The Evolution of Taxation of Split Dollar Life Insurance

by Christopher D. Scott

I. Introduction

The federal government recently published final regulations and issued a revenue ruling that changes the way participants in a split- dollar life insurance agreement (SDA) are taxed. These agreements are most commonly used as an income-tax-advantaged way of providing nonqualified deferred compensation to highly compensated employees.[1] Also, many employees use these plans as a gift- tax-advantaged way to pass wealth to younger generations. The changes in the tax law applicable to these agreements are disadvantageous to taxpayers and should be reviewed by anyone who is associated with an existing SDA or is contemplating entering into such an agreement.

(a) *Structure of Agreements*. The essential terms of an SDA include: (1) an employer pays for all or a portion of the premiums generated by a life insurance policy, (2) the policy provides mortality protection and has an investment feature, (3) the employer is entitled to a portion of the policy's death benefits equal to the aggregate of the premiums it paid, with or without an interest factor, (4) the employee's estate or designated beneficiary is entitled to the balance of the policy's death benefits, and (5) the employee (or the employee's donee) may buy out the employer's interest before the employee's death by paying an amount equal to the aggregate of premiums paid by the employer. Often, an employer seeks to secure its interest in the life insurance policy by owning it or by placing a lien on the policy. When the employer owns the life insurance policy, the arrangement is called the endorsement method. When the employee or some other party owns the life insurance policy and the employer's interest is secured by a lien, the arrangement is called the collateral assignment method.

(b) *Underlying Theories for Taxation of SDAs.* The underlying theory for taxation of SDAs has evolved over the past 50 years.

(1) *Pre-1964 Guidance*. Initially, the Internal Revenue Service analyzed SDA transactions as an interest-free loan from an employer to an employee in an amount equal to the amount of premiums paid by the employer.[2] Under prior law, interest-free loans made by an employer to an employee did not generate wage income or an interest deduction to the employee and did not generate corresponding interest income or a deduction related to employee compensation for the employer.[3] Thus, under this prior law, analyzing an SDA transaction as an interest-free loan resulted in no taxpayer recognizing additional income or deductions. At this time, the top individual federal income tax marginal rate was 91 percent, and the top corporate federal income tax marginal rate was 52 percent. This tax benefit enticed many corporate employers to compensate high-level employees with SDAs.

(2) *Economic Benefit Guidance*. The Treasury Department sought legislation to impose taxation on SDAs as part of the 1964 Revenue Act.[4] However, Congress chose not to act regarding this proposal and implicitly directed the IRS to issue new administrative guidance regarding these transactions.[5] The IRS responded to Congress's invitation by issuing Rev. Rul. 64-328 that analyzed SDAs using the economic benefit doctrine.[6] This ruling held that employees recognized taxable income equal to the value of the mortality protection provided by the insurance policy and that employers are not allowed to deduct the cost of premium payments, despite the employee's inclusion of income, because of the operation of section 264.[7] This 1964 ruling is the seminal authority for determining the tax consequences of SDAs created after November 13, 1964, and on or before September 17, 2003.

(3) *Change in Law of Taxation of Interest-Free Loans*. Prior case law that held that interest-free loans do not create income tax consequences was called into question by the U.S. Supreme Court in a federal gift tax case decided in 1984.[8] In that case, the Court held that a lender made a taxable gift to a borrower in an amount equal to the value of forgone interest when the parties entered into an

interest-free transaction.[9] Soon after, Congress reacted to this Supreme Court opinion by enacting a statute that subjects forgone interest from an interest-free loan to income taxation and subjects donors who make interest-free gift loans to gift taxation.[10] Despite this statute and the U.S. Supreme Court opinion, the IRS did not revoke or modify its rulings based on the economic benefit doctrine until 2001.[11] The recently issued Treasury regulations are an attempt to harmonize taxation of parties to an SDA with modern federal income and gift tax law.

(c) *Applicable Federal Income Tax Law*. Because of the evolution of the underlying theory of taxation, these agreements are subject to different sets of tax rules depending on when the SDA was created. Agreements set up after November 13, 1964, and on or before September 17, 2003, are taxed in conformity with Rev. Rul. 64-328 and its progeny, subject to a few minor modifications listed in Notice 2002-8, 2002-1 C.B. 398.[12] Agreements established after September 17, 2003, and agreements that pre-date September 17, 2003, that are substantially modified after September 17, 2003, are subject to the new Treasury regulations.[13] Presumably, agreements created on or before November 13, 1964, are still governed by Rev. Rul. 55-713, 1955-2 C.B. 23.[14] Tax practitioners must understand both the new Treasury regulations and Rev. Rul. 64-328 and its progeny as long as agreements created on or before September 17, 2003, continue to exist in significant numbers.

II. Taxation Under Rev. Rul. 64-328 and Its Progeny

The seminal authority for taxation of SDAs is Rev. Rul. 64- 328.[15] The IRS has amplified this revenue ruling with numerous administrative authorities issued after 1964.

(a) *Tax Consequences While SDA Is in Effect*. The underlying theory of taxing participants in an SDA is that the employee should be taxed as if he received term insurance as compensation, despite owning a life insurance policy with an investment feature, and the employer should be taxed as if it is investing in life insurance.

(1) *Income Tax Consequences to Employee*. An employee can recognize income from an SDA through the payment of premiums by the employer, distributions from the insurance company, and, arguably, from buildup of cash surrender value payable to the employee.

(i) *Income Tax Consequences From Premium Payments*. Under the traditional analysis of the income tax consequences of an SDA, an employee is required to include in his taxable income an amount equal to the cost of comparable term life insurance less any premium payment or reimbursement to the employer made by the employee during the year.[16] The cost of comparable insurance is calculated by using actuarial tables published by the IRS or comparable term rates published by an insurer. The income tax consequences to the employee from premium payments by the employer are the same regardless of whether the agreement is structured using the collateral assignment or endorsement methods.[17]

Calculation of Economic Benefit Using Tables Published by the IRS. The parties may compute the cost of comparable term insurance using actuarial tables published by the IRS.[18] From 1964 through 2001, the PS 58 Rates actuarial table published by the IRS measured economic benefit generated by a life insurance policy covering a single life.[19] Economic benefit generated by a second-to-die life insurance policy was calculated using the PS 38 Rates table.[20] These tables overstate the economic benefit derived from life insurance

because they are based on life expectancies from the 1940s. Consequently, taxpayers are no longer authorized to use the tables unless an SDA created before January 28, 2002, contractually mandates that parties use the PS 58 Rates.[21] Otherwise, taxpayers must use Table 2001 to measure economic benefit from a life insurance policy covering one life and use the actuarial principles of Table 2001 when calculating economic benefit generated from a life insurance policy insuring multiple lives.[22]

This is generally a pro-taxpayer change because the Table 2001 Rates are much lower than the PS 58 Rates.

Calculation of Economic Benefit Using Rates Published by Insurers. The parties may compute the cost of comparable term insurance using rates that are published by the insurer that issued the policies subject to the SDA.[23] Every major insurance company publishes comparable term insurance rates on policies that insure a single life, and many insurance companies publish rates on second-to-die term policies. These rates are dramatically lower than the PS 58 and PS 38 Rates and are significantly lower than the rates published in Table 2001. Therefore, most employers and employees choose to measure economic benefit using these insurer-published term rates.

Special Rule for SDAs Created After January 28, 2002, and On or Before September 17, 2003. The comparable term rates published by insurers are generally low, and the IRS views use of these rates as somewhat abusive.[24] Consequently, SDAs created after January 28, 2002, and on or before September 17, 2003, may not use term rates published by an insurance company unless the insurer makes them generally available to the public and regularly sells policies with them.[25]

EXAMPLE 1: Employer and Employee enter into an SDA in 1991. One of the policies subject to the SDA is a $5,000,000 second-to-die whole life insurance policy that generates $52,388 of annual premiums during 2003. The annual premium charged by the insurer for a comparable original issue term life insurance policy is $1,500, the premium that would be charged using the rates in Table 2001 is $2,500, and the premium that would be charged using the PS 38 rates is $11,850. Assuming the comparable term policy meets the requirements of Rev. Rul. 66-110, 1966-1 C.B. 12, and Rev. Rul. 67-154, 1967-1 C.B. 11, the employee is required to include $1,500 in his taxable income from the economic benefit generated by this SDA in 2003. Otherwise, the employee is required to include $2,500 in his taxable income during 2003. Consequently, the employee enjoys an insurance policy that costs $52,388, while he is taxed as if he received $1,500 or $2,500 of compensation from his employer.

EXAMPLE 2: In addition to the facts in Example 1, the employee pays $1,500 to the employer in partial reimbursement for the premiums paid by the employer. That means the employee's economic benefit from the SDA is reduced by $1,500. Under this example, the employee includes nothing in his taxable income regarding the SDA if the comparable term policy meets the requirements of revenue rulings 66-110 and 67-154. Otherwise, the employee must include $1,000 in his taxable income during 2003.

(ii) *Income Tax Consequences of Dividends and Other Distributions*. Generally, dividends paid by an insurer to the owner of an insurance policy are considered a return of previously paid premiums and are included in the measure of the owner's taxable income only to the extent they exceed the aggregate of premiums paid regarding the policy.[26] However, a dividend or other lifetime distribution to an employee or the employee's donee from an insurer regarding a policy subject to an SDA is taxable income to the employee because the dividend or other distribution is an economic benefit to the employee.[27]

EXAMPLE 3: In addition to the facts in Example 1, the insurance company pays a $100 dividend to the employee during 2003. Under this example, the employee is required to include the $100 dividend plus the economic benefit to the employee generated by the insurance policy during 2003 in his taxable income.

(iii) *Income Tax Consequences From Buildup of Cash Surrender Value of Policy*. Generally, the owner of an insurance policy does not include increases in a life insurance policy's cash surrender value in the measure of taxable income.[28] Despite that general rule, the IRS issued a technical advice memorandum in 1996 that asserts that, in the SDA context, employees must include incremental increases in a policy's cash surrender value in taxable income, to the extent the cash surrender value of a policy exceeds the amount the employer is entitled to receive upon termination of an SDA.[29] Consequently, regardless of whether the insurance company makes a

distribution to the employee, the employee recognizes taxable income equal to the difference between the policy's cash surrender values at the beginning and end of a tax year if the cash surrender value exceeds the amount payable to the employer upon termination of the SDA. Commentators criticized the TAM because it reaches a result that is contrary to section 7702(g) and case law applicable to policies issued before this statute's effective date.[30] Nonetheless, many planners responded to the TAM by drafting SDA documents so that the employer is entitled to a payment at the termination of the plan equal to the greater of the cash surrender value of life insurance policies subject to an SDA or the aggregate of unreimbursed premiums paid by the employer. In 2002 the IRS announced it will no longer enforce this alleged rule if the SDA is effective on or before September 17, 2003.[31]

EXAMPLE 4: In addition to the facts in Example 1, during calendar year 2003 the life insurance policy's cash surrender value increased significantly. At the beginning of the year and at all prior times, the cash surrender value was less than the amount payable to the employer on termination of the SDA. At the end of the year, the cash surrender value was $1,000 in excess of the employer's right to be repaid upon termination of the SDA. Under current IRS policy, the employee's taxable income is not affected by the cash surrender value of the policy. However, under the approach taken in TAM 9604001, the employee's 2003 taxable income would include $1,000 attributable to the increase in the policy's cash surrender value.

(iv) *Income Tax Consequences From Borrowing Against a Life Insurance Policy*. The rules regarding taxation of employees who borrow against a life insurance policy subject to an SDA are unclear. Under generally applicable federal income tax law, the proceeds of a loan are not included in the measure of taxable income.[32] However, there are two arguments for subjecting the principal amounts of the loans to immediate income taxation. First, the loans could be considered an economic benefit to the employee under the economic benefit doctrine.[33] Second, sections 72 and 7702 could be interpreted as causing the loans to be taxable income if made before the 15th anniversary of the issuance of the life insurance policy, in an amount equal to the lesser of: (1) the amount of the loan, (2) the excess of the policy's cash surrender value over the investment in the life insurance policy, or (3) one of the two alternative statutory caps described in section 7702(f)(7)(C) and (D). [34] Further, borrowing against a life insurance policy subject to an SDA that is structured using the endorsement method should be subject to section 7872.[35] Therefore, the tax consequences to an employee from borrowing against a life insurance policy subject to an SDA are unclear and fraught with potential bad income tax consequences.

(2) *Income Tax Consequences to Employer*. Generally, compensation paid in kind to an employee can be deducted against an employer's taxable income as an ordinary and necessary business expense.[36] However, employers will usually be unable to deduct compensation paid to an employee in the form of life insurance subject to an SDA.

(i) *Premium Payments*. Under section 264, an employer that pays premiums generated by an insurance policy subject to an SDA may not deduct the premiums against the employer's taxable income.[37]

EXAMPLE 5: Same facts as example 1. The employer is not entitled to any deduction against its taxable income during 2003 or thereafter regarding premiums paid by the employer under the SDA.

(ii) *Dividends and Other Distributions*. There is no authority regarding the tax consequences to an employer flowing from an insurance company paying dividends or other distributions to an employee regarding an insurance policy that is subject to an SDA. Logically, the income tax consequences to the employer should be determined by the structure of the agreement.

(I) *Endorsement Method*. An SDA that is structured using the endorsement method should result in all distributions made during an insured's lifetime belonging to the employer. Consequently, a dividend (or other distribution) paid directly to an employee should be treated as if it were first paid to the employer and then the employer paid that same amount to the employee. That should result in the employer recognizing income to the extent the distribution from the insurance company generates taxable income and in the employer being able to deduct the amount distributed to the employee as a business expense under section 162.

(II) *Collateral Assignment Method*. An SDA that is structured using the collateral assignment method should result in all lifetime distributions belonging to the employee. Consequently, a dividend (or other distribution) paid directly to an employee should have no tax consequences to the employer.

However, Rev. Rul. 64-328 states that the income tax consequences flowing from an SDA do not turn on the structure of the agreement. An argument can be made for either approach, but the IRS and a court are likely to tax dividends in conformity with the above-described approach for SDAs structured using the endorsement method.

(iii) *Buildup of Cash Surrender Value*. There is no authority that explicitly deals with the income tax consequences to an employer from an incremental increase in the employee's share of a life insurance policy's cash surrender value. However, to the extent an employee is required to recognize income attributable to a life insurance policy's cash surrender value, the employer should be entitled to a corresponding deduction against its taxable income.[38] As mentioned above, the IRS has abandoned its prior attempts to impose tax on incremental increases in an employee's share of a policy's cash surrender.[39] Therefore, employers should not attempt to deduct a corresponding amount against taxable income.

(iv) *Borrowing Against Policy*. There is no authority that explicitly deals with the income tax consequences to an employer from an employee borrowing against a life insurance policy subject to an SDA. Logically, the income tax consequences to the employer should depend on the structure of the agreement.

(I) *Endorsement Method*. An SDA that is structured using the endorsement method should result in all borrowing by the employee against the policy being analyzed as a borrowing by the employer from the insurance company, followed by a corresponding borrowing by the employee from the employer. The borrowing by the employee from the employer should be subject to section 7872.[40]

(II) *Collateral Assignment Method*. An employer should have no income tax consequences from an employee borrowing against a life insurance policy subject to an SDA that is structured using the collateral assignment method to the extent the employer's collateral is not imperiled. It is less clear how a loan from an insurance company to an employee should be taxed to the extent the loan amount exceeds the employee's share of the policy's cash surrender value.

Again, Rev. Rul. 64-328 states that the income tax consequences flowing from an SDA do not turn on the structure of the agreement. Therefore, an argument can be made for either approach, but the IRS and a court are likely to tax borrowing in this context using the above-described approach for SDAs structured using the endorsement method.

(3) *Employment Taxes*. For purposes of FICA and FUTA taxes, an employee is paid wages equal to the amount of taxable income recognized each year through participating in an SDA.

(4) *Gift Tax Consequences to Employee*. A gift in kind in the form of a life insurance policy or premiums paid on a life insurance policy subject to an SDA is a tax-advantaged way for an employee to make gifts.

(i) *Initial Gift of Policy*. A gift of all of the employee's rights in an existing life insurance policy subject to an SDA causes the employee to make a taxable gift equal to the difference between fair market values of the policy and the employer's right to be repaid from the policy's proceeds measured at the time the policy is transferred to the donees.[41] The fair market value of a newly issued insurance policy is equal to the premium paid upon its issuance.[42] The fair market value of a fully paid- up life insurance policy that has been in effect for a significant period before the time of the gift is usually equal to the amount of a single premium that would be charged by the issuing insurance company, at the date of the gift, for a policy with the same face amount, based on the insured's age at the time of the gift.[43] The fair market value of an insurance policy that was issued a significant time before the time of the gift and is not fully paid up is generally equal to its cash surrender value plus a proportionate share of the last premium paid on the policy that cover a period extending beyond the date of the gift.[44] However, the fair market value of a life insurance policy covering a terminally ill person approaches the value of the death benefits payable under the policy.[45] The transfer of an existing policy is a present-interest gift subject to the employee's annual federal gift tax exclusion unless there are other circumstances that would cause this gift to be a gift of a future interest in property.[46]

> EXAMPLE 6: On September 1, 2003, an employee who is the insured of a life insurance policy that is subject to an SDA transfers all of his rights in the policy to his son immediately before the due date for the next annual premium payable under the insurance contract. At the time of the transfer, the employee is in good health, the policy's cash surrender value is $100,000, and the employer is entitled to be paid $75,000 upon termination of the SDA or upon payment of the policy's death benefits. The value of the gift is $25,000. The gift of the insurance policy is considered a present- interest gift for the purposes of federal gift tax. Assuming that the employee makes no other gifts to his son during that year, he is entitled to exclude $11,000 from the value of this gift, causing him to have made a $14,000 taxable gift.

(ii) *Gift of Annual Premium Payments*. The federal gift tax treatment of an employee follows the income tax consequence to him flowing from an SDA. An employee makes annual taxable gifts to the donees of an SDA life insurance policy equal to the difference between the employee's economic benefit generated by the policy (measured as if no premium is paid by the employee or the donee) and the amount of any premiums paid by the donees.[47] These premium payments are present-interest gifts unless there are other circumstances that would cause the payment to be considered a future interest under section 2503(b).[48]

> EXAMPLE 7: In addition to the facts in example 1, the employer and the employee initially set up the SDA so that the life insurance policy is owned by the employee's son at all times and the employee makes no other gifts to the son during 2003. Assuming the comparable term policy meets the requirements of revenue rulings 66-110 and 67-154, the employee makes a present-interest gift to his son equal to $1,500 during 2003. Otherwise, under Table 2001, the employee makes a present-interest gift of $2,500. The employee is entitled to exclude the first $11,000 of present- interest gifts to his son from the computation of taxable gifts for federal gift tax purposes. Consequently, the employee makes no taxable gift to his son during 2003 even though his son enjoys a life insurance policy that generates $52,388 of premiums during that year.
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> EXAMPLE 8: In addition to the facts in Example 1, the employee's son owns the insurance policy subject to the SDA at all times during 2003, and the son pays $1,500 to the employer in partial reimbursement of the premiums it paid. Assuming the comparable term policy meets the requirements of revenue rulings 66-110 and 67-154, the employee makes no gift for federal gift tax purposes by engaging in this SDA and is free to use his annual exclusion against other gifts.

(b) *Tax Consequences of Termination of Plan*. Eventually, as the insured employee ages or the whole life insurance policy subject to an SDA becomes fully paid up, the original issue annual premiums associated with a comparable term life insurance policy exceed the cost of premiums actually paid by the SDA participants. At that point, the employee will be required to include an amount in taxable income that exceeds the amount of annual premiums paid by the employer. To avoid this phantom income, the parties usually terminate the SDA and the employer transfers its interest in the life insurance policy to the employee or the employee's donee. An SDA is usually drafted to allow the employee or the employee's donee to buy out the employer by repaying all premiums previously paid by the employer. Alternatively, an SDA is sometimes drafted to provide for a buyout price equal to the greater of the aggregate of all premiums paid by the employer or the cash value of the policy if that exceeds the aggregate of premiums paid by the employer.

EXAMPLE 9: The employer and employee entered into an SDA during 1991 that governs a $1,000,000 whole life insurance policy that insures only the employee's life. This policy generates $32,890 of premiums during 2003. The annual premium charged by the insurer for a comparable original issue term life insurance policy is $7,710, the premium that would be charged using the rates in Table 2001 is $36,330, and the premium that would be charged using the PS 58 rates is $79,630. Assuming the comparable term policy meets the requirements of revenue rulings 66-110 and 67-154, the employee is required to include only $7,710 in his taxable income. However, if this assumption is not correct, the employee is required to include $36,330 in his taxable income even though the employer paid only $32,890 of premiums regarding this life insurance policy during 2003. The parties will be motivated to terminate the SDA if the employee must include an amount in taxable income that is greater than the premium paid.

(1) *Income Tax Consequences to Employee*. It is unclear whether the starting point for determining taxable income recognized by the employee upon termination of an SDA is the cash surrender value of a life insurance policy or the aggregate of unreimbursed premiums paid by the employer. The IRS issued two private letter rulings, based on section 83, that measured the income recognized by an employee upon termination as equal to the cash surrender value of the policy at the time of termination less any payments previously made by the employee that are properly allocable to the cash surrender value.[49] Presumably, under this rule, the amount of income recognized by the employee would also be reduced by any additional consideration given by the employee to the employer for release of its interest in the life insurance policy. This is a pro-taxpayer rule when the cash surrender value is less than the aggregate of unreimbursed premiums paid by the employer. However, this rule will result in greater taxable income recognized by employees when the cash surrender value exceeds the aggregate of unreimbursed premiums paid by an employer. In these cases, most tax advisers recommend the employee report his taxable income based on the amount of the policy's cash surrender value that is payable to the employer upon termination of the SDA if the employer does not release its interest.

EXAMPLE 10: Employer and employee set up an SDA in 1991 with the following terms: (1) the employer is required to pay insurance premiums on a whole life insurance policy each year, (2) the employee is required to pay an amount equal to the employee's economic benefit from the life insurance policy to the employer each year, and (3) the employer is entitled to the aggregate of insurance payments less the amounts paid by the employee to the employer under the agreement upon the death of the employee or termination of the agreement. The insurance policies subject to the SDA generated $200,000 of premiums each year from 1991 through 2003, resulting in $2.6 million of premiums paid during this time, and the employee paid the employer $400,000 over this same 13-year period to offset his economic benefit. Consequently, at the end of 2003, the employer was entitled to $2.2 million if the SDA was terminated or the employee died. The cash surrender value of the insurance policy was $4,000,000 at that time, and the employee has never included any increase in the cash surrender value in his income. The employer gratuitously released its interest in the life insurance policy to the employee on January 2, 2004. Under the approach used by the IRS in the aforementioned private letter ruling, the

employee would recognize $4,000,000 of taxable income in 2004. However, most tax advisers would recommend the employee report $2.2 million of taxable income in 2004.

(2) *Income Tax Consequences to Employer*. The income tax consequences for the employer should turn on the amount of consideration received from the employee (or the employee's donee) in exchange for a release of the employer's interest.

(i) *Gratuitous Release of Employer's Interest in SDA.* A termination of the employer's interest in the SDA life insurance policy should end the applicability of section 264 to the employer. Consequently, subject to the principles of section 162, the employer should be able to deduct the value of its interest in the life insurance policy in the year of release.[50]

If the employer gratuitously releases its interest, the logic of the aforementioned private letter rulings should enable the employer to deduct the full cash surrender value of the policy,[51] whereas most practitioners have been reporting the value of the employer's interest as equal to the aggregate of unreimbursed premiums paid by the employer.

EXAMPLE 11: Same facts as Example 10. Under the approach described by the IRS in private letter rulings, the employer is entitled to deduct $4,000,000 against its taxable income in 2004 if these payments can meet the requirements of section 162. Under the approach advocated by most tax attorneys who represent employee participants, the employer should be able to deduct $2.2 million against its 2004 taxable income.

(ii) *Payment to Employer Upon Termination*. Usually, the SDA will call for the employee (or the employee's donee) to make a payment to the employer upon termination. The employer will recognize gain or loss equal to the difference between its investment in the insurance policy and the amount received from the employee or the employee's donee upon termination.[52] Any gain recognized will be ordinary income.[53] (Presumably, any loss will be capital.)[54] The employer's investment in the insurance policy is equal to the aggregate of premiums paid by the employer less the aggregate amount received under the contract, to the extent amounts received under the contract have not been included in the employer's taxable income.[55] Typically, an SDA will require the employee or employee's donee to pay an amount to the employer equal to the aggregate of the premiums paid by the employer that have not been reimbursed before the time of termination. This would result in the amount realized by the employer from the transfer being equal to the employer's basis in its interest in the policy unless the employer has received tax-free distributions from the insurer. Consequently, the employer would usually realize no gain or loss from the termination of the SDA. Occasionally, an SDA requires the employee or the employee's donee to pay an amount equal to the cash surrender value of the insurance policy or an amount equal to the greater of the cash surrender value of the insurance policy or the aggregate of unreimbursed premiums paid by the employer. Those agreements will cause the employer to recognize ordinary income upon termination if the policy's cash surrender value exceeds unreimbursed premiums paid by the employer.

EXAMPLE 12: Same facts as Example 10, except the employee pays $2.2 million to the employer on January 2, 2004. The employer's amount realized is $2.2 million, and its basis is this same amount. Consequently, the employer will receive a return of capital and recognize no gain or loss from termination. The employer may consider deducting the difference between the insurance policy's cash surrender value, $4,000,000, and its investment in the policy, $2.2 million, under the approach described by the IRS in private letter ruling 8310027. Assuming the IRS does not successfully challenge that reporting position, the employer would be entitled to reduce its taxable income by $1.8 million. However, that would require the employer to include a corresponding amount in income under Treas. Reg. section 1.83-6(b).[56]

EXAMPLE 13: Same facts as Example 10, except that the SDA calls for the employer to be paid the greater of the aggregate of unreimbursed premiums or the cash surrender value of

the policies, and the employee pays $4,000,000 to the employer on January 2, 2004. The employer's amount realized is $4,000,000, and its investment in the policy is $2.2 million, resulting in $1.8 million of ordinary income recognized on termination. Also, the employer is entitled to no deduction under section 162.

(3) *Income Tax Consequences to Donee*. Often an employee gives his interest in a life insurance policy subject to an SDA to a donee. The release or purchase of an employer's interest in the life insurance policy could have income tax consequences to the donee.

(i) *Income Tax Consequences to Donee at Time of Transfer of Employer's Interest*. Assuming the employee's donee owns the insurance policies at the time an employer releases or sells its rights under an SDA so that the donee now owns unencumbered policies, the employee has made a gift to the donee equal to the value of the employer's interest in the policies.[57] A donee is not required to include the value of a gift in income for federal income tax purposes.[58]

EXAMPLE 14: Same facts as Example 10, except the life insurance policies are all owned by the employee's son on January 2, 2004. Consequently, the employee makes a gift to his son equal to the value of the employer's interest in the policy. (This is either $2.2 million or $4 million.) The value of this gift is excluded from the son's 2003 taxable income under section 102.

(ii) *Income Tax Consequences to Donee at Time of Payment of Death Benefits*. Termination of an employer's interest in a life insurance policy subject to an SDA may cause the policy's death benefits to be included in the beneficiary's taxable income. Generally, death benefits paid by an insurance company under a life insurance policy are excluded from the beneficiary's taxable income.[59] However, death benefits that are paid under a life insurance policy that was transferred for value from one owner to another after the policy's issuance are included in the beneficiary's taxable income unless the new owner is a partner of the insured, a partnership in which the insured is a partner or a corporation in which the insured is a shareholder.[60] (This rule is commonly referred to as the transfer for value rule.) Many commentators believe the applicability of the transfer for value rule to a life insurance policy that was formerly subject to an SDA turns on whether the SDA is structured using the collateral assignment or the endorsement method. Structuring an SDA using the endorsement method should result in application of the transfer for value rule if an employer transfers its interest in a life insurance policy directly to a donee who is not a partner of the insured or a partnership or a corporation that is partially owned by the insured, whereas a release of an employer's lien on an insurance policy owned by a donee that was formerly subject to an SDA structured using the collateral assignment method should not be a transfer of an insurance policy under the transfer for value rule.[61] Consequently, structuring an SDA using the collateral assignment method should usually avoid application of the transfer for value rule.

EXAMPLE 15: Same facts as Example 10 except that the employer was the owner of the insurance policy at all times. Also, the employee assigned his interest in the policy to his son at some time before 2003; the son paid the employer $2.2 million on January 2, 2004, in full cancellation of the employer's interest in the policy; the employee died on February 1, 2004; and the insurance company paid $20,000,000 of death benefits to the son soon after. The son will be required to include a portion of the death benefits in his 2004 taxable income. (It is unclear how much will be included in the son's taxable income. However, the son will be entitled to exclude at least the amount paid to the employer, $2.2 million, from his taxable income.)

EXAMPLE 16: Same facts as Example 15 except that the policy was owned by the employee's son at all times since the SDA was created and the employer retained a lien on the policy, securing $2.2 million of unreimbursed premium payments as of January 2, 2004. The release of the employer's lien is probably not a transfer for value under Treas. Reg.

section 1.101- 1(b)(4). Assuming this understanding of the law is correct, the son may exclude the entire $20,000,000 of death benefits from his 2004 taxable income.

Alternatively, many commentators suggest avoiding the transfer for value rule by structuring a termination so that the insured or employee purchases the employer's interest in the policy and the employee makes a gift of the recently purchased interest. This procedure will avoid income taxation of the death benefits through application of the transfer for value rule.[62] However, the procedure will probably subject a corresponding percentage of the death benefits to the federal estate tax if the employee or insured dies within three years of the transfer.[63]

EXAMPLE 17: Same facts as Example 15 except that the employee paid the employer $2.2 million for an assignment of the employer's interest in the policy on January 2, 2004, and then the employee transferred this newly acquired interest in the policy to his son on January 3, 2004. The $20,000,000 of death benefits paid to the

son will not be subject to federal income tax. However, a portion of the death benefits will be included in the employee's gross estate for federal estate tax purposes under section 2035(a).

(4) *Gift Tax Consequences to Employee Upon Termination*. For a life insurance policy that is already owned by the employee's donee, the employee makes a gift equal to the value of the employer's interest in the life insurance policy less any consideration furnished by the donee for the employer's release of its interest when the SDA is terminated.[64]

EXAMPLE 18: Same facts as Example 16, except the employee paid $2.2 million to the employer on January 2, 2004. By relieving the employee's son of a $2.2 million liability burdening the employee's property, the employee made a $2.2 million taxable gift to his son during 2004. This gift should be a present-interest gift entitling the employee to deduct $11,000 against the value of this taxable gift if the exemption is not fully used by other gifts to the son in 2004.

However, if the employer or the employee owned the policy, the employee makes a gift equal to the fair market value of the insurance policy upon transfer of its ownership to a donee.[65] The fair market value of an insurance policy formerly subject to an SDA is generally equal to the interpolated terminal reserve of the policy plus its unearned premiums.[66] However, in a case involving a terminally ill employee or insured, the fair market value of an insurance policy will approach the death benefits payable upon the employee's death.[67] These gifts should be considered present-interest gifts.[68]

EXAMPLE 19: Same facts as Example 10. Also, the employee transferred the insurance policy to his son on January 4, 2004. The employee has made a taxable gift to his son in 2004 that is equal to $4 million plus a proportionate share of any premium allocable to coverage occurring after January 4, 2004. This gift should be a present-interest gift entitling the employee to deduct $11,000 against the value of this taxable gift if the exemption is not fully used by other gifts to the son in 2004.

(5) *Safe Harbor for Terminations*. The IRS announced it will not assert that there has been a taxable transfer of property to a benefited person upon termination of an SDA if: (1) the SDA was entered into before January 28, 2002, (2) the employer has paid premiums or made other payments under the SDA, (3)(a) the employer has received full repayment of all of its payments, or (b) the employer is entitled to receive full repayment of all of its payments, and (4)(a) the SDA is terminated before January 1, 2004, or (b)(i) the parties treat all amounts paid by the employer since the inception of the agreement as loans, and (ii) the parties comply with sections 1271-1275 and 7872 regarding these amounts for all periods beginning on or after January 1, 2004.[69] This rule has two major ambiguities. First, the term "taxable transfer" is undefined. It is unclear whether the IRS intends to grant a safe harbor against threatened scrutiny under sections 61, 83, or 101 or whether this safe harbor has federal transfer tax applications. (Staff attorneys at the Office of Chief Counsel have strongly implied that the term means the IRS will not subject the spread between a life insurance policy's cash

surrender value and the aggregate of premiums paid by the employer to the federal income tax upon termination of an SDA. The attorneys expressed no opinion regarding whether this guidance had application regarding the federal transfer taxes.) Second, it is unclear what the IRS means when it uses the phrase "full repayment of all of its payments." An immediate payment by the employee to the employer in an amount equal to unreimbursed premiums paid by the employer should qualify. However, it is unclear whether a repayment in the form of a life insurance policy with death benefits equal to the amount due the employer under the SDA at the time of termination would also be considered a full repayment of all of an employer's payments. The IRS is unlikely to issue additional guidance in this area, and litigation is likely to be the only avenue for clarification.

EXAMPLE 20: Same facts as Example 10 except the employee pays $2.2 million to the employer upon termination of the SDA on December 30, 2003. Under these facts, according to statements made by staff attorneys at the Office of Chief Counsel, the employee will fall within the aforementioned safe harbor and will recognize no taxable income regarding the termination of the SDA.

(c) *Tax Consequences of Death Benefit Payments*. The payment of death benefits will have both income and estate tax consequences.

(1) *Income Tax Consequences to Employer*. Death benefits payable to the employer are exempt from federal income tax under section 101.[70]

(2) *Income Tax Consequences to Employee's Estate*. Death benefits payable to the employee's estate will be exempt from federal income tax.[71] Repayment of indebtedness, both principal and interest, owed by the employee to the employer under an SDA should not entitle the employee's estate to an income tax deduction.[72]

(3) *Income Tax Consequences to Employee's Beneficiary*. As more fully explained above, an employee's designated beneficiary receives his or her share of the death benefits free of income tax except to the extent the transfer for value rule applies.[73] Also, the beneficiary should not be entitled to an income tax deduction for any amounts paid to the employer in satisfaction of the employee's indebtedness associated with the SDA.[74]

(4) *Estate Tax Consequences*. The estate tax consequences of an SDA are governed by generally applicable rules.

(i) *Inclusion of Death Benefits*. Death benefits from a policy subject to an SDA will be included in the employee's gross estate to the extent sections 2033 or 2042 apply. Generally these rules cause death benefits to be subject to estate tax if the decedent owned the policy directly or through some controlled entity or if the death benefits are payable to the decedent's estate.[75] Also, death benefits that are payable under an insurance policy that was owned by the decedent less than three years before his death will be subject to the estate tax.[76]

PLANNING CONSIDERATION: The best way for avoiding potential federal estate taxation of death benefits is by structuring an SDA so that someone other than the employee owns the underlying life insurance policy from the beginning of the policy's existence and the death benefits are always payable to someone other than the employee's estate. This will create taxable gifts every year but should cause fewer transfer tax problems than subjecting the full amount of the death benefits to estate taxation upon the decedent's death.

(ii) *Indebtedness of Employee*. Any indebtedness that is primarily owed by the employee to the employer will be deductible against the decedent's gross estate to the extent allowed by section 2053. Indebtedness that is secured by the life insurance policy will be deductible only if the death benefits, undiminished by the indebtedness, are included in the employee's gross estate.[77] Unsecured indebtedness associated with an SDA should be fully deductible regardless of whether the death benefits are included in the employee's gross estate.[78]

PLANNING CONSIDERATION: The use of unsecured indebtedness as part of an SDA can create a double estate tax benefit. First, a life insurance policy that has always been owned (or at least owned for three years before the insured's death) by someone other than the insured should not be included in the measure of the insured's gross estate. Second, unsecured indebtedness owed to the employer and now owed by his estate should be fully deductible against the decedent's gross estate for federal estate tax purposes despite the death benefits being exempt from estate tax.

III. Rules Under Newly Issued Treasury Regulations

The newly issued regulations regarding taxation of parties to an SDA are generally less advantageous to taxpayers than the rules based on Rev. Rul. 64-328. Under these new regulations, the income and gift tax consequences of an SDA will be determined under two alternative sets of rules that are based on the identity of the owner of the insurance policy. Agreements that are structured using the endorsement method, whereby the employer owns the policy, will continue to be taxed based on the economic benefit doctrine under rules in Treas. Reg. section 1.61-22.[79] Agreements that are structured using the collateral assignment method, whereby the employee or the employee's donee owns the policy, will be taxed based on the below-market interest rate rules of section 7872 that are primarily in Treas. Reg. section 1.7872-15.[80] This is a significant change from prior law because Rev. Rul. 64-328 stated that the tax consequences flowing from an SDA while the agreement was in effect were the same regardless of the method of structuring the agreement.

(a) *Application of New Rules*. These new rules apply to agreements that are created or materially modified after September 17, 2003.[81]

(1) *Time of Creation.* An agreement is created upon the latest of the following events: (1) the date of issuance of the life insurance contract, (2) the effective date of the life insurance contract, (3) the date of the first premium payment, (4) the date the parties to the SDA agree to its terms regarding the life insurance contract, and (5) the date when the agreement meets the requirements of Treas. Reg. sections 1.61-22(b)(1) or (2).[82]

EXAMPLE 21: An employer and an employee agree to the terms of an SDA on September 2, 2003, that meets the requirements of Treas. Reg. section 1.61-22(b)(1). A life insurance company issues a policy on September 16, 2003, with an effective date of September 16, 2003. However, the employer delivered a check to the insurance company as the first premium payment on September 22, 2003. Consequently, all participants will be taxed in conformity with the new Treasury regulations.

(2) *Material Modification.* An arrangement created on or before September 17, 2003, becomes subject to the new Treasury regulations if it is materially modified after September 17, 2003.[83] The Treasury regulations list the following transactions as not being material modifications: (1) change in the frequency of premium payments, (2) change in the beneficiary of the life insurance policy if the beneficiary is not a party to the SDA, (3) change in the interest rate payable under a life insurance contract on loans secured by a policy, (4) change made to avoid having the life insurance contract considered a modified endowed contract, (5) change in the ministerial provisions of the life insurance contract, (6) change made under a binding commitment in effect before September 17, 2003, (7) change in the owner of a life insurance policy caused by some acquisitive corporate reorganizations and liquidations of a controlled corporate subsidiary, (8) change to a life insurance policy required by a court or a state insurance commissioner as a result of the insurer's insolvency, and (9) change in the insurer as a result of an assumption reinsurance transaction.[84] Also, a change made to an SDA to comply with the requirements of Notice 2002-8, article iv, paragraph 4 will not be considered a material modification.[85] Except for these narrow categories of changes that are not considered material modifications, it is unclear what is not a material modification of an SDA.[86] A practitioner should be very careful when considering any change to an agreement that was created on or before

September 17, 2003, to avoid inadvertently causing the agreement to be subject to the new Treasury regulations.

(b) *Tax Consequences of SDA -- Economic Benefit Regime*. An SDA that is structured using the endorsement method, whereby an employer is the owner of the insurance policy, will continue to be taxed under rules that are based on the economic benefit doctrine.[87]

(1) *Income and Gift Tax Consequences During Insured's Lifetime*. The new regulations alter the income and gift tax consequences to an employee that flow from participating in an SDA.

(i) *Income Tax Consequences to Employee While Plan Is in Effect*. When an employer pays premiums on a life insurance policy subject to an endorsement method SDA, the employee must include the economic benefit generated by his interest in the insurance policy less any consideration paid for the policy by the employee in his taxable income.[88] (This is the same basic rule as the rule first announced in Rev. Rul. 64-328. However, the way economic benefit is measured will change in several taxpayer-unfavorable ways.) The employee's economic benefit during a tax year is equal to: (1) the value of current life insurance protection provided to the employee, (2) the value of the employee's right to the cash surrender value in the policy less the value of the employee's right to the cash surrender value in the policy at the end of the employee's previous tax year, (3) the value of distributions made to the employee, and (4) other economic benefit to the employee from the SDA.[89]

(I) *Premiums Paid by Employer*. An employee recognizes taxable income each time an employer pays a premium generated by a life insurance policy subject to an SDA in an amount equal to the value of current life insurance protection. Generally, the value of current life insurance protection is equal to: (Life Insurance Premium Factor Published in Internal Revenue Bulletin) X ((Total Death Benefits Payable Under Policy) - [(Amount of Death Benefits Payable to Employer at the End of the Employee's Tax Year) + (Amount of Cash Surrender Value of Policy Included in Employee's Taxable Income During Prior Years and Current Tax Year)]).[90] The life insurance premium factors to be used are in Table 2001.

EXAMPLE 22: Employer and employee enter into an SDA in 2004. One of the policies subject to the SDA is a $5,000,000 second-to-die whole life insurance policy that generates $52,000 of annual premiums during 2004. Using the actuarial principles of Table 2001, the premium rate under Table 2001 is $0.50/$1,000 of death benefit. Consequently, the annual premium that would be charged for a $5,000,000 second-to-die insurance policy using rates based on Table 2001 is $2,500. However, assuming the employer is entitled to be repaid $52,000 at the end of 2004 and no cash surrender value is payable to the employee during the first year the policy is in effect, the base for determining economic benefit will be reduced from $5,000,000 to $4,948,000, resulting in total economic benefit to the employee of $2,474. Consequently, the employee enjoys the benefits of an insurance policy that generated $52,000 of premiums while he is taxed as if he received $2,474 of compensation from his employer under the SDA.

In this example, the parties are better off under the new Treasury regulations in the first year. Compared to the economic benefit generated under Rev. Rul. 64-328 and its progeny, the employee's taxable income is reduced from $2,500 to $2,474 under the new rules. However, this benefit is short-lived and will be more than offset by numerous taxpayer-disadvantageous changes.

(II) *Dividends and Other Distributions*. An employee will recognize taxable income upon receiving a dividend, drawing money against an insurance policy's cash surrender value or upon receiving other distributions that are not described in the new regulations.[91] The amount of the employee's taxable income is equal to: (The Amount of the Distribution to the Employee From the Insurance Company) - [(Aggregate of Economic Benefit Included in the Employee's Taxable Income in Prior Tax Years and the Current Tax Year) + (Amount Paid by

Employee or Donee to Employer Under Agreement) - (Aggregate of the Value of Current Life Insurance Protection Included in the Employee's Taxable Income in Prior Tax Years and the Current Tax Year)].[92]

> EXAMPLE 23: The insurer pays a $10,000 dividend to the employee in 2006 regarding a life insurance policy subject to an SDA that is structured using the endorsement method. At the time of the dividend payment, the employee has paid $4,000 to the employer in consideration for the benefits received under the SDA, and the employee has recognized no taxable income in regard to economic benefit from the SDA other than mortality protection. Consequently, upon receipt of the dividend, the employee will recognize taxable income equal to $10,000 less $4,000, or $6,000.

(III) *Amount of Cash Surrender Value Included in Employee's Taxable Income.* An employee must include in his taxable income an amount equal to: (Cash Surrender Value of Policy at the End of the Employee's Tax Year) - (Amount Payable to the Employer Upon Termination of the SDA if Termination Occurred at the End of the Employee's Tax Year) - (Aggregate of Cash Surrender Value Included in Employee's Taxable Income During Previous Tax Years).[93]

> EXAMPLE 24: Same facts as Example 22 except that at the end of 2004 the insurance policy has a cash surrender value of $52,050, the employer is entitled to $52,000 of the cash surrender value upon termination of the SDA, and the employee is entitled to the remaining $50 of this cash surrender value at the end of 2004. This cash surrender value will affect calculation of the employee's economic benefit generated by the cost of current life insurance protection in two ways. First, the employee's $50 of cash surrender value must be included in his taxable income. Second, the Table 2001 rate will be multiplied by $4,947,950 instead of $4,948,000. Consequently, the employee's economic benefit generated by the cost of current life insurance protection is reduced from $2,474 to $2,473.98. Therefore, the employee must include $2,523.98 in his taxable income for 2004 as economic benefit to him generated by the insurance policy, instead of $2,474.

(IV) *Borrowing Against Life Insurance Policy*. An employee who borrows money that is secured by an insurance policy will be treated as having received a lifetime distribution from the insurer (and will recognize taxable income to the extent the employee would recognize taxable income from a lifetime distribution) if the loan is a *specified policy loan*.[94] A loan to an employee or the employee's donee is a specified policy loan to the extent that: (1) the proceeds of the loan are distributed directly to the employee (or the employee's donee), (2) a reasonable person would expect the borrower to not repay the loan, or (3) the obligation to repay can be satisfied by the employer.[95] This rule casts a broad net that will cover virtually all borrowing against an insurance policy's cash surrender value or that is secured by a policy's cash surrender value.

> EXAMPLE 25: The insurer loans $10,000 to the employee during 2005. The employee included $5,000 of cash surrender value from this policy in his taxable income during 2004 and no cash surrender value from the policy in prior years. Except for the incremental increase in the policy's cash surrender value that was included in the employee's taxable income during 2004 and the annual value of current life insurance protection from the policy, no amounts have been included in the employee's taxable income during any tax year occurring before 2005. Under these facts, this loan is a specified loan because the insurer directly loaned money to the employee. The first $5,000 of the loan will be a tax-free return of capital, but the balance will generate taxable income to the employee. Consequently, the $10,000 loan will result in the employee recognizing $5,000 of taxable income during 2005.

(V) *Other Economic Benefits From Agreement*. The new regulations retain an ill-defined factor for measuring economic benefit described as "other economic benefit" that was first

enunciated by the IRS in Rev. Rul. 66-110. The IRS relied on this factor in TAM 9604001 in ruling that cash surrender value is taxable to the employee.

EFFECT ON EMPLOYEES FROM NEW RULE: The new rule measuring an employee's income is less favorable to taxpayers than the traditional approach in three ways. First, the parties will no longer be able to use the generally lower comparable term rates published by insurers to measure economic benefit.[96] Second, the employee will be required to include the incremental increase in the cash surrender value of the insurance policy payable to the employee in his taxable income each year regardless of whether this increase in cash surrender value is distributed to the employee. (As mentioned above, this position was advocated by a controversial 1996 technical advice memorandum and has generally not been followed by parties to an SDA whose tax consequences are governed by Rev. Rul. 64-328 and its progeny.) Third, the regulations cause an employee to have no basis in a life insurance policy subject to an SDA despite the employee making payments to the employer in consideration for the economic benefits received under the agreement. This makes virtually all distributions from an insurer -- including loans to an employee from an insurer or secured by a life insurance policy subject to an SDA -- to an employee taxable income to the employee.

(ii) *Income Tax Consequences to Employer*. The income tax consequences to the employer are similar to the tax consequences under the traditional economic benefit doctrine analysis prescribed by the 1960's revenue rulings.

(I) *Payment of Insurance Premiums*. Under the new regulations, an employer still may not deduct premiums paid regarding a life insurance policy subject to an SDA.[97] Also, the employer must include in its taxable income any consideration paid by the employee (or on the employee's behalf) in consideration for economic benefits received under the SDA.[98]

EXAMPLE 26: During 2005, an insurance policy subject to an SDA generates $25,000 of premiums, the employer pays $20,000 of this amount, and the employee pays the remaining $5,000. The employer is not entitled to deduct the $20,000 of premiums against its taxable income during 2005 and must include the $5,000 paid by the employee in taxable income.

EFFECT ON EMPLOYERS FROM NEW RULE: The new rule requiring the employer to include premium payments by the employee in taxable income is particularly disadvantageous to taxpayers. The rule will force employers to recognize income to the extent the employee wishes to minimize economic benefit from an SDA life insurance policy by paying a portion of the policy's premiums. Consequently, few employers will agree to an SDA that is designed to eliminate the employee's economic benefit through requiring the employee to pay a portion of a life insurance policy's annual premiums. This will create gift tax complications for the employee because taxable gifts made by an employee in the SDA context are measured by the employee's annual economic benefit.

SUGGESTED MODIFICATION OF REGULATIONS. Conceptually, this rule conflicts with the rule in Treas. Reg. section 1.61-22(e)(3)(ii). Under that subparagraph, an employee may deduct consideration paid to the employer from a lifetime distribution made by the insurer to the employee in computing the employee's taxable income generated by the distribution. This is the practical equivalent of the employee having basis in the insurance policy despite the language in Treas. Reg. section 1.61-22(f)(2)(i) that says an employee has no basis in the policy. Treas. Reg. sections 1.61- 22(f)(2)(i) and (ii) should be amended so that employers are not taxed on consideration paid by employees for their economic benefits, employees are explicitly given basis in a life insurance policy for those payments, and the employer's basis in the policy is limited to the portion of the premiums it pays.

(II) *Dividends and Other Distributions*. All lifetime distributions (including loans that are specified policy loans) made by the insurance company to the employee or a beneficiary of

an employee will be taxed as if they were first made to the employer and the employer then distributed those same amounts to the employee.[99]

(a) *Tax Consequences From Implicit Lifetime Distribution From Insurer to Employer*. Generally, lifetime distributions from an insurer do not generate taxable income to the owner of the policy until the employer's basis is exhausted.[100] The employer's basis in a life insurance policy subject to an SDA is equal to the aggregate of premiums paid by the employer and employee less distributions made by the insurer that did not generate taxable income to the employer.[101]

EXAMPLE 27: The insurer distributes a $5,000 dividend to the employee in 2005 when the employer's basis in the policy exceeds $5,000. The policy has been in effect for more than 15 years and is not a modified endowment contract. Under these facts, the employer recognizes no taxable income from the dividend, and the employer's basis in the policy is reduced by $5,000.

CAUTION: The general rule of charging distributions against basis first does not apply to life insurance policies that are modified endowment contracts, nor does it apply to a partial redemption of an insurance policy whereby the death benefit is reduced, if the redemption occurs before the 15th anniversary of the policy's issuance.[102] In a modified endowment contract, most lifetime distributions, including loans secured by the contract, will generate taxable income to the recipient to the extent the cash surrender value of the policy exceeds the owner's basis in the policy immediately before the distribution.[103] In a partial redemption of an insurance policy before the 15th anniversary of its issuance, the distribution is taxable income to the extent of the lesser of the difference between the cash surrender value of the policy and the owner's basis in the policy or two alternative caps described under section 7702(f)(7)(C) and (D).[104]

EXAMPLE 28: The employer's basis in a life insurance policy subject to an SDA is equal to $200,000, the cash surrender value in the policy is $250,000, the insurer pays $50,000 to the employee as a partial redemption of the policy whereby the death benefits payable upon the death of the employee are reduced by one-fifth, and the policy was issued less than 15 years before the $50,000 distribution. In this case, the employer will recognize taxable income equal to the lesser of $50,000 or the applicable cap under sections 7702(f)(7)(C) and (D).

(b) *Tax Consequences From Implicit Payment by Employer to Employee*. The new regulations imply that the employer is entitled to deduct the amount of an implicit payment from an employer to an employee to the extent the lifetime distribution from the insurer to the employee causes the employee to recognize taxable income.[105]

EXAMPLE 29: Same facts as Example 27. Also, the employee recognizes $5,000 of taxable income from the dividend under Treas. Reg. section 1.61-22(e). Under these facts, the employer will be entitled to deduct $5,000 against its taxable income to the extent this amount can be deducted under section 162.

(III) *Buildup of Cash Surrender Value*. The employer is not entitled to a corresponding deduction because the employee includes a policy's cash surrender value in taxable income.[106]

(IV) *Borrowing Against Policy*. The rules for determining the tax consequences to an employer from borrowing against a life insurance policy are analogous to the rules applicable to dividends. First, the employer will be treated as if it borrowed against the policy.[107] Generally, the borrowing will be tax-free to the employer.[108] Second, the employer will be treated as if it paid the funds to the employee.[109] It will be entitled to a deduction that corresponds to the amount of taxable income recognized by the employee from the distribution.[110]

(iii) *Gift Tax Consequences to Employee While Plan Is in Effect*. The employee makes a taxable gift when a premium is paid if the employee's interest in the life insurance policy subject to an

SDA has been transferred to a third person as a gift.[111] The amount of the annual gift from the employee to the donee is equal to: ((Life Insurance Premium Factor Published in Internal Revenue Bulletin) X [(Total Death Benefits Payable Under Policy) - (Aggregate of Premiums Paid by Employer)]) + (Accretion During Year to the Donee's Right to the Cash Surrender Value in the Policy) + (Accretion During Year to Other Economic Benefit to the Donee From the SDA Not Including Mortality Protection) - (Premium Paid by the Donee During Year).[112] This formula is identical to the formula calculating economic benefit to the employee for income tax purposes.

EXAMPLE 30: Same facts as Example 22. Also, all of the death benefits payable under the life insurance policy are payable to the employee's son. As discussed in Example 22, the employee's economic benefit during 2004 from the employer paying the insurance premiums is $2,474. The employee's taxable gift to his son in the form of mortality protection generated by the policy is equal to this same amount. However, the mortality protection is a present-interest gift for gift tax purposes and will be excluded from the computation of taxable gifts made in 2004 to the extent permitted under section 2503(b).

EFFECT ON DONORS FROM NEW RULE: The measure of annual taxable gifts generated by an SDA is the same as the measure of taxable income to an employee from these agreements. Consequently, this new gift tax rule is unfavorable to donors for the same reasons that the corresponding income tax rule is unfavorable to employees.

SUGGESTED MODIFICATION OF REGULATIONS. The portion of the Treasury regulations governing how to measure a gift of an interest in an SDA is in Treas. Reg. section 1.61-22. Generally, valuation of taxable gifts is governed by section 2512, and Treas. Reg. section 25.2512-6 governs valuation of life insurance contracts. Treas. Reg. sections 1.61-22 and 25.2512-6 should both be amended so that the gift tax regulatory language in section 1.61-22 is moved to section 25.2512-6.

(2) *Income Tax and Gift Tax Consequences From SDA Termination*. Termination of an SDA during an employee's lifetime that results in the employer no longer owning an interest in the life insurance policy will cause the employee to recognize taxable income and the employer to be entitled to a deduction against taxable income and may cause the employee to make a taxable gift.

(i) *Taxable Income Recognized by Employee*. Upon termination of the SDA, the employee will recognize taxable income equal to: (Fair Market Value of the Insurance Policy) - [(Amount Paid by the Employee for Termination of SDA) + (Value of the Employee's Right to the Policy's Cash Surrender Value That Has Been Included in the Employee's Taxable Income During Prior Years) + (Other Economic Benefit to the Employee From the SDA That Has Been Included in the Employee's Taxable Income Other Than the Value of Current Life Insurance Protection)].[113] Under this rule, the fair market value of a life insurance policy is equal to the policy's cash surrender value plus the value of all other rights in the policy not including value attributable to mortality protection.[114]

EXAMPLE 31: An employer and employee agree to terminate an SDA during 2006. At that time, the cash surrender value of the policy is $100,000, the employer is entitled to $75,000 of this value, the employee has included $10,000 of the policy's cash surrender value in his taxable income in prior years and has included no other economic benefit in taxable income (other than mortality protection) during prior years, and the employee will pay nothing to the employer upon termination of the SDA. The employee will recognize taxable income in 2006 generated by the termination in an amount equal to $100,000 less $85,000, or $15,000.

SPECIAL CONSIDERATION: The measure of fair market value for income tax and payroll tax purposes is formulaic regardless of the health of the insured. This rule does not apply for gift tax purposes. Instead, Treas. Reg. section 25.2512-6 governs determination of fair market value in the gift tax context and includes the state of the insured's health in determining fair market value of a life insurance policy.[115] Upon termination of an SDA that benefits a donee of the employee,

the employee's taxable gift to the donee could be much larger than the amount of taxable income recognized by the employee.

(ii) *Employee's Basis in Insurance Policy After Termination*. After termination of the SDA, the employee is the new owner of the insurance policy.[116] The employee's basis in this policy is equal to the greater of: (1) the fair market value of the insurance policy at the time of termination, as determined for income tax purposes, or (2) the sum of the amount paid by the employee to the employer upon termination, the policy's cash surrender value at the time of termination, and the value of rights in the policy other than mortality protection measured at the time of termination.[117]

> EXAMPLE 32: Same facts as Example 31. After termination of the SDA, the employee will be the owner of the policy, and his investment (basis) in the policy will be $100,000.

(iii) *Income Tax Consequences to Employer of SDA Termination*. Upon termination of an SDA during the employee's lifetime and the lapse of any restrictions imposed by the employer that could cause the employee's rights under the policy to become divested, the employer is entitled to deduct from taxable income an amount equal to: (Amount Included in Employee's Taxable Income Upon Termination of SDA) + [(Value of the Employee's Right to the Policy's Cash Surrender Value That Has Been Included in the Employee's Taxable Income During Prior Years) + (Other Economic Benefit to the Employee From the SDA That Has Been Included in the Employee's Taxable Income Other Than the Value of Current Life Insurance Protection)].[118]

> EXAMPLE 33: Same facts as Example 31. Upon termination of the SDA, section 264 no longer applies, and the employer is entitled to deduct $25,000 from its taxable income to the extent permitted by section 162.

(iv) *Gift Tax Consequences to Employee From SDA Termination*. When an SDA is terminated so that the employee's donee becomes the owner of the life insurance policy, the employee will make a taxable gift at the time of termination. The amount of the taxable gift is equal to: (Fair Market Value of the Insurance Policy) - [(Amount Paid by the Donee for Termination of SDA) + (Value of the Donee's Right to the Policy's Cash Surrender Value That Has Been Gifted by Employee During Prior Years) + (Other Economic Benefit Gifted by Employee in Prior Years Other Than the Value of Current Life Insurance Protection)].[119] For the purposes of this rule, the fair market value of a life insurance is determined under the principles of Treas. Reg. section 25.2512-6(a).[120]

> EXAMPLE 34: Same facts as Example 31 except the beneficiary of the life insurance policy is the employee's son, the son was entitled to the employee's share of the policy's cash surrender value at all times, the son is the new owner of the policy after the parties terminate the SDA, and a new annual premium is due at the time of termination. Upon termination, the employee will be considered to have made a $15,000 taxable gift. This is a present- interest gift that will be reduced to the extent the employee is entitled to exclude its value under section 2503(b).

(3) *Income Tax and Estate Tax Consequences of Death Benefits*. Upon an insured's death, the insurance company is contractually obligated to pay the agreed on death benefits to the beneficiaries of the policy. In the SDA context, those payments will be made to the employer and the beneficiary of the policy or the employee's estate if no beneficiary is named by the employee. Generally, death benefits paid under an insurance policy are excluded from the payee's taxable income unless the transfer for value rule applies.[121] The new Treas. regulations expand the possibility that death benefits paid under a policy governed by an SDA can be subject to income tax.

(i) *Income Tax Consequences of Death Benefits to Employee's Estate or Beneficiaries.* Death benefits paid to the employee's estate or beneficiaries are excluded from the measure of taxable income if the death benefits are from current life insurance protection attributable to premiums

paid by the employee (or employee's donee) or premiums paid by the employer that are included in the employee's taxable income.[122] Death benefits paid to the employee's estate or beneficiaries that are not excluded from taxable income under this rule are treated as if they were paid to the employer and the employer posthumously paid an equal amount as compensation to the employee.[123]

(ii) *Income Tax Consequences of Death Benefits to Employer*. Death benefits paid to the employer are excluded from the employer's taxable income if the death benefits are not allocated to current life insurance protection provided to the employee (or the employee's donee) under the SDA.[124] Death benefits not excluded from taxable income would be treated as a posthumous transfer from the employee (or the employee's donee) to the employer.[125]

(iii) *Estate Tax Consequences of Death Benefits*. The new Treasury regulations do not change the federal estate tax consequences flowing from an SDA taxed under the economic benefit regime. Estate taxation of death benefits continues to be governed by sections 2031 and 2042.

(c) *Tax Consequences of SDA -- Loan Regime*. An SDA that is structured using the collateral assignment method will now cause the parties to the agreement to be taxed as if the employer made a loan to the employee each time the employer makes a premium payment.[126] These loans will be subject to the normal taxation rules regarding indebtedness if the loan generates sufficient stated interest, or they will be subject to the below-market interest rate rules if they generate insufficient stated interest.[127] This approach brings taxation of these agreements back to the loan approach first described in Rev. Rul. 55-713.

(1) *Threshold Issue -- Adequate Interest Rate*. A loan that generates sufficient interest is subject to the ordinary rules applicable to debt instruments.[128] The rules for determining whether a loan generates sufficient interest turn on whether the loan is a demand or term loan. When determining whether a gift term loan generates sufficient interest, the loan is tested using the demand loan rules for income tax purposes but is tested using the term loan rules for gift tax purposes.[129]

(i) *Demand Loans*. A demand loan is tested for adequate interest each calendar year.[130] The loan generates sufficient interest to avoid imposition of the section 7872 rules if its interest rate during the year is at least equal to the blended annual rate for that year.[131]

(ii) *Term Loans*. A term loan is tested for adequate interest when it is created.[132] The loan generates sufficient interest to avoid imposition of the section 7872 rules if the present value of all payments due under the loan, using a discount rate equal to the appropriate applicable federal rate (AFR) for the month when the loan is made, equals or exceeds the amount of the loan.[133]

Length of Term. Generally, a loan's term is measured from the date the loan is made through its stated maturity date.[134] However, there are contingencies that can cause the stated maturity date to be undeterminable when the loan is made, and the Treasury regulations provide special rules for determining the length of the term in these cases.[135] For example, the term of a loan that is payable on the death of an insured is equal to the insured's life expectancy under the appropriate table in Treas. Reg. section 1.72-9 determined as of the day the loan is made.[136] Also, a loan that is payable upon an employee's separation from service with an employer is presumed to have a seven- year term.[137] Upon expiration of the aforementioned presumed terms, the loans are treated as retired and reissued for new terms.[138]

(2) *Rules Applicable to Loans With Adequate Interest*. SDA loans that generate adequate stated interest will have no gift tax issues associated with them but will have timing issues in the income tax context.

(i) *General Income Tax Rules Regarding Indebtedness*. Generally, a creditor includes interest in his income as it accrues or is paid, depending on the creditor's method of tax accounting, and a payment of principal is a return of capital that does not generate taxable income to the payee to the extent of the creditor's basis in the indebtedness.[139]

> *Character of Creditor's Income*. Interest received or receivable is ordinary income to the payee. Also, without a statute, receipt of principal payments in discharge of indebtedness in an amount greater or lesser than the creditor's basis in the indebtedness results in the creditor recognizing ordinary income or loss equal to the difference because retirement of the debt does not constitute an exchange under section 1222.[140] However, almost all retirements of indebtedness are statutorily treated as an exchange.[141] Consequently, creditors usually recognize capital gain or loss and ordinary gain or loss depending on whether the obligation is a capital or ordinary asset of the creditor.

Correspondingly, a debtor is entitled to deduct interest as it accrues or is paid if it meets the requirements of section 163 and principal repayments do not give rise to income tax deductions. The nondeductibility of principal repayments is the flip side of not including borrowed amounts in taxable income when the money was borrowed.

(ii) *Original Issue Discount Rules.* The aforementioned general rules applicable to indebtedness can be easily manipulated by adjusting the principal amount of a loan and its interest rate so that the debtor will pay more or less interest as suits the parties. The original issue discount rules of sections 163(e) and 1271 through 1288 are primarily designed to: (a) prevent creditors and debtors from increasing the face amount of a loan and reducing its interest rate to obtain tax advantages, and (b) prevent creditors and debtors from manipulating the timing of interest payments to obtain tax advantages. These statutory rules are applicable to SDA loans that generate adequate interest under Treas. Reg. section 1.7872-15.[142]

> (I) *Manipulation of Principal Amount of Loan and Interest Rate.* Except for income taxes generated by a transaction, a taxpayer who sells a capital asset for $1 million should not care whether the transaction is structured as a $1 million sale that generates $100,000 of interest until the debt is repaid one year after the sale (assuming the market rate for interest is 10 percent) or the transaction is structured as a sale of the asset for $1.1 million payable one year from the date of sale. However, without the original issue discount rules, the tax results would be significantly different. Under the first alternative, the seller would realize $100,000 of ordinary income from the interest payment that he would not realize in the second transaction, and the seller would realize $100,000 less from the capital transaction in the first alternative than he would under the second alternative. Sellers generally want their income taxed as capital gain to receive lower marginal rates and to offset capital losses that are otherwise not deductible.[143] Buyers are often indifferent between paying interest or a higher price for a purchased item because of the numerous restrictions on deducting interest.[144] Consequently, in those cases, the buyer will not suffer a corresponding tax detriment by structuring a transaction to maximize the seller's capital gain. Congress enacted sections 1272 through 1274 to act as a policing mechanism in determining the principal amount of indebtedness by requiring the parties to calculate the principal amount of the loan as equal to the present discounted value of all payments required to be made using an adequate interest rate.
>
> > *Applicability of Manipulation of Principal Rules to SDAs*. In the context of SDAs, manipulation of the face amount of the indebtedness is not a concern because the original issue discount rules will apply only to indebtedness associated with an SDA if the parties provide for adequate interest.
>
> (II) *Manipulation of Timing of Interest Payments.* A creditor should not care whether he receives interest payable annually or interest that compounds annually but is paid less

frequently. In the absence of the original issue discount rules, cash method taxpayers could defer income tax liability from interest generated during a tax year into future years by structuring transactions so that interest is payable in later years. As mentioned above, many debtors have no countervailing incentive to prevent deferral because they cannot deduct the interest payments against their own taxable incomes. Consequently, for federal income tax purposes, sections 1272(a)(1) and (3) police the system by generally requiring a cash-method creditor to include interest in his income as it accrues.

Exception to Timing Rules. Despite the general rule requiring a creditor to recognize interest as it accrues, a debtor and creditor may jointly elect to use the cash method of accounting regarding the indebtedness if the creditor does not generally use the accrual method of tax accounting and the principal amount of the loan does not exceed $3,129,500 if the loan was made during 2004.[145] For the purposes of this exception, loans between the same parties arising from the same set of transactions are aggregated.[146] As a practical matter, most loans made by an employer to an employee under an SDA will aggregate to less than $3,129,500 in 2004 or the inflation- adjusted number for the appropriate subsequent calendar year. However, most employers use the accrual method of accounting. Consequently, an SDA involving a cash-method employer can be structured to avoid any income tax consequences during the lifetime of the insured if the outstanding balance of the loan stays below the appropriate amount until the insured's death.

(III) *Interest on Some Deferred Payments*. Section 483 imposes a second set of rules for determining the face amount of indebtedness that is applicable to most loans that are exempt from the original issue discount rules. This section has no application in the SDA context because it would come into play only if the loan charged inadequate interest and neither the original issue discount rules nor this section apply to SDA loans that charge inadequate interest.

(IV) *Interest Regarding Indebtedness Between Related Taxpayers*. Section 267(a)(2) prohibits accrual-method taxpayers from deducting an item as an expense until a cash-method related party includes the item in income if the parties to the transaction are related to each other. This rule will have limited applicability because section 264 generally prohibits taxpayers from deducting interest generated by loans used to finance payment of insurance premiums.

(3) *General Rules Applicable to Employment and Gratuitous Loans With Inadequate Interest*. The below-market interest rate rules of section 7872 are applicable to the parties to an SDA loan that generates inadequate interest. These rules have both income and gift tax consequences.

(i) *Income Tax Consequences of Demand Loans*. A loan that does not generate adequate interest and is payable on demand of the creditor is generally subject to the following income tax rules.

(I) *Employment-Related Demand Loans*. An employer-creditor and an employee-debtor are treated as if the creditor paid wages to the employee in an amount equal to the forgone interest that would have been generated during a calendar year and the employee paid a corresponding amount to the employer as interest.[147]

(II) *Gratuitous Demand Loans*. A donor-creditor and a donee-debtor are treated as if the creditor made a gift to the debtor in an amount equal to the forgone interest that would have been generated during a calendar year and the debtor made a corresponding interest payment to the creditor.[148] The amount considered as constructively paid interest by a donee-debtor to a donor- creditor is capped by the debtor's investment income if the aggregate amount of loans between them is less than or equal to $100,000.[149]

Generally, the deemed payments of wages, gifts, and interest are all considered as having been made on December 31 of each year.[150]

(ii) *Income Tax Consequences of Term Loans*. A term loan that does not generate adequate interest is subject to the following income tax rules.

(I) *Employment-Related Term Loans*. An employer- creditor and an employee-debtor are treated as if the creditor paid wages to the employee in an amount equal to the forgone interest that would have been generated over the entire term of the loan.[151] The constructive payments of wages and interest shall be deemed to have occurred on the date the loan was made.[152]

(II) *Gratuitous Term Loans*. Contrary to the treatment of employment-related loans, a donor-creditor and a donee-debtor are treated as if the creditor made a gift to the debtor in an amount equal to the forgone interest that would have been generated during a calendar year and the debtor made a corresponding interest payment to the creditor.[153] (This measure of gift and interest paid applies regardless of whether a gift loan is due on demand or at the expiration of a term.) Again, the amount considered as constructively paid interest by a donee-debtor to a donor-creditor is capped by the debtor's investment income if the aggregate amount of loans between them is less than or equal to $100,000.[154] For income tax purposes, the date of the gift and corresponding interest payment are both deemed to occur on December 31 of each year.[155]

(iii) *Gift Tax Consequences of Below-Market Loans*. Contrary to the income tax consequences flowing from gift loans, the gift tax consequences of a loan will turn on whether the loan is payable on demand or the expiration of a term. Demand loans will generate a taxable gift equal to the amount of forgone interest calculated for income tax purposes,[156] whereas term loans will generate a taxable gift equal to the amount of forgone interest generated under the rules applicable to compensation-related term loans.[157] For gift tax purposes, the date of the gift will be December 31 of each year if the loan is a demand loan and on the date the loan was made if the obligation is a term loan.[158]

All of these rules are subject to a de minimis exception that exempts loans between a creditor and a debtor from these rules if the aggregate amount of the indebtedness is less than $10,000 and, if the loan is a gift loan, the proceeds of the loan are not invested in an income-producing asset.[159] The new Treasury regulations attempt to make these de minimis rules inapplicable to SDA loans.[160] However, this portion of the new regulations is contrary to section 7872(c)(2) and (3) and should be found invalid if challenged.[161]

SUGGESTED MODIFICATION OF REGULATIONS. The attempt to make the statutory de minimis rules of sections 7872(c)(2) and (3) inapplicable in the SDA context through administrative regulations is probably invalid. Treas. Reg. section 1.7872-15(a)(3) should be repealed or modified so that it ceases to conflict with this statute.

(4) *Tax Consequences of SDA During Insured's Lifetime -- Loan Regime Inadequate Interest*. The new Treasury regulations prescribe detailed rules governing the proper federal tax treatment of SDA loans that generate inadequate interest.

(i) *Income Tax Consequences to Employee*.

(I) *Premiums Paid by Employer*. Generally, the employee will not immediately recognize income when an employer pays insurance premiums on the employee's behalf. (To the extent the employer's premium payment is not properly classified as a loan, the employee will recognize wage income.[162]) Instead the employee will begin to accrue wage income equal

to the forgone interest as each premium payment is made and will be treated as if he paid a corresponding amount to the employer as interest.

Calculation of Forgone Interest. For federal income tax purposes, forgone interest is calculated using the rules in proposed Treas. Reg. section 1.7872-13.

Interest Paid Deduction. Under sections 163(h) and 264, interest constructively paid by the employee to the employer is not deductible against the employee's taxable income.[163]

(II) *Dividends and Other Distributions*. Generally, dividends paid by an insurer to the owner of an insurance policy are considered a return of previously paid premiums and are included in the measure of the owner's taxable income only to the extent they exceed the aggregate of premiums paid regarding the policy.[164] An SDA structured using the loan regime that is created after September 17, 2003, results in the life insurance policy being owned by the employee for federal income tax purposes.[165] Consequently, dividends received by the employee will be taxable to him to the extent required under the generally applicable rules applying to dividends paid by an insurer to an owner of an insurance policy.

(III) *Buildup of Cash Surrender Value*. Generally, the owner of an insurance policy does not include increases in a life insurance policy's cash surrender value in the measure of taxable income.[166] There is no authority in the new Treasury regulations that would cause the cash surrender value of a policy to be taxable.

(IV) *Borrowing Against Policy*. Under generally applicable federal income tax law, the proceeds of a loan are not included in the measure of taxable income.[167] This general rule should apply to employees who borrow money against an insurance policy that is owned by the employee as part of an SDA structured using the loan regime.

CAUTION: Borrowing against an insurance policy that secures an employer's right to be repaid under an SDA structured using the loan regime may cause a change in the calculation of interest forgone by the employer. To the extent that the employer's right to be repaid from the policy is not fully secured by adequate cash surrender value, the loan is considered to be subject to contingent payments unless the employee or borrower is personally obligated on the loan or the parties make certain representations to the Internal Revenue Service.[168] This could cause the employer or lender and employee or borrower to constructively forgo additional interest that would generate further tax consequences under section 7872. Consequently, employees should avoid borrowing amounts that will cause an employer's interest in an SDA to be less than fully secured.

(ii) *Income Tax Consequences to Employer*.

(I) *Premium Payments*. Each premium payment by an employer is a separate loan to the employee. The payments themselves are not wages paid by the employer; instead, interest generated by the loans will be wages if the employee is performing services for the employer contemporaneously with when the interest was generated.

(II) *Dividends and Other Distributions*. Under the loan regime, the employer owns nothing other than a security interest in a life insurance policy. Consequently, payment of dividends by an insurance company to the employee will have no tax consequences to the employer. Dividend payments made by the insurance company to the employer will be treated as constructively paid to the employee and the employee paid an amount equal to the dividend to the employer.[169]

(III) *Buildup of Cash Surrender Value*. Under the loan regime, the employer owns no interest in the life insurance policy other than its possibly serving as collateral for enforcing the employer's right to be repaid. Consequently, an increase in the cash surrender value of an

insurance policy subject to an SDA structured using the loan regime will have no tax consequences to the employer.

(IV) *Borrowing Against Policy*. An employee borrowing against an insurance policy subject to an SDA structured using the loan regime should have no tax consequences to the employer as long as the employer's loan continues to be fully secured by the cash surrender value of the policy or the employee is personally obligated to repay the employer.

(iii) *Employment Taxes*. Whenever an employee recognizes wage income for federal income tax purposes, the employer and employee will be treated as if the employee was paid wages for payroll tax purposes.[170] This same rule applies whenever a taxpayer recognizes self-employment income as a result of an SDA.[171]

(iv) *Gift Tax Consequences to Employee*.

(I) *Initial Gift of Policy*. Please see section (a)(4)(i) of the portion of this article that discusses Rev. Rul. 64-328 and its progeny for a full discussion of this issue.[172]

(II) *Annual Premium Payments*. An employee will be considered to have made a loan to a donee on the same terms as the loan made by the employer if the donee owns the policy that is subject to the employer's security interest.[173] Consequently, there will be two loans for federal tax purposes. The first loan will be from the employer to the employee, and it will be subject to the income tax rules applicable to employers and employees under section 7872. The second loan will be a deemed loan from the employee to the donee that is subject to the income tax and gift tax rules of section 7872 that are applicable to donors and donees. The amount of the employee's taxable gift is measured in conformity with the rules in prop. Treas. Reg. sections 1.7872-13 and -14.

(5) *Tax Consequences of Lifetime Termination*. Generally, terminating an SDA during an employee's lifetime will cause both the employee and the employer to recognize taxable income. Payments made by the employee to the employer will first be considered repayment of accrued interest to the extent thereof; second repayment of principal to the extent thereof; third repayment of amounts advanced by the employer that were not expected to be repaid; and finally, other payments.[174] Any forgiveness of accrued but unpaid interest will be taxed as if the interest were paid by the employee to the employer and the employer paid the same amount back to the employee as wages.[175] Further, the deemed payment of wages by the employer is subject to a deferral charge unless the parties made representations under Treas. Reg. section 1.7872-15(d)(2).[176]

(i) *Income Tax Consequences to Employee*. Generally, the employee will not be entitled to deduct any of the repayments made to the employer regardless of whether the payments are considered as interest, capital, or other.[177] Any deemed payment of wages in the amount of forgiven accrued but unpaid interest is ordinary income.[178]

(ii) *Income Tax Consequences to Employer*. Presumably, the payments received regarding stated interest and original issue discount will be ordinary income to a cash-method employer if the amounts have not previously been recognized as income under some other rule.[179] Likewise, repayments of principal will not generate taxable income to the employer, and other payments received should generate capital gain to the employer.

(iii) *Income Tax Consequences to Donee*. The donee could recognize income or deductions at the time the employer releases its interest and when death benefits are paid.

(I) *Time of Termination*. Generally, a donee who owns the SDA life insurance policy insuring the employee's life will recognize no income at the time the employer's security interest in the policy is terminated. A gratuitous release by the employer or a payment by the employee in satisfaction of the indebtedness secured by the policy should be considered a gift by the

employee to the donee that would have no income tax consequences to the donee.[180] Likewise, a payment by the donee to the employer that satisfies the indebtedness secured by the policy and extinguishes the employer's security interest will not generate taxable income to the employee and should not generate any income tax deductions regarding interest paid.[181]

(II) *Time of Payment of Death Benefits*. The transfer for value rule could cause the death benefits payable to the employee's donee to be subject to income tax. The law in this area has not been changed by the new Treasury regulations and this issue is discussed more fully in the portion of this article that discusses Rev. Rul. 64-328 and its progeny at section (b)(3)(ii).[182]

(iv) *Gift Tax Consequences to Employee*. The employee makes a gift to the donee in an amount of the indebtedness secured by the insurance policy owned by the donee upon termination of the employer's security interest if either the employee satisfies the indebtedness or the employer gratuitously releases its interest in the policy.[183]

(6) *Tax Consequences of Death Benefits*.

(i) *Income Tax Consequences to Employer*. Generally, section 101 exempts death benefits paid under a life insurance policy from federal income tax.[184] Despite this general rule, no amount received by an employer qualifies for exemption from federal income tax under section 101.[185] Instead, those payments will be subject to the ordering rules of Treas. Reg. section 1.7872-15(k).[186] This means the payments will first be considered repayment of accrued interest to the extent thereof; second, repayment of principal to the extent thereof; third, repayment of amounts advanced by the employer that were not expected to be repaid; and finally, other payments.[187]

(ii) *Income Tax Consequences to Employee's Estate*. The employee's estate should recognize no income if it receives death benefits from a life insurance policy subject to an SDA, and it should get no deductions for repaying amounts owed the employer.[188]

(iii) *Income Tax Consequences to Employee's Beneficiary*. Death benefits payable to the employee's beneficiary are taxed in conformity with the normal rules of section 101.[189]

(iv) *Estate Tax Consequences*. The estate tax consequences flowing from an SDA structured using the collateral assignment method are unchanged by the new Treasury regulations.[190]

IV. Conclusion

The new Treasury regulations that were finalized on September 17, 2003, are a long-anticipated change in the law regarding split dollar life insurance agreements that finally brings this part of the tax law into conformity with section 7872 and more recent court cases involving interest-free loans. Whole life insurance policies are often expensive, and many life insurance agents, employees, and employers will continue looking to create structures to finance purchasing this insurance in tax-advantaged ways. The best advice will take account of the alternative tax regimes and the characteristics of the parties. There are a few general rules in this area that can be followed.

Modification of Old Agreements. The economic benefit rules of Rev. Rul. 64-328 and its progeny are almost always more favorable to taxpayers than the new rules under Treas. Reg. sections 1.61-22 and 1.7872-15. Two valuable planning features are no longer available to SDAs: (1) the ability to zero out the employee's economic benefit and taxable gifts through the employee or his donee making payments to the employer, and (2) the ability to use low term rates published by the insurer to reduce the economic benefit generated by an SDA. Consequently, in most cases, a practitioner who represents parties to an SDA subject to the old rules should be careful to avoid making a material modification to the agreement that would cause it to become subject to the new rules. The parties to an existing agreement should

continue with these agreements in their present form unless nontax considerations compel the parties to make a change.

New Agreements. The decision whether to structure a new SDA using the endorsement method or the collateral assignment method will turn on the age of the employee, the applicable federal rates, the size of the insurance policy, and whether the employer uses the cash method of accounting.

> *Age of Employee and Interest Rates*. The level of compensation and imputed gifts from an SDA structured using the endorsement method will turn on the employee's age, whereas the level of compensation, imputed interest payments, and gifts generated by an SDA structured using the collateral assignment method will turn on the applicable federal rates. As interest rates increase, the endorsement method will become more favorable. As an employee ages, the collateral assignment method will become more favorable.

Accounting Method of Employer and Size of Policy. Usually, an employer is unlikely to make more than $3,129,500 of premium payments while an SDA is in effect. Consequently, the OID timing rules will not apply if the employer is a cash-method taxpayer and the employee and the employer jointly elect to have section 1274A(c) apply. Therefore, an SDA structured using the collateral assignment method that generates adequate interest can defer all income tax consequences to the employer and the employee or his estate until there is more than $3,129,500 of indebtedness, and the employee starts making interest payments or the SDA is terminated.

> CAUTION: Use of section 1274A(c) to defer income tax consequences was probably not contemplated by the drafters of the new Treasury regulations. Consequently, the IRS may scrutinize agreements designed to rely on this statute in deferring tax consequences to the employee.[191]

Each agreement will have different considerations, and determining the most tax-efficient approach will usually require much thought.

Many practitioners have mistakenly concluded that SDAs are no longer a viable planning tool. Contrary to that view, most of the benefits from these agreements are still available and the existence of the loan regime under Treas. Reg. section 1.7872-15 makes the tax considerations of these agreements more advantageous to older employees. Consequently, SDAs continue to be useful for compensating high-level employees and minimizing gift tax when making gifts involving whole life insurance policies. This tool should be considered whenever an employer and employee are seeking creative ways to finance the purchase of whole life insurance policies on the life of the employee.

FOOTNOTES

[1] An SDA can involve two persons that are related in some way other than employer and employee. For instance, an SDA can be structured advantageously for a corporation and its shareholder. However, this paper will be limited to examining employment-related SDAs because most agreements are between employers and employees.

[2] Rev. Rul. 55-713, 1955-2 C.B. 23, *revoked by* Rev. Rul. 64-328, 1964-2 C.B. 11.

[3] *Dean v. CIR*, 35 T.C. 1083, 1090 (1961), *nonacq.* 1973-2 C.B. 4; *See Brandtjen & Kluge Inc. v. CIR*, 34 T.C. 416, 447 (1960); Rev. Rul. 55-713.

[4] P.L. 88-272.

[5] House Report No. 749, 1964-1 (Part 2) C.B. 123, 186; Senate Report No. 830, 1964-1 (Part 2) C.B. 505, 582.

[6] 1964-2 C.B. 11; *modified* Notice 2002-8, 2002-4 IRB 398.

[7] *Id.*

[8] *Dickman v. CIR* , 465 U.S. 330, 334 (1984).

[9] *Id.*

[10] Section 7872.

[11] Notice 2001-10, 2001-1 C.B. 459.

[12] Rev. Rul. 2003-105, 2003-40 IRB 696.

[13] Treas. Reg. sections 1.61-22(j) and 1.7872-15(n).

[14] This article will not explore the taxation of participants to an SDA that was created before November 14, 1964, because there are few if any of those agreements still in effect.

[15] *Supra* note 6. The economic benefit doctrine requires a cash method payee to include a payment in income, despite the payee not being in actual or constructive receipt of the payment, if the payment is irrevocably beyond the reach of the payer's creditors and the payee's interest in the payment is indefeasibly vested. *See Sproull v. CIR*, 16 T.C. 244, 247-248 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60- 31, 1960-1 C.B. 174. Under this doctrine, a cash-method taxpayer must include the present discounted value of property received from a payer in taxable income when the doctrine's timing requirements are met. Rev. Rul. 62-74, 1962-1 C.B. 68. Apparently, the IRS considered the present discounted value of a whole life insurance policy to be equal to the premium paid on a term policy. Please see BNA Tax Management Portfolio 570, *Accounting Methods -- General Principles*, pages A-56 through A-66, for a more complete discussion of the economic benefit doctrine and the closely related doctrine known as cash equivalence.

[16] Rev. Rul. 67-154, 1967-1 C.B. 11; Rev. Rul. 66-110, 1966-1 C.B. 12; Rev. Rul. 64-328, 1964-2 C.B. 11; *Healy v. United States*, 843 F.Supp. 562, 563-564 (D.N.D. 1994).

[17] Rev. Rul. 64-328, 1964-2 C.B. 11.

[18] Rev. Rul. 64-328; Notice 2002-8, 2002-4 IRB 398.

[19] Rev. Rul. 55-747, 1955-2 C.B. 228, 229.

[20] PLR 9709027.

[21] Notice 2002-8, 2002-4 IRB 398.

[22] *Id.*

[23] Rev. Rul. 66-110, 1966-1 C.B. 12; Rev. Rul. 67-154, 1967-1 C.B. 11. More stringent application of these rules will be applicable to insurance policies issued after January 28, 2002. Notice 2002-8.

[24] *See Healy v. U.S.*, 843 F.Supp. 562 (D.N.D. 1994).

[25] Notice 2002-8, Article III, Section 3, 2002-4 IRB 398.

[26] Treas. Reg. section 1.72-11(b)(1).

[27] Rev. Rul. 66-110, 1966-1 C.B. 12.

[28] Section 7702(g); *Cohen v. CIR*, 39 T.C. 1055, 1063- 1064 (1963), *acq.* 1964-1 (Part 1) C.B. 4; *Nesbitt v. CIR*, 43 T.C. 629, 633-634 (1965).

[29] TAM 9604001.

[30] *Cohen v. CIR* , 39 T.C. 1055, 1063-1064 (1963), *acq.* 1964-1 (Part 1) C.B. 4; *Nesbitt v. CIR*, 43 T.C. 629, 633-634 (1965).

[31] Notice 2002-8, Article IV, Section 1, 2002-4 IRB 398.

[32] *CIR v. Tufts*, 461 U.S. 300, 307 (1983).

[33] According to attorneys employed by the Office of Chief Counsel, this is the unofficial position of the IRS.

[34] Sections 72(e)(4)(A) and (e)(5)(C) and 7702(f)(7)(B). As a practical matter, no insurer is reporting these loans as taxable income. The insurers justify this nonreporting by arguing that borrowing against a life insurance policy does not create a change in the benefits from the insurance policy. Consequently, they argue that section 7702(f)(7)(A) does not apply and loans cannot be classified as a distribution under section 72(e)(4)(A).

[35] Section 7872(c)(1)(B)(i).

[36] Section 162.

[37] Rev. Rul. 64-328.

[38] Section 83(h). Most commentators consider the taxability of cash surrender value to be governed by section 83. However, the same result should occur if cash surrender value is included in the employee's income through application of the economic benefit doctrine. *Supra* note 15.

[39] *Supra* note 31.

[40] Section 7872(c)(1)(B)(i).

[41] Rev. Rul. 81-198, 1981-2 C.B. 188.

[42] *Guggenheim v. Rasquin*, 312 U.S. 254, 257-258 (1941).

[43] *U.S. v. Ryerson,* 312 U.S. 260, 261 (1941).

[44] Treas. Reg. section 25.2512-6(a).

[45] *See Estate of Pritchard v. CIR*, 4 T.C. 204, 208 (1944); *But see Estate of Wein v. CIR*, 441 F.2d 32, 40 (5th Cir. 1971).

[46] Treas. Reg. section 25.2503-3(c) Example 6.

[47] Rev. Rul. 81-198, 1981-2 C.B. 188; Rev. Rul. 78-420, 1978-2 C.B. 67; Rev. Rul. 66-110, 1966-1 C.B. 12.

[48] Treas. Reg. section 25.2503-3(c) Example 6.

[49] PLR 8310027; PLR 7916029.

[50] Section 83(h).

[51] *Id.*

[52] Section 1001.

[53] *See Gallun v. CIR*, 327 F.2d 809, 811 (7th Cir. 1964).

[54] Section 1221.

[55] Sections 72(c)(1) and (e)(6).

[56] PLR 8310027.

[57] *See* Treas. Reg. section 25.2511-1(h)(8).

[58] Section 102(a).

[59] Section 101(a)(1).

[60] Section 101(a)(2).

[61] *See* Treas. Reg. section 1.101-1(b)(4). However, a close reading of the language in this regulation shows that a pledge or assignment of an interest in a life insurance policy as collateral is not a transfer for value and the creditor is not required to include death benefits payable under this pledge or assignment in the creditor's taxable income. The regulation does not state that a release of such a pledge or assignment is also not a transfer for value.

[62] Section 101(a)(2); Treas. Reg. section 1.101- 1(b)(2).

[63] Section 2035(a).

[64] *Supra* note 41

[65] *See* Rev. Rul. 81-198, 1981-2 C.B. 188.

[66] *Supra* note 44.

[67] *Supra* note 45.

[68] *See* Rev. Rul. 76-490, 1976-2 C.B. 300.

[69] Notice 2002-8, art. IV, section 4, 2002-4 IRB 398.

[70] Rev. Rul 64-328, 1964-2 C.B. 11.

[71] Section 101(a).

[72] Sections 264 and 691(b)(1)(A).

[73] *Supra* notes 57 through 63.

[74] Sections 264 and 691(b)(1)(B).

[75] Section 2042.

[76] Section 2035(a).

[77] Treas. Reg. section 20.2053-7.

[78] Treas. Reg. section 20.2053-4. Generally, the aggregate of deductions allowed under section 2053(a) is limited to the greater of the value of the decedent's probate estate or the amount of items actually paid before the due date of the insured's federal estate tax return. Section 2053(c)(2).

[79] Treas. Reg. section 1.61-22(b)(3)(ii).

[80] Treas. Reg. section 1.61-22(b)(3)(i).

[81] Treas. Reg. sections 1.61-22(j)(1)(i) and 1.7872- 15(n)(1).

[82] Treas. Reg. sections 1.61-22(j)(1)(ii) and 1.7872- 15(n)(1). It is unclear when a premium is paid if the parties paid the insurance company by check. The general rule is that a cash- method taxpayer's expenditure is paid when a check is delivered to the payee if it is presented and satisfied by the drawee bank in due course. *Eagleton v. CIR*, 35 B.T.A. 551, 558-559 (1937); *Estate of Spiegel v. CIR*, 12 T.C. 524, 529-533 (1949). For transfer tax purposes, a gift made by check is completed when the check is deposited in the donee's bank account if the check is honored in due course while the donor is alive.

Metzger v. CIR, 38 F.3d 118, (4th Cir. 1994); Rev. Rul 96-56, 1996- 2 C.B. 162. Presumably, the rule stated in *Eagleton* would apply in this context, but the issue is not free of doubt.

83 Treas. Reg. sections 1.61-22(j)(2)(i) and 1.7872- 15(n)(2).

84 Treas. Reg. section 1.61-22(j)(2)(ii).

85 Background and Explanation of Provisions to T.D. 9092.

86 The Treasury Department may issue additional administrative guidance regarding what constitutes a material modification. Treas. Reg. section 1.61-22(j)(2)(iii).

87 *See generally*, Treas. Reg. sections 1.61- 22(d) through (g).

88 Treas. Reg. section 1.61-22(d)(1).

89 Treas. Reg. sections 1.61-22(d)(2) and (e).

90 Treas. Reg. sections 1.61-22(d)(3) and (5). *See* Treas. Reg. section 1.61-22(d)(6) Example 1.

91 Treas. Reg. section 1.61-22(e)(1).

92 Treas. Reg. section 1.61-22(e)(3).

93 Treas. Reg. sections 1.61-22(d)(4) and (5). *See* Treas. Reg. section 1.61-22(d)(6) Example 1.

94 Treas. Reg. section 1.61-22(e)(1).

95 Treas. Reg. section 1.61-22(e)(2).

96 The disadvantage associated with not being allowed to use comparable term rates published by the insurers is ameliorated in two ways. First, the base amount that will be multiplied by the life insurance premium factor is reduced. Under the old regime, the employee's economic benefit was calculated using the gross amount of death benefits. Under the new regime, the employee's economic benefit is calculated using the net amount of death benefits payable to the employee's beneficiary, less the policy's cash surrender value that has been included in the employee's taxable income or is currently included in the employee's taxable income. Second, the rates published in Table 2001 are much lower than the PS 58 and 38 rates.

97 Section 264(a)(1); Treas. Reg. section 1.61- 22(f)(2)(ii).

98 Treas. Reg. section 1.61-22(f)(2)(ii).

99 Treas. Reg. section 1.61-22(e)(1).

100 Section 72(e)(5)(C).

101 Section 72(e)(6); Treas. Reg. section 1.61- 22(f)(2)(ii).

102 Sections 72(e)(5)(c) and (10) and 7702(f)(7).

103 Section 72(e)(3)(A).

104 Section 7702(f)(7)(B)

105 Treas. Reg. section 1.61-22(f)(2)(ii). The employer is not entitled to deduct amounts described in Treas. Reg. section 1.61-22(d) except as allowed in Treas. Reg. section 1.83-6(a)(5). *Id.* Lifetime distributions from an insurer to an employee are described in Treas. Reg. section 1.61-22(e). Therefore, those distributions are not described within the language disallowing the employer's deduction. Also, the distributions to the employee that are taxed as implicit distributions from the insurer to the employer

followed by payments from the employer to the employee cannot be payments of insurance premiums because the employer is not making a payment to the insurer. Consequently, the restrictions of section 264 should not apply and the amounts should be deductible against the employer's taxable income to the extent allowed under section 162.

106 Treas. Reg. sections 1.61-22(d)(2)(ii) and (f)(2)(ii).

107 *Supra* note 99.

108 *Supra* note 100.

109 *Supra* note 99.

110 *Supra* notes 94, 95, and 105.

111 Treas. Reg. section 1.61-22(d)(1).

112 Treas. Reg. sections 1.61-22(d)(2), (3), (4), and (5).

113 Treas. Reg. sections 1.61-22(g)(1), 1.83-1(a)(2), and 1.83-3(a)(1) and (e). However, a termination of an SDA whereby the employer retains an interest in the life insurance policy that causes the employee's interest to be subject to a substantial risk of forfeiture under section 83 will postpone recognition of income by the employee from termination of the SDA until the restriction lapses. Treas. Reg. section 1.61-22(g)(3). Further, the amount of taxable income recognized by the employer will be measured at the time of that lapse. *Id.*

114 Treas. Reg. section 1.61-22(g)(2).

115 *Id. See also* the text accompanying notes 41 through 46.

116 Treas. Reg. section 1.61-22(g)(4)(i). This rule does not apply if there is still a significant risk of forfeiture under section 83. *Id*; Treas. Reg. section 1.61-22(g)(3). In those cases, the employer is still the owner of the policy until the substantial risk of forfeiture lapses.

117 Treas. Reg. section 1.61-22(g)(4)(ii)(A).

118 Treas. Reg. section 1.83-6(a)(5)(i).

119 Treas. Reg. sections 1.61-22(g)(1).

120 Treas. Reg. section 1.61-22(g)(2). Please *see* section (a)(4)(i) of the discussion of Rev. Rul. 64-328 and its progeny for a complete discussion of the valuation of life insurance policies for gift tax purposes. *Supra* notes 41-46.

121 Section 101. Please see the text accompanying notes 59 through 62 for a full discussion of this issue.

122 Treas. Reg. section 1.61-22(f)(3)(i).

123 Treas. Reg. section 1.61-22(f)(3)(iii).

124 Treas. Reg. section 1.61-22(f)(3)(ii).

125 *Supra* note 123.

126 Treas. Reg. section 1.7872-15(a)(2).

127 Treas. Reg. section 1.7872-15(a); *See generally*, sections 483, 1271-1275, and 7872.

128 Treas. Reg. sections 1.7872-15(a)(1) and (f)(1).

[129] Treas. Reg. section 1.7872-15(e)(5)(iv)(B). For federal gift tax purposes, a gift term loan's adequacy is determined under the term loan rules. Treas. Reg. section 1.7872- 15(e)(5)(iv)(D).

[130] Treas. Reg. section 1.7872-15(e)(3)(ii).

[131] *Id*. The IRS publishes the blended annual rate for each calendar year in the Internal Revenue Bulletin in July. The blended annual rate for 2003 is 1.52 percent. Rev. Rul. 2003-71.

[132] Treas. Reg. section 1.7872-15(e)(4)(ii).

[133] *Id* . AFR is divided into short-, medium- and long-term rates that are published monthly by the IRS. A short-term loan is for three years or less, a medium-term loan is for more than three years but not over nine years, and a long-term loan is for over nine years. Section 1274(d)(1).

[134] Treas. Reg. section 1.7872-15(e)(4)(iii)(A).

[135] *See generally*, Treas. Reg. section 1.7872- 15(e)(5).

[136] Treas. Reg. section 1.7872-15(e)(5)(ii)(C).

[137] Treas. Reg. section 1.7872-15(e)(5)(iii)(C).

[138] Treas. Reg. sections 1.7872-15(e)(5)(ii)(D) and (iii)(D).

[139] Section 61(a)(4).

[140] *Fairbanks v. U.S.*, 306 U.S. 436 (1939).

[141] Section 1271(a)(1).

[142] Treas. Reg. section 1.7872-15(a)(1).

[143] *See generally* sections 1(h), 1211, and 1212.

[144] *See generally* section 163.

[145] Section 1274A(c); Rev. Rul. 2003-119. This amount will be adjusted each year and a new amount will be published in the Internal Revenue Bulletin.

[146] Section 1274A(d)(1).

[147] Section 7872(a) and (c)(1)(B).

[148] Section 7872(a) and (c)(1)(A).

[149] Section 7872(d)(1).

[150] Section 7872(a)(2).

[151] Section 7872(b).

[152] *Id*.

[153] *Supra* note 148.

[154] *Supra* note 149.

[155] *Supra* note 150. There is a different rule applicable for federal gift tax purposes. *See* note 158.

[156] Section 7872(a). The amount of the taxable gift is calculated in conformity with the rules in proposed Treas. Reg. sections 1.7872-13(a), (b), (c), (d), (f), and (g).

[157] Section 7872(d)(2). The amount of the taxable gift is calculated in conformity with the rules contained in proposed Treas. Reg. sections 1.7872-13(e), (f), and (g) and 1.7872-14.

[158] Section 7872(a)(2) and (d)(2).

[159] Section 7872(c)(2) and (3).

[160] Treas. Reg. section 1.7872-15(a)(3).

[161] *Chevron, U.S.A. Inc. v. Natural Resources Defense*, 467 U.S. 837, 842-844 (1984). Under *Chevron* analysis, Treas. Reg. section 1.7872-15(a)(3) is a legislative regulation promulgated under to authority delegated by Congress in section 7872(h)(1) and will be valid unless it is manifestly contrary to section 7872 or some other statute. *Id*, at p. 844. This is a very high burden to meet. Nonetheless, in this case, the Treasury regulation cannot be harmonized with IRC Sections 7872(c)(2) and (3) in the SDA -- Loan Regime context, and this portion of the regulation should be struck down. For an excellent short discussion of judicial review of Treasury regulations, please *see* Cunningham and Repetti, "Textualism and Tax Shelters," 24 *Va. Tax Rev.* 1, 43-55 (2004).

[162] *See* Treas. Reg. sections 1.61-22(b)(5) and 1.7872- 15(a)(2)(ii).

[163] Treas. Reg. section 1.7872-15(c).

[164] *Supra* note 26.

[165] Treas. Reg. section 1.7872-15(a)(2).

[166] *Supra* note 28.

[167] *CIR v. Tufts,* 461 U.S. 300, 307 (1983).

[168] Treas. Reg. sections 1.7872-15(d) and (j).

[169] Treas. Reg. section 1.7872-15(m).

[170] Treas. Reg. sections 31.3121(a)-1(k), 31.3231(e)- 1(a)(6), 31.3306(b)-1(l) and 31.3401(a)-1(b)(15).

[171] Treas. Reg. section 1.1402(a)-18.

[172] *Supra* notes 41-46.

[173] Treas. Reg. section 1.7872-15(e)(2).

[174] Treas. Reg. section 1.7872-15(k).

[175] Treas. Reg. section 1.7872-15(h)(1)(i).

[176] Treas. Reg. section 1.7872-15(h)(1)(iv). The deferral charge is calculated differently depending on whether the loan was a term or demand loan. *See generally* Treas. Reg. sections 1.7872-15(h)(2) and (3).

[177] Section 264.

[178] Section 61; Treas. Reg. sections 1.7872-15(h)(1)(i) and (e)(1)(i).

[179] *See* section 1271(d).

[180] *See* section 102(a) and (c).

[181] *See* section 264.

[182] *Supra* notes 59-63 with special emphasis on note 61.

[183] *Supra* note 57.

[184] Section 101(a)(1).

[185] Treas. Reg. section 1.7872-15(m).

[186] *Id.*

[187] Treas. Reg. section 1.7872-15(k).

[188] Sections 101 and 264.

[189] This issue is discussed extensively in the portion of this article that examines Rev. Rul. 64-328 and its progeny at section (b)(3)(ii). *Supra* notes 59 through 63.

[190] *Supra* notes 75 and 76.

[191] One line of attack may be to assert that the employee's indebtedness owed to the employer is not a qualified debt instrument under section 1274A(b) by asserting that there was no sale or exchange between the employer and the employee. *See generally*, *Fairbanks v. U.S.*, 306 U.S. 436 (1939).

END OF FOOTNOTES