(B) The employee certifies to the employer that the employee reasonably expects to be entitled to and will itemize deductions for each year the loan is outstanding; and

(C) The loan agreement requires that the loan proceeds be used only to purchase the new principal residence of the employee.

(ii) *Bridge loans*. In the case of a compensation-related loan to an employee which is not described in paragraph (c)(1)(i) of this section, and which is used to purchase a new principal residence (within the meaning of section 217 and the regulations thereunder) of the employee acquired in connection with the transfer of that employee to a new principal place of work (which meets the requirements in section 217(c) and the regulations thereunder), the loan will be exempt from section 7872 if the following conditions are satisfied:

(A) The conditions contained in paragraphs (c)(1)(i) (A), (B), and (C) of this section;

(B) The loan agreement provides that the loan is payable in full within 15 days after the date of the sale of the employee's immediately former principal residence;

(C) The aggregate principal amount of all outstanding loans described in this paragraph (c)(1)(ii) to an employee is no greater than the employer's reasonable estimate of the amount of the equity of the employee and the employee's spouse in the employee's immediately former principal residence, and

(D) The employee's immediately former principal residence is not converted to business or investment use.

(2) *Below-market loans involving foreign persons*. (i) Section 7872 shall not apply to a below-market loan (other than a compensation-related loan or a corporation-shareholder loan where the borrower is a shareholder that is not a C corporation as defined in section 1361(a)(2)) if the lender is a foreign person and the borrower is a U.S. person unless the interest income imputed to the foreign lender (without regard to this paragraph) would be effectively connected with the conduct of a U.S. trade or business within the meaning of section 864(c) and the regulations thereunder and not exempt from U.S. income taxation under an applicable income tax treaty.

(ii) Section 7872 shall not apply to a below-market loan where both the lender and the borrower are foreign persons unless the interest income imputed to the lender (without regard to this paragraph) would be effectively connected with the conduct of a U.S. trade or business within the meaning of section 864(c) and the regulations thereunder and not exempt from U.S. income taxation under an applicable income tax treaty.

(iii) For purposes of this section, the term ''foreign person'' means any person that is not a U.S. person.

(3) *Loans without significant tax effect*. Whether a loan will be considered to be a loan the interest arrangements of which have a significant effect on any Federal tax liability of the lender or the borrower will be determined according to all of the facts and circumstances. Among the factors to be considered are—

(i) Whether items of income and deduction generated by the loan offset each other;

(ii) The amount of such items;

(iii) The cost to the taxpayer of complying with the provisions of section 7872 if such section were applied; and

(iv) Any non-tax reasons for deciding to structure the transaction as a below-market loan rather than a loan with interest at a rate equal to or greater than the applicable Federal rate and a payment by the lender to the borrower.

(26 U.S.C. 7872)

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§ 1.7872–15 Split-dollar loans.

(a) *General rules*—(1) *Introduction*. This section applies to split-dollar loans as defined in paragraph (b)(1) of this section. If a split-dollar loan is not a below-market loan, then, except as provided in this section, the loan is governed by the general rules for debt instruments (including the rules for original issue discount (OID) under sections 1271 through 1275 and the regulations thereunder). If a split-dollar loan is a below-market loan, then, except as provided in this section, the loan is governed by section 7872. The timing, amount, and characterization of the imputed transfers between the lender and borrower of a below-market split-dollar loan depend upon the relationship between the parties and upon whether the loan is a demand loan or a term loan. For additional rules relating to the treatment of split-dollar life insurance arrangements, *see* § 1.61–22.

(2) *Loan treatment*—(i) *General rule.* A payment made pursuant to a split-dollar life insurance arrangement is treated as a loan for Federal tax purposes, and the owner and non-owner are treated, respectively, as the borrower and the lender, if—

(A) The payment is made either directly or indirectly by the non-owner to the owner (including a premium payment made by the non-owner directly or indirectly to the insurance company with respect to the policy held by the owner);

(B) The payment is a loan under general principles of Federal tax law or, if it is not a loan under general principles of Federal tax law (for example, because of the nonrecourse nature of the obligation or otherwise), a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest); and

(C) The repayment is to be made from, or is secured by, the policy's death benefit proceeds, the policy's cash surrender value, or both.

(ii) *Payments that are only partially repayable.* For purposes of § 1.61–22 and this section, if a non-owner makes a payment pursuant to a split-dollar life insurance arrangement and the non-owner is entitled to repayment of some but not all of the payment, the payment is treated as two payments: One that is repayable and one that is not. Thus, paragraph (a)(2)(i) of this section refers to the repayable payment.

(iii) *Treatment of payments that are not split-dollar loans. See* § 1.61–22(b)(5) for the treatment of payments by a non-owner that are not split-dollar loans.

(iv) *Examples.* The provisions of this paragraph (a)(2) are illustrated by the following examples:

Example 1. Assume an employee owns a life insurance policy under a split-dollar life insurance arrangement, the employer makes premium payments on this policy, there is a reasonable expectation that the payments will be repaid, and the repayments are secured by the policy. Under paragraph (a)(2)(i) of this section, each premium payment is a loan for Federal tax purposes.

Example 2. (i) Assume an employee owns a life insurance policy under a split-dollar life insurance arrangement and the employer makes premium payments on this policy. The employer is entitled to be repaid 80 percent of each premium payment, and the repayments are secured by the policy. Under paragraph (a)(2)(ii) of this section, the taxation of 20 percent of each premium payment is governed by § 1.61–22(b)(5). If there is a reasonable expectation that the remaining 80 percent of a payment will be repaid in full, then, under paragraph (a)(2)(i) of this section, the 80 percent is a loan for Federal tax purposes.

(ii) If less than 80 percent of a premium payment is reasonably expected to be repaid, then this paragraph (a)(2) does not cause any of the payment to be a loan for Federal tax purposes. If the payment is not a loan under general principles of Federal tax law, the taxation of the entire premium payment is governed by § 1.61–22(b)(5).

(3) *No de minimis exceptions.* For purposes of this section, section 7872 is applied to a split-dollar loan without regard to the *de minimis* exceptions in section 7872(c)(2) and (3).

(4) *Certain interest provisions disregarded*—(i) *In general.* If a split-dollar loan provides for the payment of interest and all or a portion of the interest is to be paid directly or indirectly by the lender (or a person related to the lender), then the requirement to pay the interest (or portion thereof) is disregarded for purposes of this section. All of the facts and circumstances determine whether a payment to be made by the lender (or a person related to the lender) is sufficiently independent from the split-dollar loan for the payment to not be an indirect payment of the interest (or a portion thereof) by the lender (or a person related to the lender).

(ii) *Examples.* The provisions of this paragraph (a)(4) are illustrated by the following examples:

Example 1. (i) On January 1, 2009, Employee *B* issues a split-dollar term loan to Employer *Y*. The split-dollar term loan provides for five percent interest, compounded annually.

Interest and principal on the split-dollar term loan are due at maturity. On January 1, 2009, *B* and *Y* also enter into a fully vested non-qualified deferred compensation arrangement that will provide a payment to *B* in an amount equal to the accrued but unpaid interest due at the maturity of the split-dollar term loan.

(ii) Under paragraph (a)(4)(i) of this section, *B*'s requirement to pay interest on the split-dollar term loan is disregarded for purposes of this section, and the split-dollar term loan is treated as a loan that does not provide for interest for purposes of this section.

Example 2. (i) On January 1, 2004, Employee *B* and Employer *Y* enter into a fully vested non-qualified deferred compensation arrangement that will provide a payment to *B* equal to *B*'s salary in the three years preceding the retirement of *B*. On January 1, 2009, *B* and *Y* enter into a split-dollar life insurance arrangement and, under the arrangement, *B* issues a split-dollar term loan to *Y* on that date. The split-dollar term loan provides for five percent interest, compounded annually. Interest and principal on the split-dollar term loan are due at maturity. Over the period in which the non-qualified deferred compensation arrangement is effective, the terms and conditions of *B*'s non-qualified deferred compensation arrangement do not change in a way that indicates that the payment of the non-qualified deferred compensation is related to *B*'s requirement to pay interest on the split-dollar term loan. No other facts and circumstances exist to indicate that the payment of the non-qualified deferred compensation is related to *B*'s requirement to pay interest on the split-dollar term loan.

(ii) The facts and circumstances indicate that the payment by *Y* of non-qualified deferred compensation is independent from *B*'s requirement to pay interest under the split-dollar term loan. Under paragraph (a)(4)(i) of this section, the fully vested non-qualified deferred compensation does not cause *B*'s requirement to pay interest on the split-dollar term loan to be disregarded for purposes of this section. For purposes of this section, the split-dollar term loan is treated as a loan that provides for stated interest of five percent, compounded annually.

(b) *Definitions.* For purposes of this section, the terms *split-dollar life insurance arrangement*, *owner*, and *non-owner* have the same meanings as provided in §1.61–22(b) and (c). In addition, the following definitions apply for purposes of this section:

(1) A *split-dollar loan* is a loan described in paragraph (a)(2)(i) of this section.

(2) A *split-dollar demand loan* is any split-dollar loan that is payable in full at any time on the demand of the lender (or within a reasonable time after the lender's demand).

(3) A *split-dollar term loan* is any split-dollar loan other than a split-dollar demand loan. See paragraph (e)(5) of this section for special rules regarding certain split-dollar term loans payable on the death of an individual, certain split-dollar term loans conditioned on the future performance of substantial services by an individual, and gift split-dollar term loans.

(c) *Interest deductions for split-dollar loans.* The borrower may not deduct any qualified stated interest, OID, or imputed interest on a split-dollar loan. *See* sections 163(h) and 264(a). In certain circumstances, an indirect participant may be allowed to deduct qualified stated interest, OID, or imputed interest on a deemed loan. See paragraph (e)(2)(iii) of this section (relating to indirect loans).

(d) *Treatment of split-dollar loans providing for nonrecourse payments*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, if a payment on a split-dollar loan is nonrecourse to the borrower, the payment is a contingent payment for purposes of this section. *See* paragraph (j) of this section for the treatment of a split-dollar loan that provides for one or more contingent payments.

(2) *Exception for certain loans with respect to which the parties to the split-dollar life insurance arrangement make a representation*—(i) *Requirement.* An otherwise noncontingent payment on a split-dollar loan that is nonrecourse to the borrower is not a contingent payment under this section if the parties to the split-dollar life insurance arrangement represent in writing that a reasonable person would expect that all payments under the loan will be made.

(ii) *Time and manner for providing written representation.* The Commissioner may prescribe the time and manner for providing the written representation required by paragraph (d)(2)(i) of this section. Until the Commissioner prescribes otherwise, the written representation that is required by paragraph (d)(2)(i) of this section must meet the requirements of this paragraph (d)(2)(ii). Both the borrower and the lender must sign the representation not later than the last day (including extensions) for filing the Federal income tax return of the borrower or lender, whichever is earlier, for the taxable year in which the lender makes the first split-dollar loan under the split-dollar life insurance arrangement. This representation must include the names, addresses, and taxpayer identification numbers of the borrower, lender, and any indirect participants. Unless otherwise stated therein, this representation applies to all subsequent split-dollar loans made pursuant to the split-dollar life insurance arrangement. Each party should retain an original of the representation as part of its books and records and should attach a copy of this representation to its Federal income tax return for any taxable year in which the lender makes a loan to which the representation applies.

(e) *Below-market split-dollar loans*—(1) *Scope*—(i) *In general.* This paragraph (e) applies to below-market split-dollar loans enumerated under section 7872(c)(1), which include gift loans, compensation-related loans, and corporation-shareholder loans. The characterization of a split-dollar loan under section 7872(c)(1) and of the imputed transfers under section 7872(a)(1) and (b)(1) depends upon the relationship between the lender and the borrower or the lender, borrower, and any indirect participant. For example, if the lender is the borrower's employer, the split-dollar loan is generally a compensation-related loan, and any imputed transfer from the lender to the borrower is generally a payment of compensation. The loans covered by this paragraph (e) include indirect loans between the parties. *See* paragraph (e)(2) of this section for the treatment of certain indirect split-dollar loans. *See* paragraph (f) of this section for the treatment of any stated interest or OID on split-dollar loans. *See* paragraph (j) of this section for additional rules that apply to a split-dollar loan that provides for one or more contingent payments.

(ii) *Significant-effect split-dollar loans.* If a direct or indirect below-market split-dollar loan is not enumerated in section 7872(c)(1)(A), (B), or (C), the loan is a significant-effect loan under section 7872(c)(1)(E).

(2) *Indirect split-dollar loans*—(i) *In general.* If, based on all the facts and circumstances, including the relationship between the borrower or lender and some third person (the indirect participant), the effect of a below-market split-dollar loan is to transfer value from the lender to the indirect participant and from the indirect participant to the borrower, then the below-market split-dollar loan is restructured as two or more successive below-market loans (the deemed loans) as provided in this paragraph (e)(2). The transfers of value described in the preceding sentence include (but are not limited to) a gift, compensation, a capital contribution, and a distribution under section 301 (or, in the case of an S corporation, under section 1368). The deemed loans are—

(A) A deemed below-market split-dollar loan made by the lender to the indirect participant; and

(B) A deemed below-market split-dollar loan made by the indirect participant to the borrower.

(ii) *Application.* Each deemed loan is treated as having the same provisions as the original loan between the lender and borrower, and section 7872 is applied to each deemed loan. Thus, for example, if, under a split-dollar life insurance arrangement, an employer (lender) makes an interest-free split-dollar loan to an employee's child (borrower), the loan is restructured as a deemed compensation-related below-market split-dollar loan from the lender to the employee (the indirect participant) and a second deemed gift below-market split-dollar loan from the employee to the employee's child. In appropriate circumstances, section 7872(d)(1) may limit the interest that accrues on a deemed loan for Federal income tax purposes. For loan arrangements between husband and wife, *see* section 7872(f)(7).

(iii) *Limitations on investment interest for purposes of section 163(d).* For purposes of section 163(d), the imputed interest from the indirect participant to the lender that is taken into account by the indirect participant under this paragraph (e)(2) is not investment interest to the extent of the excess, if any, of—

(A) The imputed interest from the indirect participant to the lender that is taken into account by the indirect participant; over

(B) The imputed interest to the indirect participant from the borrower that is recognized by the indirect participant.

(iv) *Examples*. The provisions of this paragraph (e)(2) are illustrated by the following examples:

Example 1. (i) On January 1, 2009, Employer *X* and Individual *A* enter into a split-dollar life insurance arrangement under which *A* is named as the policy owner. *A* is the child of *B*, an employee of *X*. On January 1, 2009, *X* makes a $30,000 premium payment, repayable upon demand without interest. Repayment of the premium payment is fully recourse to *A*. The payment is a below-market split-dollar demand loan. *A*'s net investment income for 2009 is $1,100, and there are no other outstanding loans between *A* and *B*. Assume that the blended annual rate for 2009 is 5 percent, compounded annually.

(ii) Based on the relationships among the parties, the effect of the below-market split-dollar loan from *X* to *A* is to transfer value from *X* to *B* and then to transfer value from *B* to *A*. Under paragraph (e)(2) of this section, the below-market split-dollar loan from *X* to *A* is restructured as two deemed below-market split-dollar demand loans: a compensation-related below-market split-dollar loan between *X* and *B* and a gift below-market split-dollar loan between *B* and *A*. Each of the deemed loans has the same terms and conditions as the original loan.

(iii) Under paragraph (e)(3) of this section, the amount of forgone interest deemed paid to *B* by *A* in 2009 is $1,500 ([$30,000 × 0.05]—0). Under section 7872(d)(1), however, the amount of forgone interest deemed paid to *B* by *A* is limited to $1,100 (*A*'s net investment income for the year). Under paragraph (e)(2)(iii) of this section, *B*'s deduction under section 163(d) in 2009 for interest deemed paid on *B*'s deemed loan from *X* is limited to $1,100 (the interest deemed received from *A*).

Example 2. (i) The facts are the same as the facts in *Example 1*, except that *T*, an irrevocable life insurance trust established for the benefit of *A* (*B*'s child), is named as the policy owner. *T* is not a grantor trust.

(ii) Based on the relationships among the parties, the effect of the below-market split-dollar loan from *X* to *T* is to transfer value from *X* to *B* and then to transfer value from *B* to *T*. Under paragraph (e)(2) of this section, the below-market split-dollar loan from *X* to *T* is restructured as two deemed below-market split-dollar demand loans: a compensation-related below-market split-dollar loan between *X* and *B* and a gift below-market split-dollar loan between *B* and *T*. Each of the deemed loans has the same terms and conditions as the original loan.

(iii) Under paragraph (e)(3) of this section, the amount of forgone interest deemed paid to *B* by *T* in 2009 is $1,500 ([$30,000 × 0.05]—0). Section 7872(d)(1) does not apply because *T* is not an individual. The amount of forgone interest deemed paid to *B* by *T* is $1,500. Under paragraph (e)(2)(iii) of this section, *B*'s deduction under section 163(d) in 2009 for interest deemed paid on *B*'s deemed loan from *X* is $1,500 (the interest deemed received from *T*).

(3) *Split-dollar demand loans*—(i) *In general*. This paragraph (e)(3) provides rules for testing split-dollar demand loans for sufficient interest, and, if the loans do not provide for sufficient interest, rules for the calculation and treatment of forgone interest on these loans. *See* paragraph (g) of this section for additional rules that apply to a split-dollar loan providing for certain variable rates of interest.

(ii) *Testing for sufficient interest*. Each calendar year that a split-dollar demand loan is outstanding, the loan is tested to determine if the loan provides for sufficient interest. A split-dollar demand loan provides for sufficient interest for the calendar year if the rate (based on annual compounding) at which interest accrues on the loan's adjusted issue price during the year is no lower than the blended annual rate for the year. (The Internal Revenue Service publishes the blended annual rate in the Internal Revenue Bulletin in July of each year (*see* § 601.601(d)(2)(ii) of this chapter).) If the loan does not provide for sufficient interest, the loan is a below-market split-dollar demand loan for that calendar year. *See* paragraph (e)(3)(iii) of this section to determine the amount and treatment of forgone interest for each calendar year the loan is below-market.

(iii) *Imputations*—(A) *Amount of forgone interest*. For each calendar year, the amount of forgone interest on a split-dollar demand loan is treated as transferred by the lender to the borrower and as retransferred as interest by the borrower to the lender. This amount is the excess of—

(*1*) The amount of interest that would have been payable on the loan for the calendar year if interest accrued on the loan's adjusted issue price at the blended annual rate (determined in paragraph (e)(3)(ii) of this section) and were payable annually on the day referred to in paragraph (e)(3)(iii)(B) of this section; over

(*2*) Any interest that accrues on the loan during the year.

(B) *Timing of transfers of forgone interest*—(*1*) *In general.* Except as provided in paragraphs (e)(3)(iii)(B)(*2*) and (*3*) of this section, the forgone interest (as determined under paragraph (e)(3)(iii)(A) of this section) that is attributable to a calendar year is treated as transferred by the lender to the borrower (and retransferred as interest by the borrower to the lender) on the last day of the calendar year and is accounted for by each party to the split-dollar loan in a manner consistent with that party's method of accounting.

(*2*) *Exception for death, liquidation, or termination of the borrower.* In the taxable year in which the borrower dies (in the case of a borrower who is a natural person) or is liquidated or otherwise terminated (in the case of a borrower other than a natural person), any forgone interest is treated, for both the lender and the borrower, as transferred and retransferred on the last day of the borrower's final taxable year.

(3) *Exception for repayment of below-market split-dollar loan.* Any forgone interest is treated, for both the lender and the borrower, as transferred and retransferred on the day the split-dollar loan is repaid in full.

(4) *Split-dollar term loans*—(i) *In general.* Except as provided in paragraph (e)(5) of this section, this paragraph (e)(4) provides rules for testing split-dollar term loans for sufficient interest and, if the loans do not provide for sufficient interest, rules for imputing payments on these loans. *See* paragraph (g) of this section for additional rules that apply to a split-dollar loan providing for certain variable rates of interest.

(ii) *Testing a split-dollar term loan for sufficient interest.* A split-dollar term loan is tested on the day the loan is made to determine if the loan provides for sufficient interest. A split-dollar term loan provides for sufficient interest if the imputed loan amount equals or exceeds the amount loaned. The imputed loan amount is the present value of all payments due under the loan, determined as of the date the loan is made, using a discount rate equal to the AFR in effect on that date. The AFR used for purposes of the preceding sentence must be appropriate for the loan's term (short-term, mid-term, or long-term) and for the compounding period used in computing the present value. *See* section 1274(d)(1). If the split-dollar loan does not provide for sufficient interest, the loan is a below-market split-dollar term loan subject to paragraph (e)(4)(iv) of this section.

(iii) *Determining loan term.* This paragraph (e)(4)(iii) provides rules to determine the term of a split-dollar term loan for purposes of paragraph (e)(4)(ii) of this section. The term of the loan determined under this paragraph (e)(4)(iii) (other than paragraph (e)(4)(iii)(C) of this section) applies to determine the split-dollar loan's term, payment schedule, and yield for all purposes of this section.

(A) *In general.* Except as provided in paragraph (e)(4)(iii)(B), (C), (D) or (E) of this section, the term of a split-dollar term loan is based on the period from the date the loan is made until the loan's stated maturity date.

(B) *Special rules for certain options*—(*1*) *Payment schedule that minimizes yield.* If a split-dollar term loan is subject to one or more unconditional options that are exercisable at one or more times during the term of the loan and that, if exercised, require payments to be made on the split-dollar loan on an alternative payment schedule (for example, an option to extend or an option to call a split-dollar loan), then the rules of this paragraph (e)(4)(iii)(B)(*1*) determine the term of the loan. However, this paragraph (e)(4)(iii)(B)(*1*) applies only if the timing and amounts of the payments that comprise each payment schedule are known as of the issue date. For purposes of determining a split-dollar loan's term, the borrower is projected to exercise or not exercise an option or combination of options in a manner that minimizes the loan's overall yield. Similarly, the lender is projected to exercise or not exercise an option or combination of options in a manner that minimizes the loan's overall yield. If different projected patterns of exercise or non-exercise produce the same minimum yield, the parties are projected to exercise or not exercise an option or combination of options in a manner that produces the longest term.

(*2*) *Change in circumstances.* If the borrower (or lender) does or does not exercise the option as projected under paragraph (e)(4)(iii)(B)(*1*) of this section, the split-dollar loan is treated for purposes of this section as retired and reissued on the date the option is or is not exercised for an amount of cash equal to the loan's adjusted issue price on that date. The reissued loan must be retested using the appropriate AFR in effect on the date of reissuance to determine whether it is a below-market loan.

(*3*) *Examples.* The following examples illustrate the rules of this paragraph (e)(4)(iii)(B):

Example 1. Employee *B* issues a 10-year split-dollar term loan to Employer *Y*. *B* has the right to prepay the loan at the end of year 5. Interest is payable on the split-dollar loan at 1 percent for the first 5 years and at 10 percent for the remaining 5 years. Under paragraph (e)(4)(iii)(B)(*1*) of this section, this arrangement is treated as a 5-year split-dollar term loan from *Y* to *B*, with interest payable at 1 percent.

Example 2. The facts are the same as the facts in *Example 1*, except that B does not in fact prepay the split-dollar loan at the end of year 5. Under paragraph (e)(4)(iii)(B)(*2*) of this section, the first loan is treated as retired at the end of year 5 and a new 5-year split-dollar term loan is issued at that time, with interest payable at 10 percent.

Example 3. Employee *A* issues a 10-year split-dollar term loan on which the lender, Employer *X*, has the right to demand payment at the end of year 2. Interest is payable on the split-dollar loan at 7 percent each year that the loan is outstanding. Under paragraph (e)(4)(iii)(B)(*1*) of this section, this arrangement is treated as a 10-year split-dollar term loan because the exercise of *X*'s put option would not reduce the yield of the loan (the yield of the loan is 7 percent, compounded annually, whether or not *X* demands payment).

(C) *Split-dollar term loans providing for certain variable rates of interest.* If a split-dollar term loan is subject to paragraph (g) of this section (a split-dollar loan that provides for certain variable rates of interest), the term of the loan for purposes of paragraph (e)(4)(ii) of this section is determined under paragraph (g)(3)(ii) of this section.

(D) *Split-dollar loans payable upon the death of an individual.* If a split-dollar term loan is described in paragraph (e)(5)(ii)(A) or (v)(A) of this section, the term of the loan for purposes of paragraph (e)(4)(ii) of this section is determined under paragraph (e)(5)(ii)(C) or (v)(B)(*2*) of this section, whichever is applicable.

(E) *Split-dollar loans conditioned on the future performance of substantial services by an individual.* If a split-dollar term loan is described in paragraph (e)(5)(iii)(A)(*1*) or (v)(A) of this section, the term of the loan for purposes of paragraph (e)(4)(ii) of this section is determined under paragraph (e)(5)(iii)(C) or (v)(B)(*2*) of this section, whichever is applicable.

(iv) *Timing and amount of imputed transfer in connection with below-market split-dollar term loans.* If a split-dollar term loan is a below-market loan, then the rules applicable to below-market term loans under section 7872 apply. In general, the loan is recharacterized as consisting of two portions: an imputed loan amount (as defined in paragraph (e)(4)(ii) of this section) and an imputed transfer from the lender to the borrower. The imputed transfer occurs at the time the loan is made (for example, when the lender makes a premium payment on a life insurance policy) and is equal to the excess of the amount loaned over the imputed loan amount.

(v) *Amount treated as OID.* In the case of any below-market split-dollar term loan described in this paragraph (e)(4), for purposes of applying sections 1271 through 1275 and the regulations thereunder, the issue price of the loan is the amount determined under §1.1273–2, reduced by the amount of the imputed transfer described in paragraph (e)(4)(iv) of this section. Thus, the loan is generally treated as having OID in an amount equal to the amount of the imputed transfer described in paragraph (e)(4)(iv) of this section, in addition to any other OID on the loan (determined without regard to section 7872(b)(2)(A) or this paragraph (e)(4)).

(vi) *Example.* The provisions of this paragraph (e)(4) are illustrated by the following example:

Example. (i) On July 1, 2009, Corporation *Z* and Shareholder *A* enter into a split-dollar life insurance arrangement under which *A* is named as the policy owner. On July 1, 2009, *Z* makes a $100,000 premium payment, repayable without interest in 15 years. Repayment of the premium payment is fully recourse to *A*. The premium payment is a split-dollar term loan. Assume the long-term AFR (based on annual compounding) at the time the loan is made is 7 percent.

(ii) Based on a 15-year term and a discount rate of 7 percent, compounded annually (the long-term AFR), the present value of the payments under the loan is $36,244.60, determined as follows: $\$100{,}000/[1+(0.07/1)]^{15}$. This loan is a below-market split-dollar term loan because the imputed loan amount of $36,244.60 (the present value of the amount required to be repaid to *Z*) is less than the amount loaned ($100,000).

(iii) In accordance with section 7872(b)(1) and paragraph (e)(4)(iv) of this section, on the date that the loan is made, *Z* is treated as transferring to *A* $63,755.40 (the excess of $100,000 (amount loaned) over $36,244.60 (imputed loan amount)). Under section 7872 and paragraph (e)(1)(i) of this section, *Z* is treated as making a section 301 distribution to *A* on July 1, 2009, of $63,755.40. *Z* must take into account as OID an amount equal to the imputed transfer. See §1.1272–1 for the treatment of OID.

(5) *Special rules for certain split-dollar term loans*—(i) *In general.* This paragraph (e)(5) provides rules for split-dollar loans payable on the death of an individual, split-dollar loans conditioned on the future performance of substantial services by an individual, and gift term loans. These split-dollar loans are split-dollar term loans for purposes of determining whether the loan provides for sufficient interest. If, however, the loan is a below-market split-dollar loan, then, except as provided in paragraph (e)(5)(v) of this section, forgone interest is determined annually, similar to a demand loan, but using an AFR that is appropriate for the loan's term and that is determined when the loan is issued.

(ii) *Split-dollar loans payable not later than the death of an individual*—(A) *Applicability.* This paragraph (e)(5)(ii) applies to a split-dollar term loan payable not later than the death of an individual.

(B) *Treatment of loan.* A split-dollar loan described in paragraph (e)(5)(ii)(A) of this section is tested under paragraph (e)(4)(ii) of this section to determine if the loan provides for sufficient interest. If the loan provides for sufficient interest, then section 7872 does not apply to the loan, and the interest on the loan is taken into account under paragraph (f) of this section. If the loan does not provide for sufficient interest, then section 7872 applies to the loan, and the loan is treated as a below-market demand loan subject to paragraph (e)(3)(iii) of this section. For each year that the loan is outstanding, however, the rate used in the determination of forgone interest under paragraph (e)(3)(iii) of this section is not the blended annual rate but rather is the AFR (based on annual compounding) appropriate for the loan's term as of the month in which the loan is made. *See* paragraph (e)(5)(ii)(C) of this section to determine the loan's term.

(C) *Term of loan.* For purposes of paragraph (e)(5)(ii)(B) of this section, the term of a split-dollar loan payable on the death of an individual (including the death of the last survivor of a group of individuals) is the individual's life expectancy as determined under the appropriate table in §1.72–9 on the day the loan is made. If a split-dollar loan is payable on the earlier of the individual's death or another term determined under paragraph (e)(4)(iii) of this section, the term of the loan is whichever term is shorter.

(D) *Retirement and reissuance of loan.* If a split-dollar loan described in paragraph (e)(5)(ii)(A) of this section remains outstanding longer than the term determined under paragraph (e)(5)(ii)(C) of this section because the individual outlived his or her life expectancy, the split-dollar loan is treated for purposes of this section as retired and reissued as a split-dollar demand loan at that time for an amount of cash equal to the loan's adjusted issue price on that date. However, the loan is not retested at that time to determine whether the loan provides for sufficient interest. For purposes of determining forgone interest under paragraph (e)(5)(ii)(B) of this section, the appropriate AFR for the reissued loan is the AFR determined under paragraph (e)(5)(ii)(B) of this section on the day the loan was originally made.

(iii) *Split-dollar loans conditioned on the future performance of substantial services by an individual*—(A) *Applicability*—(*1*) *In general*. This paragraph (e)(5)(iii) applies to a split-dollar term loan if the benefits of the interest arrangements of the loan are not transferable and are conditioned on the future performance of substantial services (within the meaning of section 83) by an individual.

(*2*) *Exception*. Notwithstanding paragraph (e)(5)(iii)(A)(*1*) of this section, this paragraph (e)(5)(iii) does not apply to a split-dollar loan described in paragraph (e)(5)(v)(A) of this section (regarding a split-dollar loan that is payable on the later of a term certain and the date on which the condition to perform substantial future services by an individual ends).

(B) *Treatment of loan*. A split-dollar loan described in paragraph (e)(5)(iii)(A)(*1*) of this section is tested under paragraph (e)(4)(ii) of this section to determine if the loan provides for sufficient interest. Except as provided in paragraph (e)(5)(iii)(D) of this section, if the loan provides for sufficient interest, then section 7872 does not apply to the loan and the interest on the loan is taken into account under paragraph (f) of this section. If the loan does not provide for sufficient interest, then section 7872 applies to the loan and the loan is treated as a below-market demand loan subject to paragraph (e)(3)(iii) of this section. For each year that the loan is outstanding, however, the rate used in the determination of forgone interest under paragraph (e)(3)(iii) of this section is not the blended annual rate but rather is the AFR (based on annual compounding) appropriate for the loan's term as of the month in which the loan is made. *See* paragraph (e)(5)(iii)(C) of this section to determine the loan's term.

(C) *Term of loan*. The term of a split-dollar loan described in paragraph (e)(5)(iii)(A)(*1*) of this section is based on the period from the date the loan is made until the loan's stated maturity date. However, if a split-dollar loan described in paragraph (e)(5)(iii)(A)(*1*) of this section does not have a stated maturity date, the term of the loan is presumed to be seven years.

(D) *Retirement and reissuance of loan*. If a split-dollar loan described in paragraph (e)(5)(iii)(A)(*1*) of this section remains outstanding longer than the term determined under paragraph (e)(5)(iii)(C) of this section because of the continued performance of substantial services, the split-dollar loan is treated for purposes of this section as retired and reissued as a split-dollar demand loan at that time for an amount of cash equal to the loan's adjusted issue price on that date. The loan is retested at that time to determine whether the loan provides for sufficient interest.

(iv) *Gift split-dollar term loans*—(A) *Applicability*. This paragraph (e)(5)(iv) applies to gift split-dollar term loans.

(B) *Treatment of loan*. A split-dollar loan described in paragraph (e)(5)(iv)(A) of this section is tested under paragraph (e)(4)(ii) of this section to determine if the loan provides for sufficient interest. If the loan provides for sufficient interest, then section 7872 does not apply to the loan and the interest on the loan is taken into account under paragraph (f) of this section. If the loan does not provide for sufficient interest, then section 7872 applies to the loan and the loan is treated as a below-market demand loan subject to paragraph (e)(3)(iii) of this section. For each year that the loan is outstanding, however, the rate used in the determination of forgone interest under paragraph (e)(3)(iii) of this section is not the blended annual rate but rather is the AFR (based on annual compounding) appropriate for the loan's term as of the month in which the loan is made. *See* paragraph (e)(5)(iv)(C) of this section to determine the loan's term.

(C) *Term of loan*. For purposes of paragraph (e)(5)(iv)(B) of this section, the term of a gift split-dollar term loan is the term determined under paragraph (e)(4)(iii) of this section.

(D) *Limited application for gift split-dollar term loans*. The rules of paragraph (e)(5)(iv)(B) of this section apply to a gift split-dollar term loan only for Federal income tax purposes. For purposes of Chapter 12 of the Internal Revenue Code (relating to the gift tax), gift below-market split-dollar term loans are treated as term loans under section 7872(b) and paragraph (e)(4) of this section. *See* section 7872(d)(2).

(v) *Split-dollar loans payable on the later of a term certain and another specified date*—(A) *Applicability*. This paragraph (e)(5)(v) applies to any split-dollar term loan payable upon the later of a term certain or—

(*1*) The death of an individual; or

(*2*) For a loan described in paragraph (e)(5)(iii)(A)(*1*) of this section, the date on which the condition to perform substantial future services by an individual ends.

(B) *Treatment of loan*—(*1*) *In general*. A split-dollar loan described in paragraph (e)(5)(v)(A) of this section is a split-dollar term loan, subject to paragraph (e)(4) of this section.

(*2*) *Term of the loan*. The term of a split-dollar loan described in paragraph (e)(5)(v)(A) of this section is the term certain.

(*3*) *Appropriate AFR*. The appropriate AFR for a split-dollar loan described in paragraph (e)(5)(v)(A) of this section is based on a term of the longer of the term certain or the loan's expected term as determined under either paragraph (e)(5) (ii) or (iii) of this section, whichever is applicable.

(C) *Retirement and reissuance*. If a split-dollar loan described in paragraph (e)(5)(v)(A) of this section remains outstanding longer than the term certain, the split-dollar loan is treated for purposes of this section as retired and reissued at the end of the term certain for an amount of cash equal to the loan's adjusted issue price on that date. The reissued loan is subject to paragraph (e)(5) (ii) or (iii) of this section, whichever is applicable. However, the loan is not retested at that time to determine whether the loan provides for sufficient interest. For purposes of paragraph (e)(3)(iii) of this section, the appropriate AFR for the reissued loan is the AFR determined under paragraph (e)(5)(v)(B)(*3*) of this section on the day the loan was originally made.

(vi) *Example*. The provisions of this paragraph (e)(5) are illustrated by the following example:

Example. (i) On January 1, 2009, Corporation *Y* and Shareholder *B*, a 65 year-old male, enter into a split-dollar life insurance arrangement under which *B* is named as the policy owner. On January 1, 2009, *Y* makes a $100,000 premium payment, repayable, without interest, from the death benefits of the underlying contract upon *B*'s death. The premium payment is a split-dollar term loan. Repayment of the premium payment is fully recourse to *B*. Assume the long-term AFR (based on annual compounding) at the time of the loan is 7 percent. Both *Y* and *B* use the calendar year as their taxable years.

(ii) Based on Table 1 in §1.72–9, the expected term of the loan is 15 years. Under paragraph (e)(5)(ii)(C) of this section, the long-term AFR (based on annual compounding) is the appropriate test rate. Based on a 15-year term and a discount rate of 7 percent, compounded annually (the long-term AFR), the present value of the payments under the loan is $36,244.60, determined as follows: $\$100{,}000/[1+(0.07/1)]^{15}$. Under paragraph (e)(5)(ii)(B) of this section, this loan is a below-market split-dollar term loan because the imputed loan amount of $36,244.60 (the present value of the amount required to be repaid to *Y*) is less than the amount loaned ($100,000).

(iii) Under paragraph (e)(5)(ii)(B) of this section, the amount of forgone interest for 2009 (and each subsequent full calendar year that the loan remains outstanding) is $7,000, which is the amount of interest that would have been payable on the loan for the calendar year if interest accrued on the loan's adjusted issue price ($100,000) at the long-term AFR (7 percent, compounded annually). Under section 7872 and paragraph (e)(1)(i) of this section, on December 31, 2009, *Y* is treated as making a section 301 distribution to *B* of $7,000. In addition, *Y* has $7,000 of imputed interest income for 2009.

(f) *Treatment of stated interest and OID for split-dollar loans*—(1) *In general*. If a split-dollar loan provides for stated interest or OID, the loan is subject to this paragraph (f), regardless of whether the split-dollar loan has sufficient interest. Except as otherwise provided in this section, split-dollar loans are subject to the same Internal Revenue Code and regulatory provisions for stated interest and OID as other loans. For example, the lender of a split-dollar loan that provides for stated interest must account for any qualified stated interest (as defined in §1.1273–1(c)) under its regular method of accounting (for example, an accrual method or the cash receipts and disbursements method). *See* §1.446–2 to determine the amount of qualified stated interest that accrues during an accrual period. In addition, the lender must account under §1.1272–1 for any OID on a split-dollar loan. However, §1.1272–1(c) does not apply to any split-dollar loan. *See* paragraph (h) of this section for a subsequent waiver, cancellation, or forgiveness of stated interest on a split-dollar loan.

(2) *Term, payment schedule, and yield.* The term of a split-dollar term loan determined under paragraph (e)(4)(iii) of this section (other than paragraph (e)(4)(iii)(C) of this section) applies to determine the split-dollar loan's term, payment schedule, and yield for all purposes of this section.

(g) *Certain variable rates of interest*—(1) *In general.* This paragraph (g) provides rules for a split-dollar loan that provides for certain variable rates of interest. If this paragraph (g) does not apply to a variable rate split-dollar loan, the loan is subject to the rules in paragraph (j) of this section for split-dollar loans that provide for one or more contingent payments.

(2) *Applicability*—(i) *In general.* Except as provided in paragraph (g)(2)(ii) of this section, this paragraph (g) applies to a split-dollar loan that is a variable rate debt instrument (within the meaning of §1.1275–5) and that provides for stated interest at a qualified floating rate (or rates).

(ii) *Interest rate restrictions.* This paragraph (g) does not apply to a split-dollar loan if, as a result of interest rate restrictions (such as an interest rate cap), the expected yield of the loan taking the restrictions into account is significantly less than the expected yield of the loan without regard to the restrictions. Conversely, if reasonably symmetric interest rate caps and floors or reasonably symmetric governors are fixed throughout the term of the loan, these restrictions generally do not prevent this paragraph (g) from applying to the loan.

(3) *Testing for sufficient interest*—(i) *Demand loan.* For purposes of paragraph (e)(3)(ii) of this section (regarding testing a split-dollar demand loan for sufficient interest), a split-dollar demand loan is treated as if it provided for a fixed rate of interest for each accrual period to which a qualified floating rate applies. The projected fixed rate for each accrual period is the value of the qualified floating rate as of the beginning of the calendar year that contains the last day of the accrual period.

(ii) *Term loan.* For purposes of paragraph (e)(4)(ii) of this section (regarding testing a split-dollar term loan for sufficient interest), a split-dollar term loan subject to this paragraph (g) is treated as if it provided for a fixed rate of interest for each accrual period to which a qualified floating rate applies. The projected fixed rate for each accrual period is the value of the qualified floating rate on the date the split-dollar term loan is made. The term of a split-dollar loan that is subject to this paragraph (g)(3)(ii) is determined using the rules in §1.1274–4(c)(2). For example, if the loan provides for interest at a qualified floating rate that adjusts at varying intervals, the term of the loan is determined by reference to the longest interval between interest adjustment dates. *See* paragraph (e)(5) of this section for special rules relating to certain split-dollar term loans, such as a split-dollar term loan payable not later than the death of an individual.

(4) *Interest accruals and imputed transfers.* For purposes of paragraphs (e) and (f) of this section, the projected fixed rate or rates determined under paragraph (g)(3) of this section are used for purposes of determining the accrual of interest each period and the amount of any imputed transfers. Appropriate adjustments are made to the interest accruals and any imputed transfers to take into account any difference between the projected fixed rate and the actual rate.

(5) *Example.* The provisions of this paragraph (g) are illustrated by the following example:

Example. (i) On January 1, 2010, Employer *V* and Employee *F* enter into a split-dollar life insurance arrangement under which *F* is named as the policy owner. On January 1, 2010, *V* makes a $100,000 premium payment, repayable in 15 years. The premium payment is a split-dollar term loan. Under the arrangement between the parties, interest is payable on the split-dollar loan each year on January 1, starting January 1, 2011, at a rate equal to the value of 1-year LIBOR as of the payment date. The short-term AFR (based on annual compounding) at the time of the loan is 7 percent. Repayment of both the premium payment and the interest due thereon is nonrecourse to *F*. However, the parties made a representation under paragraph (d)(2) of this section. Assume that the value of 1-year LIBOR on January 1, 2010, is 8 percent, compounded annually.

(ii) The loan is subject to this paragraph (g) because the loan is a variable rate debt instrument that bears interest at a qualified floating rate. Because the interest rate is reset each year, under paragraph (g)(3)(ii) of this section, the short-term AFR (based on annual compounding) is the appropriate test rate used to determine whether the loan provides for sufficient interest. Moreover, under paragraph (g)(3)(ii) of this section, to determine whether the loan provides for sufficient interest, the loan is treated as if it provided for a fixed rate of interest equal to 8 percent, compounded annually. Based on a discount rate of 7 percent, compounded annually (the short-term AFR), the present value of the payments under the loan is $109,107.91. The loan provides for sufficient interest because the loan's imputed loan amount of $109,107.91 (the present value of the payments) is more than the amount loaned of $100,000. Therefore, the loan is not a below-market split-dollar term loan, and interest on the loan is taken into account under paragraph (f) of this section.

(h) *Adjustments for interest paid at less than the stated rate*—(1) *Application*—(i) *In general.* To the extent required by this paragraph (h), if accrued but unpaid interest on a split-dollar loan is subsequently waived, cancelled, or forgiven by the lender, then the waiver, cancellation, or forgiveness is treated as if, on that date, the interest had in fact been paid to the lender and retransferred by the lender to the borrower. The amount deemed transferred and retransferred is determined under paragraph (h) (2) or (3) of this section. Except as provided in paragraph (h)(1)(iv) of this section, the amount treated as retransferred by the lender to the borrower under paragraph (h) (2) or (3) of this section is increased by the deferral charge determined under paragraph (h)(4) of this section. To determine the character of any retransferred amount, *see* paragraph (e)(1)(i) of this section. *See* §1.61–22(b)(6) for the treatment of amounts other than interest on a split-dollar loan that are waived, cancelled, or forgiven by the lender.

(ii) *Certain split-dollar term loans.* For purposes of this paragraph (h), a split-dollar term loan described in paragraph (e)(5) of this section (for example, a split-dollar term loan payable not later than the death of an individual) is subject to the rules of paragraph (h)(3) of this section.

(iii) *Payments treated as a waiver, cancellation, or forgiveness.* For purposes of this paragraph (h), if a payment by the lender (or a person related to the lender) to the borrower is, in substance, a waiver, cancellation, or forgiveness of accrued but unpaid interest, the payment by the lender (or person related to the lender) is treated as an amount retransferred to the borrower by the lender under this paragraph (h) and is subject to the deferral charge in paragraph (h)(4) of this section to the extent that the payment is, in substance, a waiver, cancellation, or forgiveness of accrued but unpaid interest.

(iv) *Treatment of certain nonrecourse split-dollar loans.* For purposes of this paragraph (h), if the parties to a split-dollar life insurance arrangement make the representation described in paragraph (d)(2) of this section and the interest actually paid on the split-dollar loan is less than the interest required to be accrued on the split-dollar loan, the excess of the interest required to be accrued over the interest actually paid is treated as waived, cancelled, or forgiven by the lender under this paragraph (h). However, the amount treated as retransferred under paragraph (h)(1)(i) of this section is not increased by the deferral charge in paragraph (h)(4) of this section.

(2) *Split-dollar term loans.* In the case of a split-dollar term loan, the amount of interest deemed transferred and retransferred for purposes of paragraph (h)(1) of this section is determined as follows:

(i) If the loan's stated rate is less than or equal to the appropriate AFR (the AFR used to test the loan for sufficient interest under paragraph (e) of this section), the amount of interest deemed transferred and retransferred pursuant to this paragraph (h) is the excess of the amount of interest payable at the stated rate over the interest actually paid.

(ii) If the loan's stated rate is greater than the appropriate AFR (the AFR used to test the loan for sufficient interest under paragraph (e) of this section), the amount of interest deemed transferred and retransferred pursuant to this paragraph (h) is the excess, if any, of the amount of interest payable at the AFR over the interest actually paid.

(3) *Split-dollar demand loans.* In the case of a split-dollar demand loan, the amount of interest deemed transferred and retransferred for purposes of paragraph (h)(1) of this section is equal to the aggregate of—

(i) For each year that the split-dollar demand loan was outstanding in which the loan was a below-market split-dollar demand loan, the excess of the amount of interest payable at the stated rate over the interest actually paid allocable to that year; plus

(ii) For each year that the split-dollar demand loan was outstanding in which the loan was not a below-market split-dollar demand loan, the excess, if any, of the amount of interest payable at the appropriate rate used for purposes of imputation for that year over the interest actually paid allocable to that year.

(4) *Deferral charge.* The Commissioner may prescribe the method for determining the deferral charge treated as retransferred by the lender to the borrower under paragraph (h)(1) of this section. Until the Commissioner prescribes otherwise, the deferral charge is determined under paragraph (h)(4)(i) of this section for a split-dollar term loan subject to paragraph (h)(2) of this section and under paragraph (h)(4)(ii) of this section for a split-dollar demand loan subject to paragraph (h)(3) of this section.

(i) *Split-dollar term loan.* The deferral charge for a split-dollar term loan subject to paragraph (h)(2) of this section is determined by multiplying the hypothetical underpayment by the applicable underpayment rate, compounded daily, for the period from the date the split-dollar loan was made to the date the interest is waived, cancelled, or forgiven. The hypothetical underpayment is equal to the amount determined under paragraph (h)(2) of this section, multiplied by the highest rate of income tax applicable to the borrower (for example, the highest rate in effect under section 1 for individuals) for the taxable year in which the split-dollar term loan was made. The applicable underpayment rate is the average of the quarterly underpayment rates in effect under section 6621(a)(2) for the period from the date the split-dollar loan was made to the date the interest is waived, cancelled, or forgiven.

(ii) *Split-dollar demand loan.* The deferral charge for a split-dollar demand loan subject to paragraph (h)(3) of this section is the sum of the following amounts determined for each year the loan was outstanding (other than the year in which the waiver, cancellation, or forgiveness occurs): For each year the loan was outstanding, multiply the hypothetical underpayment for the year by the applicable underpayment rate, compounded daily, for the applicable period. The hypothetical underpayment is equal to the amount determined under paragraph (h)(3) of this section for each year, multiplied by the highest rate of income tax applicable to the borrower for that year (for example, the highest rate in effect under section 1 for individuals). The applicable underpayment rate is the average of the quarterly underpayment rates in effect under section 6621(a)(2) for the applicable period. The applicable period for a year is the period of time from the last day of that year until the date the interest is waived, cancelled, or forgiven.

(5) *Examples.* The provisions of this paragraph (h) are illustrated by the following examples:

Example 1. (i) On January 1, 2009, Employer *Y* and Employee *B* entered into a split-dollar life insurance arrangement under which *B* is named as the policy owner. On January 1, 2009, *Y* made a $100,000 premium payment, repayable on December 31, 2011, with interest of 5 percent, compounded annually. The premium payment is a split-dollar term loan. Assume the short-term AFR (based on annual compounding) at the time the loan was made was 5 percent. Repayment of both the premium payment and the interest due thereon was fully recourse to *B*. On December 31, 2011, *Y* is repaid $100,000 but *Y* waives the remainder due on the loan ($15,762.50). Both *Y* and *B* use the calendar year as their taxable years.

(ii) When the split-dollar term loan was made, the loan was not a below-market loan under paragraph (e)(4)(ii) of this section. Under paragraph (f) of this section, *Y* was required to accrue compound interest of 5 percent each year the loan remained outstanding. *B*, however, was not entitled to any deduction for this interest under paragraph (c) of this section.

(iii) Under paragraph (h)(1) of this section, the waived amount is treated as if, on December 31, 2011, it had in fact been paid to *Y* and was then retransferred by *Y* to *B*. The amount deemed transferred to *Y* and retransferred to *B* equals the excess of the amount of interest payable at the stated rate ($15,762.50) over the interest actually paid ($0), or $15,762.50. In addition, the amount deemed retransferred to *B* is increased by the deferral charge determined under paragraph (h)(4) of this section. Because of the employment relationship between *Y* and *B*, the total retransferred amount is treated as compensation paid by *Y* to *B*.

Example 2. (i) On January 1, 2009, Employer *Y* and Employee *B* entered into a split-dollar life insurance arrangement under which *B* is named as the policy owner. On January 1, 2009, *Y* made a $100,000 premium payment, repayable on the demand of *Y*, with interest of 7 percent, compounded annually. The premium payment is a split-dollar demand loan. Assume the blended annual rate (based on annual compounding) in 2009 was 5 percent and in 2010 was 6 percent. Repayment of both the premium payment and the interest due thereon was fully recourse to *B*. On December 31, 2010, *Y* demands repayment and is repaid its $100,000 premium payment in full; however, *Y* waives all interest due on the loan. Both *Y* and *B* use the calendar year as their taxable years.

(ii) For each year that the split-dollar demand loan was outstanding, the loan was not a below-market loan under paragraph (e)(3)(ii) of this section. Under paragraph (f) of this section, *Y* was required to accrue compound interest of 7 percent each year the loan remained outstanding. *B*, however, was not entitled to any deduction for this interest under paragraph (c) of this section.

(iii) Under paragraph (h)(1) of this section, a portion of the waived interest is treated as if, on December 31, 2010, it had in fact been paid to *Y* and was then retransferred by *Y* to *B*. The amount of interest deemed transferred to *Y* and retransferred to *B* equals the excess, if any, of the amount of interest payable at the blended annual rate for each year the loan is outstanding over the interest actually paid with respect to that year. For 2009, the interest payable at the blended annual rate is $5,000 ($100,000×0.05). For 2010, the interest payable at the blended annual rate is $6,000 ($100,000×0.06). Therefore, the amount of interest deemed transferred to *Y* and retransferred to *B* equals $11,000. In addition, the amount deemed retransferred to *B* is increased by the deferral charge determined under paragraph (h)(4) of this section. Because of the employment relationship between *Y* and *B*, the total retransferred amount is treated as compensation paid by *Y* to *B*.

(i) [Reserved]

(j) *Split-dollar loans that provide for contingent payments*—(1) *In general*. Except as provided in paragraph (j)(2) of this section, this paragraph (j) provides rules for a split-dollar loan that provides for one or more contingent payments. This paragraph (j), rather than §1.1275–4, applies to split-dollar loans that provide for one or more contingent payments.

(2) *Exceptions*—(i) *Certain contingencies*. For purposes of this section, a split-dollar loan does not provide for contingent payments merely because—

(A) The loan provides for options described in paragraph (e)(4)(iii)(B) of this section (for example, certain call options, put options, and options to extend); or

(B) The loan is described in paragraph (e)(5) of this section (relating to certain split-dollar term loans, such as a split-dollar term loan payable not later than the death of an individual).

(ii) *Insolvency and default*. For purposes of this section, a payment is not contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances. However, if any payment on a split-dollar loan is nonrecourse to the borrower, the payment is a contingent payment for purposes of this paragraph (j) unless the parties to the arrangement make the written representation provided for in paragraph (d)(2) of this section.

(iii) *Remote and incidental contingencies*. For purposes of this section, a payment is not a contingent payment merely because of a contingency that, as of the date the split-dollar loan is made, is either remote or incidental (within the meaning of §1.1275–2(h)).

(iv) *Exceptions for certain split-dollar loans*. This paragraph (j) does not apply to a split-dollar loan described in §1.1272–1(d) (certain debt instruments that provide for a fixed yield) or a split-dollar loan described in paragraph (g) of this section (relating to split-dollar loans providing for certain variable rates of interest).

(3) *Contingent split-dollar method*—(i) *In general*. If a split-dollar loan provides for one or more contingent payments, then the parties account for the

loan under the contingent split-dollar method. In general, except as provided in this paragraph (j), this method is the same as the noncontingent bond method described in §1.1275–4(b).

(ii) *Projected payment schedule*—(A) *Determination of schedule*. No comparable yield is required to be determined. The projected payment schedule for the loan includes all noncontingent payments and a projected payment for each contingent payment. The projected payment for a contingent payment is the lowest possible value of the payment. The projected payment schedule, however, must produce a yield that is not less than zero. If the projected payment schedule produces a negative yield, the schedule must be reasonably adjusted to produce a yield of zero.

(B) *Split-dollar term loans payable upon the death of an individual*. If a split-dollar term loan described in paragraph (e)(5)(ii)(A) or (v)(A)(*1*) of this section provides for one or more contingent payments, the projected payment schedule is determined based on the term of the loan as determined under paragraph (e)(5)(ii)(C) or (v)(B)(*2*) of this section, whichever is applicable.

(C) *Certain split-dollar term loans conditioned on the future performance of substantial services by an individual*. If a split-dollar term loan described in paragraph (e)(5)(iii)(A)(*1*) or (v)(A)(*2*) of this section provides for one or more contingent payments, the projected payment schedule is determined based on the term of the loan as determined under paragraph (e)(5)(iii)(C) or (v)(B)(*2*) of this section, whichever is applicable.

(D) *Demand loans*. If a split-dollar demand loan provides for one or more contingent payments, the projected payment schedule is determined based on a reasonable assumption as to when the lender will demand repayment.

(E) *Borrower/lender consistency*. Contrary to §1.1275–4(b)(4)(iv), the lender rather than the borrower is required to determine the projected payment schedule and to provide the schedule to the borrower and to any indirect participant as described in paragraph (e)(2) of this section. The lender's projected payment schedule is used by the lender, the borrower, and any indirect participant to compute interest accruals and adjustments.

(iii) *Negative adjustments*. If the issuer of a split-dollar loan is not allowed to deduct interest or OID (for example, because of section 163(h) or 264), then the issuer is not required to include in income any negative adjustment carryforward determined under §1.1275–4(b)(6)(iii)(C) on the loan, except to the extent that at maturity the total payments made over the life of the loan are less than the issue price of the loan.

(4) *Application of section 7872*—(i) *Determination of below-market status*. The yield based on the projected payment schedule determined under paragraph (j)(3) of this section is used to determine whether the loan is a below-market split-dollar loan under paragraph (e) of this section.

(ii) *Adjustment upon the resolution of a contingent payment*. To the extent that interest has accrued under section 7872 on a split-dollar loan and the interest would not have accrued under this paragraph (j) in the absence of section 7872, the lender is not required to recognize income under §1.1275–4(b) for a positive adjustment and the borrower is not treated as having interest expense for a positive adjustment. To the same extent, there is a reversal of the tax consequences imposed under paragraph (e) of this section for the prior imputed transfer from the lender to the borrower. This reversal is taken into account in determining adjusted gross income.

(5) *Examples*. The following examples illustrate the rules of this paragraph (j). For purposes of this paragraph (j)(5), assume that the contingent payments are neither remote nor incidental. The examples are as follows:

Example 1. (i) On January 1, 2010, Employer *T* and Employee *G* enter into a split-dollar life insurance arrangement under which *G* is named as the policy owner. On January 1, 2010, *T* makes a $100,000 premium payment. On December 31, 2013, *T* will be repaid an amount equal to the premium payment plus an amount based on the increase, if any, in the price of a specified commodity for the period the loan is outstanding. The premium payment is a split-dollar term loan. Repayment of both the premium payment and the interest due thereon is recourse to *G*. Assume that the appropriate AFR for this loan, based on annual compounding, is 7 percent. Both *T* and *G* use the calendar year as their taxable years.

(ii) Under this paragraph (j), the split-dollar term loan between *T* and *G* provides for a contingent payment. Therefore, the loan is subject to the contingent split-dollar method. Under this method, the projected payment schedule for the loan provides for a noncontingent payment of $100,000 and a projected payment of $0 for the contingent payment (because it is the lowest possible value of the payment) on December 31, 2013.

(iii) Based on the projected payment schedule and a discount rate of 7 percent, compounded annually (the appropriate AFR), the present value of the payments under the loan is $76,289.52. Under paragraphs (e)(4) and (j)(4)(i) of this section, the loan does not provide for sufficient interest because the loan's imputed loan amount of $76,289.52 (the present value of the payments) is less than the amount loaned of $100,000. Therefore, the loan is a below-market split-dollar term loan and the loan is recharacterized as consisting of two portions: an imputed loan amount of $76,289.52 and an imputed transfer of $23,710.48 (amount loaned of $100,000 minus the imputed loan amount of $76,289.52).

(iv) In accordance with section 7872(b)(1) and paragraph (e)(4)(iv) of this section, on the date the loan is made, *T* is treated as transferring to *G* $23,710.48 (the imputed transfer) as compensation. In addition, *T* must take into account as OID an amount equal to the imputed transfer. See §1.1272–1 for the treatment of OID.

Example 2. (i) Assume, in addition to the facts in *Example 1*, that on December 31, 2013, *T* receives $115,000 (its premium payment of $100,000 plus $15,000).

(ii) Under the contingent split-dollar method, when the loan is repaid, there is a $15,000 positive adjustment ($15,000 actual payment minus $0 projected payment). Under paragraph (j)(4) of this section, because *T* accrued imputed interest under section 7872 on this split-dollar loan to *G* and this interest would not have accrued in the absence of section 7872, *T* is not required to include the positive adjustment in income, and *G* is not treated as having interest expense for the positive adjustment. To the same extent, *T* must include in income, and *G* is entitled to deduct, $15,000 to reverse their respective prior tax consequences imposed under paragraph (e) of this section (*T*'s prior deduction for imputed compensation deemed paid to *G* and *G*'s prior inclusion of this amount). *G* takes the reversal into account in determining adjusted gross income. That is, the $15,000 is an ''above-the-line'' deduction, whether or not *G* itemizes deductions.

Example 3. (i) Assume the same facts as in *Example 2*, except that on December 31, 2013, *T* receives $127,000 (its premium payment of $100,000 plus $27,000).

(ii) Under the contingent split-dollar method, when the loan is repaid, there is a $27,000 positive adjustment ($27,000 actual payment minus $0 projected payment). Under paragraph (j)(4) of this section, because *T* accrued imputed interest of $23,710.48 under section 7872 on this split-dollar loan to *G* and this interest would not have accrued in the absence of section 7872, *T* is not required to include $23,710.48 of the positive adjustment in income, and *G* is not treated as having interest expense for the positive adjustment. To the same extent, in 2013, *T* must include in income, and *G* is entitled to deduct, $23,710.48 to reverse their respective prior tax consequences imposed under paragraph (e) of this section (*T*'s prior deduction for imputed compensation deemed paid to *G* and *G*'s prior inclusion of this amount). *G* and *T* take these reversals into account in determining adjusted gross income. Under the contingent split-dollar method, *T* must include in income $3,289.52 upon resolution of the contingency ($27,000 positive adjustment minus $23,710.48).

(k) *Payment ordering rule.* For purposes of this section, a payment made by the borrower to or for the benefit of the lender pursuant to a split-dollar life insurance arrangement is applied to all direct and indirect split-dollar loans in the following order—

(1) A payment of interest to the extent of accrued but unpaid interest (including any OID) on all outstanding split-dollar loans in the order the interest accrued;

(2) A payment of principal on the outstanding split-dollar loans in the order in which the loans were made;

(3) A payment of amounts previously paid by a non-owner pursuant to a split-dollar life insurance arrangement that were not reasonably expected to be repaid by the owner; and

(4) Any other payment with respect to a split-dollar life insurance arrangement, other than a payment taken into account under paragraphs (k)(1), (2), and (3) of this section.

(l) [Reserved]

(m) *Repayments received by a lender.* Any amount received by a lender under a life insurance contract that is part of a split-dollar life insurance arrangement is treated as though the amount had been paid to the borrower and then paid by the borrower to the lender. Any amount treated as received by the borrower under this paragraph (m) is subject to other provisions of the Internal

Revenue Code as applicable (for example, sections 72 and 101(a)). The lender must take the amount into account as a payment received with respect to a split-dollar loan, in accordance with paragraph (k) of this section. No amount received by a lender with respect to a split-dollar loan is treated as an amount received by reason of the death of the insured.

(n) *Effective date*—(1) *General rule*. This section applies to any split-dollar life insurance arrangement entered into after September 17, 2003. For purposes of this section, an arrangement is entered into as determined under §1.61–22(j)(1)(ii).

(2) *Modified arrangements treated as new arrangements*. If an arrangement entered into on or before September 17, 2003 is materially modified (within the meaning of §1.61–22(j)(2)) after September 17, 2003, the arrangement is treated as a new arrangement entered into on the date of the modification.

[T.D. 9092, 68 FR 54352, Sept. 17, 2003]

§ 1.7874–1T Disregard of affiliate-owned stock (temporary).

(a) *Scope*. Section 7874(c)(2)(A) provides that stock of the foreign corporation referred to in section 7874(a)(2)(B) held by members of the expanded affiliated group that includes such foreign corporation (the EAG) shall not be taken into account in determining, for purposes of section 7874(a)(2)(B)(ii), the percentage of stock in such foreign corporation held, after the acquisition, by former shareholders or partners of the domestic corporation or partnership referred to in section 7874(a)(2)(B)(i) (the domestic entity) by reason of having held stock or a partnership interest in the domestic entity. This section provides rules under section 7874(c)(2)(A).

(b) *General rule*. Except as provided in paragraph (c) of this section, for purposes of the ownership percentage determination required by section 7874(a)(2)(B)(ii), stock held by one or more members of the EAG is not included in either the numerator or the denominator of the fraction that determines such percentage. For purposes of this §1.7874–1T, stock held by a partnership shall be considered as held proportionately by its partners.

(c) *Special rules*. For purposes of the ownership percentage determination required by section 7874(a)(2)(B)(ii), stock held by one or more members of the EAG shall be included in the denominator, but not in the numerator, of the fraction that determines the percentage if:

(1)(i) Before the acquisition, 80 percent or more of the stock (by vote or value) or the capital or profits interest in the domestic entity was owned directly or indirectly by the corporation that is the common parent of the EAG after the acquisition; and

(ii) After the acquisition, stock held by non-members of the EAG by reason of holding stock or a capital or profits interest in the domestic entity, if any, does not exceed 20 percent of the stock (by vote or value) of the foreign corporation; or

(2) After the acquisition, the former shareholders or partners of the domestic entity do not own, in the aggregate, directly or indirectly, more than 50 percent of the stock (by vote or value) of any member of the EAG.

(d) *Disregard of subsidiary-owned interests*. Stock or partnership interests owned by an entity in which at least 50 percent of the stock (by vote or value), or at least 50 percent of the capital or profits interest, is owned directly or indirectly by the issuer of such stock or by the partnership in question shall not be taken into account for purposes of:

(1) Determining the percentage of ownership of an entity under paragraphs (c)(1) and (c)(2) of this section; or

(2) Treating stock held by one or more members of the EAG as included in the denominator but not in the numerator under paragraph (c) of this section.

(e) *Examples*. The application of this section is illustrated by the following examples. It is assumed that all transactions in the examples occur after March 4, 2003. In all the examples, *the EAG* means the expanded affiliated group which includes the foreign corporation that has completed the direct or indirect acquisition referred to in section 7874(a)(2)(B)(i). In all the examples, if an entity or other person is not described as either domestic or foreign,