

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 blended annual rate (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 a 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 one or more unconditional options that are exercisable at one or more times during the term of the loan and that, if exercised, require payments to be made on the split-dollar loan on an alternative payment schedule (for example, an option to extend or an option to call a split-dollar loan), then the rules of this paragraph (e)(4)(iii)(B)(1) determine the term of the loan. However, this paragraph (e)(4)(iii)(B)(1) applies only if the timing and amounts of the payments that comprise each payment schedule are known as of the issue date. 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 for purposes of this section as retired and reissued on the date the option is or is not exercised for an amount of cash equal to 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-