



Split Dollar Life Insurance Guide

Audit Technique Guide

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The taxpayer names and addresses shown in this publication are hypothetical.

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I. Split-dollar Life Insurance

A. Overview

- (1) Split-dollar life insurance arrangements can be a key feature of executive compensation packages. Over the years, the Service has provided limited guidance regarding the taxation of these arrangements. Beginning in 2001, transitional guidance on the valuation of split-dollar life insurance arrangements was provided in the form of notices and proposed treasury regulations in anticipation of final regulations. The final regulations apply to any split-dollar life insurance arrangement "entered into" or "materially modified" after September 17, 2003, the date of publication for the final split-dollar regulations.
- (2) Review the Securities and Exchange Commission (SEC) Form 10-K, Annual Report, including items 10,11 and 12 to identify the 16b executives. The Def 14A is useful as well in providing more detailed information regarding executive and director compensation. The Board of Director and Compensation Committee Minutes may also have useful information pertaining to the company's insurance arrangements. Inspect the employment contracts of executives and other highly paid individuals frequently as insurance arrangements are contractual. Inspect the Schedule M-3 for adjustments to taxable income for the payment of life insurance on employees. Inspect the general ledger and/or accounts payable journal for insurance expense payments.
- (3) Once you've established that the issue exists, determine who the policy owner is and whether the employee or the beneficiary is entitled to receive any death benefit or cash surrender value under the policy. Review contracts between the employer and employees for splitting the costs and benefits of life insurance policies. Determine how the economic benefit being provided the employee is being valued—using the alternative rates provided by the insurance company or Table 2001¹. Because this area involves transition rules, it is imperative that you obtain a copy of the split-dollar arrangement, the life insurance policy, and any amendments.

II. Interim Valuation Rules

A. Notice 2002 - 8

- (1) Notice 2002-8, 2002-1 C.B. 398, outlined the rules that were expected to be included in the final regulations. The Notice also provided interim guidance on the valuation of current life insurance protection and certain safe harbor provisions for agreements in effect before the issuance of the final regulations.

¹ See discussions in sections II.A.(1) and II.A.(2).

- (2) The key points to consider when a split-dollar arrangement is in place prior to September 17, 2003, and not materially modified thereafter are:
 - Valuation of current life insurance protection—Determine whether the taxpayer can use the alternate valuation rates furnished by the insurance provider or should they be using the new Table 2001 rates published in Notice 2002-8.
 - If the taxpayer is using the lower published premium rates instead of the PS 58 Tables or Table 2001, is the rate being used a published rate available to all persons who apply for term insurance coverage from the insurer? (See section III (3) of Notice 2002-8 for additional rules if the arrangement is entered into after January 28, 2002.)
 - Is the alternate rate for a one-year standard term policy, all risks, or is the rate based on a policy with a renewal feature?
- (3) Request a copy of the rate sheet. The rate sheet will describe the terms of the policy (renewal factor), policy applicability (standard risks, non-smoking), dollar value of the policy, etc. Look on the rate sheet for items such as "not for publication" or "internal use only." Check the company's website—do they sell individual term insurance, or do they only sell corporate policies? Any of these factors could indicate that the economic value of the term coverage should be recomputed using Table 2001.

III. Safe Harbor Rules

A. Notice 2002 - 8

- (1) Notice 2002-8 contains special provisions for split-dollar arrangements that were entered into prior to January 28, 2002, as well. The employer has several options with respect to such arrangements and must decide which option to apply to a particular arrangement by December 31, 2003. You will want to carefully review any split-dollar arrangement in effect prior to January 28, 2002, to determine that the employer has selected one of the available options.
- (2) Some of the safe harbors in Notice 2002-8 also apply to split-dollar arrangements entered into after January 28, 2002, and before the effective date of the final regulations.

IV. Final Regulations

A. Owner of Split-Dollar Policy

- (1) Under the final regulations issued September 17, 2003, it is imperative to determine who owns the split-dollar policy. If the executive owns the policy, the employer's premium payments are treated as loans to the executive. Consequently, unless the executive is required to pay the

employer interest on the loan at or above the Applicable Federal Rate (AFR), the executive will be taxed on the difference between the AFR interest and the actual interest. Verify that the rate of interest being charged is at least AFR. If the rate being charged is below market, impute the taxable income to the employee using the rules under Treas. Reg. 1.7872-15.

- (2) If the employer is the owner of the split-dollar policy, the employer's premium payments are treated as providing taxable economic benefits to the executive. The economic benefits include the executive's interest in the policy's accessible cash value and current life insurance protection. Be certain that if alternate valuation rates are being used to value the current life insurance protection, they meet the aforementioned requirements of all standard risks, the policy is for one year, etc.

B. Material Modification

- (1) The final split-dollar regulations apply to any split-dollar life insurance arrangement "entered into" after September 17, 2003. The term "entered into" is defined in Treas. Reg. 1.61-22(j)(1)(ii). Under Treas. Reg. 1.61-22(j)(2), an arrangement entered on or before September 17, 2003, that is materially modified after September 17, 2003, is treated as a new arrangement entered into on the date of the modification and is subject to the final regulations.
- (2) Treas. Reg. 1.61-22(j)(2)(ii) provides a non-exclusive list of changes that are NOT considered material modifications. Again, it is important when asking for a copy of the split-dollar arrangement and the life insurance policy to include a request for any modifications and/or amendments made after September 17, 2003.