

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, or both.

Commentators questioned whether the additional standard ("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)") is necessary. The IRS and Treasury recognize that, in the earlier years during which a split-dollar life insurance arrangement is in effect, policy surrender and loan 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, rather than a transfer under § 1.61-22(b)(5) on the date the payment is made. However, the rules in § 1.7872-15(a)(2) do not cause a payment to be treated as a loan for Federal tax purposes if, because of an agreement between the owner and non-owner, the arrangement does not provide for repayment by the owner to the non-owner. For example, if a non-owner makes a payment purported to be a split-dollar loan to an owner, and the non-owner and owner enter into a separate agreement providing that the non-owner will make a transfer to the owner in an amount sufficient to repay the purported split-dollar loan, § 1.7872-15(a)(2) will not cause the payment to be treated as a loan. See § 1.61-22(b)(5) for the treatment of payments by a non-owner that are not split-dollar loans. The final regulations include a new rule under § 1.7872-15(a)(4) that disregards certain stated interest if such interest is to be paid directly or indirectly by the lender (or person related to the lender).

Under § 1.7872-15, each payment under a split-dollar life insurance arrangement is treated as a separate loan for Federal tax purposes. Commentators have suggested that treating each payment as a separate loan will be difficult to administer and overly burdensome for certain taxpayers and have suggested allowing an election to treat all payments made during a single year (or single calendar quarter) as one loan (made on a specified date during

the year). However, the final regulations adopt the approach in the 2002 proposed regulations that each premium payment is treated as a separate loan. Treating separate extensions of credit as separate loans is consistent with the 1985 proposed regulations under section 7872 and the legislative history of section 7872, and most accurately accounts for the benefits provided by the lender to the borrower when the loans are below-market.

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. In response to a commentator, the final regulations delete the requirement in the proposed regulations that a nonrecourse split-dollar loan provide for interest payable at a stated rate.

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 below-market split-dollar loans with indirect participants.

If a split-dollar loan is a below-market loan, then, in general, the loan is recharacterized as a loan with interest at the applicable Federal rate (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.

b. Special Rules for Certain Term Loans

Special rules 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. Commentators requested clarification on whether the rate used for purposes of imputation under § 1.7872-15(e)(5) for these split-dollar loans is the AFR for the month in which the loan is made (redetermined annually) or the AFR as of the month in which the loan is made (determined on the date the loan is made). The rate used to determine the amount of forgone interest each year is the AFR based on the term of the loan, determined on the date the split-dollar loan is made, and the rate is not redetermined annually.

c. 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 required to be 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. Further, the final regulations provide that, if stated interest is subsequently waived, cancelled or forgiven, an amount is treated as retransferred from the lender to the borrower. The final regulations add a new rule under which this amount generally is increased by a deferral charge. The final regulations provide a new rule that a payment by the lender to the borrower that, in substance, is a waiver, cancellation or forgiveness is treated as a waiver, cancellation, or forgiveness under the final regulations. The final regulations also provide a new rule that, if a split-dollar loan is nonrecourse and the parties to the split-dollar life insurance arrangement had made the representation under § 1.7872-15(d)(2), although adjustments are required to be made by the parties if the interest paid on the split-dollar loan is less than the interest payments required under the split-dollar loan if all payments were made, a deferral charge is not imposed.

d. 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