable to current life insurance protection provided to the non-owner under 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 as an economic benefit provided by the owner to the non-owner. Commentators objected to this rule, arguing that the

section 101(a) exclusion extends to the entire amount of death benefit proceeds paid on the death of the insured. They asserted that there is no authority to limit the exclusion to death proceeds 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.

The IRS and Treasury disagree with that argument. Under the regulations, the owner is treated as providing economic benefits to the non-owner. Although the section 101(a) exclusion extends to the entire amount of death benefit proceeds, the IRS and Treasury believe that only the amount of the death benefit proceeds attributable to the current life insurance protection for which the non-owner paid or which the non-owner took into account under these regulations is excludable from the income of the non-owner's estate or designated beneficiary.

To the extent the non-owner has neither paid for nor taken into account the current life insurance protection, the proceeds paid to the estate or designated beneficiary of the non-owner is a separate transfer of cash that is not shielded from tax by the section 101(a) exclusion. Specifically, those proceeds are deemed payable to the owner, and are excluded from the owner's income by reason of the section 101(a) exclusion, and then paid by the owner to the non-owner's beneficiary (whether or not paid to the beneficiary directly by the insurance company) in a transfer to be taken into account under these regulations.

The character of death benefit proceeds transferred or deemed transferred by the owner to the non-owner is determined by the relationship between the owner and the non-owner. Thus, death benefit proceeds received by the beneficiary of a shareholder who is a non-owner that were paid or payable to a corporation will be treated as a taxable distribution to the shareholder. The same principle applies where death benefit proceeds under a life insurance contract subject to a split-dollar life insurance arrangement are payable to a beneficiary of a service provider who is a non-owner, except that the death benefit proceeds would constitute a compensation payment to the service provider for past services rather than a corporate distribution. This treatment is similar to the situation in Rev. Rul. 61-134 (1961-2 C.B. 250) which also denied exclusion under section 101(a) to death benefits paid under a corporate-owned life insurance

policy. In Rev. Rul. 61-134, various shareholders were the beneficiaries of a corporate-owned life insurance policy by reason of their capacity as shareholders. The ruling concluded that the death benefit proceeds received by the shareholders directly from the insurer constituted a taxable distribution of property from the corporation to the shareholders, even though the proceeds would have been excludable from the corporation's income if they had been paid directly to the corporation.

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

The final regulations follow the 2002 proposed regulations in determining the tax treatment of a transfer of the life insurance contract from the owner to the non-owner. Consistent with the general rule for determining ownership, the final regulations provide 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). 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. The fair market value of an undivided interest must be the proportionate share of the fair market value of the entire contract without regard to any discounts or other arrangements between the parties.

After a transfer of an entire life insurance contract, the transferee generally becomes the owner for Federal income, employment, and gift tax purposes, including for purposes of these final regulations. 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. Alternatively, the arrangement will be subject to the loan regime if the payments constitute split-dollar loans under § 1.7872-15.

4. Taxation Under the Loan Regime

a. In General

The final regulations generally adopt the rules of the 2002 proposed regulations for the loan regime. 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