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Taxation of Life Insurance Products: Background and Issues

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Summary

Owners and beneficiaries of life insurance contracts receive favorable treatment under the federal income tax laws. Before examining this tax treatment, this report provides an overview of the term life insurance and cash value life insurance products, including “whole” life insurance, “universal” life insurance, and “variable” life insurance. This discussion illustrates how cash value life insurance can operate as an investment vehicle that combines life insurance protection with a financial instrument that operates similarly to bank certificates of deposit and mutual fund investments.

Next, the income tax provisions that apply to the owners of life insurance are analyzed. Under the Internal Revenue Code, income measurement rules cause a portion of the investment income to not be taxed. In addition, the remaining investment income is not taxed contemporaneously, and may be totally exempt from taxation. This report provides a brief overview of Internal Revenue Code provisions that create these tax results, and the provisions that limit the favorable tax treatment.

The report then considers the current tax treatment justifications from a tax policy perspective. In this analysis, the report examines the principal arguments of supporters of the current tax treatment of the investment income credited to life insurance contracts and compares life insurance to other tax-preferred investment vehicles. The report also considers the limits on investment oriented uses of life insurance in terms of preventing inappropriate uses of life insurance as an investment.

Next, the report provides an overview of two distinct categories of life insurance: corporate-owned life insurance (“COLI”) and split dollar life insurance. These arrangements are used as tax planning devices to provide tax benefits to corporations and their corporate executives and managers. In particular, the report examines the economics and tax restrictions that apply to “leveraged” COLI arrangements, in which the corporate owner of the life insurance contract borrows to pay a substantial portion of the insurance premiums. COLI has recently been the object of critical media articles, major litigation on behalf of the IRS, and a series of legislative proposals to revise the taxation of these life insurance products. Most recently, Representative Emanuel introduced H.R. 2127, which would generally repeal the exclusion of death benefits from taxation under many corporate-owned life insurance policies.

In the last section of the report, the structure and function of split-dollar arrangements are described. This section discusses the Internal Revenue Service’s long-standing treatment of the traditional arrangement, and the report concludes with an analysis of the factors that led the IRS and the Treasury Department to reconsider this position and to issue new guidance concerning the tax treatment of split dollar arrangements. This report does not track current legislation and will not be updated.

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This report was prepared under the supervision of the Congressional Research Service. For further information on the subject of this report or its contents, contact James M. Bickley, Specialist in Public Finance, Congressional Research Service.

Taxation of Life Insurance Products: Background and Issues¹

Introduction

This report examines the tax treatment of life insurance under the Internal Revenue Code. Owners and beneficiaries of life insurance contracts receive preferential treatment under the federal income tax laws. Significantly, an owner of cash value life insurance generally avoids taxation on the entire amount of interest (or other returns on the investment) that is credited to the contract's cash value. If the life insurance contract remains in effect until the insured's death, the beneficiaries generally exclude from income the death benefits paid under the contract, including the previously untaxed interest.

The second section introduces different types of life insurance, and the financial and economic framework upon which these products are constructed. This section begins with a discussion of the concept of "pure life insurance protection" and the types of life insurance products that provide primarily pure life insurance protection. The remainder of the section examines life insurance products that combine investment features with pure life insurance protection, including "whole" life insurance, "universal" life insurance, and "variable" life insurance.

The third section examines the tax provisions of the Internal Revenue Code that apply to the owners of life insurance. First, this section discusses the application of Internal Revenue Code sections 101 and 72, which establish the basic tax treatment. Second, it provides a brief overview of Internal Revenue Code sections 7702 and 7702A, which contain highly technical limitations on the favorable tax treatment accorded certain life insurance arrangements. Section IV considers the justifications for the favorable tax treatment from a tax policy perspective.

Finally, Sections V and VI examine two types of life insurance arrangements and their tax implications — corporate-owned life insurance and split dollar life insurance — that have received attention in recent years. In both types of arrangements, some businesses and corporate executives have utilized life insurance to obtain significant economic benefits. This section provides an overview of these arrangements and a brief analysis of the tax issues that they raise.

¹ For further information on the subject of this report, or its contents, please contact James M. Bickley, Specialist in Public Finance, Government and Finance Division, Congressional Research Service, (202) 707-7794.

Description of Life Insurance Products

Pure Insurance Protection

All life insurance contracts have two defining characteristics. First, an insurance company agrees to pay a specified sum following the death of an insured. Second, premiums are paid to the life insurance company to secure the benefits specified in the life insurance contract. Although all life insurance contracts incorporate these elements, the economic terms of life insurance contracts vary widely. In broad terms, life insurance companies market two broad categories of life insurance: term life insurance and cash value life insurance.

Individuals often recognize that their deaths may leave their families with inadequate financial resources. The purchase of a life insurance contract enables an individual to shift this financial risk to a life insurance company. If the insured dies while the contract is in effect, the policy's beneficiaries receive a specified dollar amount, the "death benefit." Following the insured's death, investment of the insurance proceeds may generate income to replace a portion of the income that the insured earned prior to death.

The simpler form of life insurance is a "term" arrangement. When a life insurance company issues a term contract, it commits itself to pay a specified sum if the insured individual dies during the period of time, or "term," that the contract covers. Upon the expiration of the term, neither the owner of the policy nor the life insurance company has further obligations under the contract. The premium paid with respect to a term life insurance contract reflects the likelihood that the insured will die during the year of coverage.

Flight Life Insurance. Perhaps the simplest form of term insurance protection is "flight" insurance. Under a flight insurance contract, an individual pays a premium of a few dollars to insure her life for the duration of a flight on an airplane. The premium does not depend upon the age or health of the insured. Rather, it depends upon the likelihood of a plane crash. If the insured reaches her destination alive, then the contract terminates. If, however, the insured does not survive until the end of the flight, then the insurance company becomes obligated to pay the death benefit specified in the contract. (These policies are typically limited to accidental deaths and, accordingly, would not cover health-related deaths during a flight.) Given the short term of coverage, there is no meaningful investment incorporated into flight insurance.

Individual Term Insurance . Term life insurance provides current insurance protection for a limited time. The most common term of coverage is one year, although term contracts frequently allow the policy owner to renew the policy for additional years of coverage. As with all forms of life insurance, the insurance company pays the specified death benefit if the insured dies during the period of coverage. If the insured remains alive at the end of the policy term, the owner of the policy (or the designated beneficiaries) has no further economic claims against the life insurance company.

The premium that the life insurance company establishes for term life insurance depends upon the actuarial probability that the insured will die during the period of coverage. For example, the premium for a one-year term insurance contract with a death benefit of \$100,000 issued to a 35-year-old individual might be \$200. Among the most significant factors used in determining the probability of the insured's death are the insured's age, current health, and the insured's personal and family history of life-threatening medical conditions. In addition, the life insurance premium incorporates amounts reflecting the expenses that the life insurance company expects to incur (such as commissions payable to the life insurance agent) and anticipated profit. The linkage between the probability of the insured's death and the premium charged causes term insurance premiums to increase as the age of the insured increases.

Employment-Based Group Term Life Insurance. Many individuals acquire term life insurance as an employment-based fringe benefit. Most often, a group-term policy provides term insurance protection for all, or a large portion of, the employees of an enterprise. The employer may pay the entire premium for the employees' coverage. It is a common requirement, however, for the employees to pay a portion of the premium to obtain life insurance protection.

The premium for life insurance protection provided under a group policy is likely to differ from that charged for a term life insurance policy issued to an individual for two reasons. First, the expenses allocable to each insured are likely to be smaller in a group policy. Second, group premiums generally do not reflect the insured's individual medical history. Rather, actuarial expectations of the group's mortality are used to establish the premiums for the group.

Mortgage Life Insurance. Mortgage life insurance is a form of term insurance in which the benefit payable upon the death of the insured decreases over time. This type of insurance is used primarily to pay off a mortgage loan secured by the residence of the insured. In a typical self-amortizing mortgage loan, the initial monthly payments consist primarily of interest, with relatively small amounts consisting of principal repayments. In later years, the amount of interest decreases and the principal repayments increase. Therefore, in a mortgage life insurance policy, the decline in the death benefit matches the decline in the principal balance payable on the mortgage loan.

Key Person Life Insurance and Business Buy-sell Agreements. Businesses purchase life insurance contracts for several different purposes. First, certain small businesses purchase "key person life insurance" to provide a source of funds to pay for the services of replacement employees following the death of a key employee. For example, a member of a family may provide important (and perhaps unpaid) services for the family business. The proceeds of the "key person" life insurance enable the family business to continue in operation. Second, businesses may purchase life insurance to provide a source of funds that will be used to purchase (or buy-out) the ownership interest of a deceased owner. This type of life insurance is purchased when the owners of a business reach an agreement that the surviving owners of the business will purchase the interest of any deceased owner at a specified price.

Cash Value Life Insurance: Pure Insurance Protection Combined With Savings Elements

“Cash value life insurance” is a more complicated form of life insurance. As with term insurance, the life insurance company becomes obligated to pay a specified sum following the death of the insured. Also referred to as “whole” life insurance, cash value life insurance remains in effect for many years. The distinguishing feature of cash value life insurance is the presence of the contract’s cash value, which is the amount that the policy owner receives if the individual terminates the policy. The accumulation of cash value reflects the existence of a savings feature in this form of insurance.

The premium paid with respect to a newly issued cash value life insurance contract exceeds the term insurance premium for a given insured individual. In effect, the premium consists of the following two components: (1) a charge equal to the cost of the insured’s term insurance protection; and (2) an amount that is added to the contract’s cash value, that can be analogized to a deposit into an individual’s savings account or mutual fund account. As shown in table 1, the life insurance company credits interest (or other forms of investment income) to the cash value in subsequent years. Although the amount credited to the cash value represents an economic form of income, it is taxed in a favorable manner.

As discussed below, variations in the basic cash value life insurance design include “universal” life insurance, “variable” life insurance, single premium life insurance and “second-to-die” life insurance. In addition, “key person” life insurance, corporate-owned life insurance (COLI) and split dollar life insurance incorporate cash value life insurance into other financial arrangements.

Traditional Level-Premium and Single Premium Policies. Level-premium “whole” life insurance is the most traditional form of cash value life insurance. In a whole life insurance contract, the life insurance company establishes a fixed premium that remains in effect for the remainder of the insured’s life. The premium remains constant notwithstanding the increasing actuarial likelihood of the insured’s death. Consequently, the annual premium exceeds the cost of current insurance protection during the early years of the contract. This excess serves as the basis for computing the policy’s cash value.

To illustrate the generation of cash value under a level-premium contract, consider a simplified hypothetical contract with a death benefit of \$100,000 issued to a 35-year-old individual. The annual premium for this contract is \$1,300. During the first year, the premium of \$1,300 is applied to pay the cost of the current year’s insurance protection, which is \$200. The remaining \$1,100 might earn interest at a 4% rate, or \$44, during the first year, thereby building the cash value to \$1,144. The \$44 of interest credited is commonly called “the inside interest build-up” of a life insurance policy.

This one-year illustration sets out the basic components of all cash value life insurance policies: the premium, the charges imposed for current insurance

protection, the interest credited, and the cash value.² The precise relationship among these components depends, however, on the level of current insurance charges, the rate at which interest is credited, and the pattern and magnitude of the premium payments. For example, decreases in the charges for current insurance protection cause the cash value (and the interest credited thereon) to increase. Similarly, an increase in the rate of interest credited causes the cash value to increase at a faster rate, thereby decreasing the amount of, and charges for, current insurance protection at a more rapid rate. However, the interaction of these factors, particularly when more than one of them change, makes it quite difficult to predict the net effect of the changes.

The investment orientation of a life insurance contract depends on the amount of investment income credited to a policy's cash value relative to the cost of insurance protection during the years that the policy remains in effect. The level-premium policy represents one of the least investment-oriented cash value life insurance designs. Single premium life insurance represents the most investment-oriented design. In a single premium contract, the contract owner pays one premium when the life insurance company issues the contract. Because no further premiums are paid with respect to this contract, the single premium is much larger than the level premiums discussed above. To illustrate, consider a \$100,000 single-premium life insurance contract issued to the same 35-year-old individual discussed above. The single premium for this contract might be \$25,000. The death benefit is \$100,000. In comparison to the level-premium contract discussed previously, in every year the single-premium contract generates higher levels of cash value and credits more interest. The larger cash values reduce the amount and the cost of current insurance protection.

The differences between the level-premium contract and the single-premium contract (both having a \$100,000 death benefit) during the first year are illustrated as follows:

Table 1. Premium Contracts

	Level Premium Contract	Single Premium Contract
Yr 1: Premium	\$1,300	\$25,000
- Cost of Insurance Protection ^a	- \$200	- \$150
+ Interest Earned	+ \$44	+ \$994
= Closing Cash Value	\$1,144	\$25,834
Yr 2: Current Insurance Protection	\$98,856	\$74,166

^a As illustrated, the cost of insurance protection under the single premium contract is less than that under the level premium contract since the current insurance protection of roughly \$75,000 is proportionately less than that under the level premium contract.

² Life insurance companies also impose "loading" charges in connection with most cash value life insurance policies. These charges are designed to allow the life insurance company to recover its expenses incurred in connection with the contract (including the selling agent's commissions) and to build in a profit factor. The loading charges reduce the contract's cash value.

Universal Life Insurance. “Universal” life insurance is a modern variant of the traditional cash value life insurance contract. From a marketing perspective, universal life insurance incorporates two significant innovations: greater flexibility, and transparency.

In a traditional cash value contract, the financial terms are extraordinarily inflexible. Specifically:

- the size and the timing of the premium payments are fixed and specified in the contract;
- for many contracts (traditional “nonparticipating” contracts) the implicit rate of return on the cash value and the charges for current insurance protection are also fixed; and
- the policy owner cannot change the contract’s death benefit after the contract is issued.

The economic relationships implicit in traditional cash value life insurance are also incomprehensible to most consumers. Typically, these contracts do not disclose, in an understandable manner, the amount of interest that the insurance company credits to the cash value and the level of charges for current insurance protection. Moreover, the rate of interest implicitly credited in traditional cash value contracts credited was low in comparison to the rates available from competing investments during the late 1970s and 1980s.

Universal life insurance was designed to overcome these shortcomings. First, it allows a far greater degree of flexibility than is permitted under traditional cash value contracts. Initially, the owner of a universal life policy sets the size of the initial premium and the initial death benefit. Subsequently, the policy owner has complete discretion to determine the timing and size of subsequent premium payments. The policy owner also has the discretion to increase or decrease the death benefit as the need for insurance changes.

Second, universal life insurance provides a much greater degree of transparency and disclosure. The interrelationships existing between the financial components that were always inherent in a traditional cash value life insurance contract are made explicit in a universal life insurance contract. Specifically, premium payments are added to the contract’s cash value which, in turn, is reduced by charges for current insurance protection. The remaining cash value earns interest. Unless additional premium payments are made, insurance protection continues until the cash value is depleted. A universal life policy owner receives periodic statements summarizing these developments. Moreover, the rate of interest credited is clearly stated and the charges for current insurance protection are made explicit.

Additional Investment Choices: Variable Life Insurance and Variable Universal Life. Variable life insurance was developed to expand the range of investment options for investments made in cash value life insurance. In the traditional design, the investment component of the cash value contract is analogous to a certificate of deposit that a bank issues: the life insurance company credits interest to the cash value either at a fixed rate (in nonparticipating contracts) or at

rates that vary based upon the discretion of the life insurance company (in participating contracts).

Alternatively, in a variable life insurance contract, the investment component is analogous to an investment in one or more mutual funds. When the owner of a variable life insurance contract pays a premium, the life insurance company imposes charges for the current insurance protection and expenses. The remaining amount is invested in a pool of assets that are separate from the insurer's general investment assets. As with shares of a mutual fund, the cash value will increase or decrease in proportion to changes in the value of the assets in the separate account. Consequently, the cash value of a variable life insurance contract can decrease if the value of the underlying pool of assets declines. Most life insurance companies offer investment options relating to a range of funds, including money market funds, common stock funds, and bond funds.

Variable universal life insurance combines the investment flexibility of variable life insurance with the premium payment flexibility of universal life insurance.

Overview of Current Tax Treatment

Introduction

The owners and beneficiaries of life insurance contracts are accorded favorable treatment under the Internal Revenue Code. Specifically, during the life of the insured, the tax treatment of the interest (or other investment income) credited to the cash value of life insurance contracts differs from the tax treatment of many other forms of interest in the following significant respects:

- the income measurement rules cause a portion of the interest credited to avoid taxation;
- the interest is not taxed currently; at a minimum, taxation is deferred;
- IRC section 101 generally excludes the remaining interest from gross income if the policy remains in force until the death of the insured; and
- unlike other tax-preferred forms of investment (such as pension plans and IRAs), no dollar limits are imposed with respect to investments made in cash value life insurance.

Each of these benefits is discussed below.

Congress has enacted restrictions on the arrangements that receive this preferential tax treatment. First, contracts must satisfy the definition of "life insurance" contained in IRC section 7702. Second, contracts that are classified under IRC section 7702A as modified endowment contracts are taxed in a less preferential fashion. These limitations are also discussed below.

The Joint Committee on Taxation treats the exclusion of investment income on life insurance and annuity contracts as a tax expenditure. In April 2001, the committee estimated that these exclusions from income will reduce tax revenues in the following amounts:

Table 2. Estimated Revenue Loss

(In billions of dollars)

Fiscal Year	Individuals	Corporations	Total
2003	24.0	1.4	25.4
2004	24.6	1.4	26.0
2005	25.2	1.4	26.6
2006	25.8	1.5	27.3
2007	26.5	1.5	28.0

Source: U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Year 2003-2007*, 107th Cong., 2nd sess. (Washington: April 6, 2001). Posted on the Joint Committee on Taxation's Web site: [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2002_joint_committee_on_taxation&docid=f:83132.pdf].

Compared to the impact of other tax expenditures, the exclusion of investment income on life insurance and annuity contracts is the 11th largest in terms of forgone revenue over the estimating period, as reported by the Joint Committee on Taxation. Furthermore, according to the American Council of Life Insurers (ACLI), the number of permanent, individual "whole life" policies has increased by 20% over the past four years, from 109 million in 1998 to 131 million in 2001.³

IRC Section 72: Cash Value Life Insurance and the Taxation of Investment Income During the Insured's Life

One of the most significant benefits arising from the ownership of cash value life insurance relates to the timing of taxation: if the policy owner allows the cash value to accumulate, no portion of the investment income credited to the cash value is included in gross income. At a minimum, taxation is deferred unless (and until) the owner of the contract withdraws the cash value. By comparison, interest credited to a bank certificate of deposit (or dividends reinvested with respect to either stock or mutual fund shares) is taxed at the time it is credited. On the other hand, certain investments instruments such as pensions, 401(k)s, and savings bonds do have investment build-up free of tax. As discussed in Section IV, some question whether this favorable tax treatment of life insurance is justified.

³ American Council of Life Insurers, *1999 Life Insurers Fact Book*, 1999, and *ACLI Product Line Report: Life Insurance*, March 2003, available at [<http://www.acli.com/NR/rdonlyres/eqcnzww05rgnkqqafmqplcobx5dc5wx6fxbhshzmdc55vhsxjycpkzqgodubmgbnucocu2hxrzqsxvixil3rriit3eed/LifeInsuranceTables.pdf>].

IRC section 72 governs the tax treatment of distributions made with respect to life insurance contracts. Under this provision, further deferral results from the operation of a “stacking rule.” When a policy owner receives cash from a life insurance contract (other than a modified endowment contract discussed below), this stacking rule characterizes the distribution as a nontaxable return of the policy owner’s capital until the aggregate amount received exceeds the policy owner’s investment in the contract. As a result, taxation of the interest credited under a cash value life insurance contract is deferred until the policy owner converts their investment portion of the cash value into cash.

A policy owner can extend the period of deferral and receive cash in excess of her investment without realizing any income by borrowing the cash value of the policy from the life insurance company. All cash value policies include a provision that gives the policy owner the right to borrow most of the policy’s cash value. Loans secured by life insurance contracts (other than modified endowment contracts) are not treated as taxable distributions for purposes of IRC section 72. Although the policy owner pays interest on policy loans, the after-tax costs incurred are minimal in connection with this type of indebtedness for two reasons. First, the policy owner’s pretax “cost” of borrowing equals the difference between the interest payable on the loan and the interest credited to the allocable amount of cash value. This difference, typically, is small. Second, interest paid on the policy loan may be deductible.⁴ However, it should be noted that the proceeds of many other types of loans are generally not taxable. One example to the contrary is a loan taken from a qualified retirement plan. With certain exemptions relating to timing and use of the proceeds, the proceeds from these loans may be considered a distribution and included in an individual’s taxable gross income.

The combined effect of the income deferral allowed under IRC section 72 and the availability of nontaxable policy loans can often result in the interest credited under cash value life insurance (other than modified endowment contracts) not being taxed until the policy terminates.

IRC Section 101: Exclusion of the Death Benefit

Under IRC section 101, a life insurance contract’s beneficiary may exclude from income amounts received under a life insurance contract that are paid by reason of death of the insured. This exclusion is extremely broad in scope. It applies to:

- amounts paid with respect to term life insurance;
- amounts paid with respect to cash value life insurance, including the accumulated (and untaxed) investment income credited to the contract’s cash value; and

⁴ IRC section 163 authorizes a deduction for certain interest expenses. Taxpayers are allowed to deduct interest allocable to a trade or business. In addition, interest paid in connection with the taxpayer’s investments or the taxpayer’s home mortgage are also deductible, although subject to statutory limitations. Other anti-abuse provisions may limit these deductions.

- beneficiaries that are corporations, partnerships, trusts and the estate of the insured in addition to members of the insured's family.

From a tax policy perspective, the most significant consequence of this exclusion relates to the investment income previously credited to the cash value during the insured's life. Absent section 101, taxation of the investment income is deferred. If the contract remains in force until the insured's death, it becomes evident that taxation of the investment income is forgiven.

In response to the AIDS crisis, Congress expanded the scope of IRC section 101 so that certain "accelerated death benefits" paid during the life of the insured are also excluded from income. To qualify for this treatment, the insured must be either terminally ill or chronically ill. Moreover, the payments must be used to pay for long-term care of the insured that otherwise would not be covered by insurance.

IRC Section 79: Provision of Group Term Life Insurance for Employees

Many employees acquire life insurance protection as a fringe benefit provided by their employers. Until 1964, the value of this employer-provided benefit was treated as a tax-free fringe benefit. IRC section 79 now limits the extent to which employer-provided group term life is a tax-free fringe benefit for an employee.

First, the value of the first \$50,000 of employer-provided group term life insurance coverage is excluded from an employee's income. The value of this exclusion is quite modest for most employees: the value of \$50,000 of term life insurance protection for most employees younger than age 50 is less than \$100 per year. The entire value of the life insurance protection provided to a disabled retired employee is excluded from the ex-employee's income.

Second, the value of any additional employer-provided group-term life insurance protection is included in the employee's income. In general, the amount included in income does not depend upon the actual value (or cost) of the insurance protection. Rather, the taxable benefit is computed using the rates specified in Table I contained in section 1.79-3(d)(2) of the Income Tax Regulations. Because these rates do not reflect the medical condition or gender of the employee, the amount included in income may differ from the actual value of the insurance protection.

IRC Section 7702: Definition of Life Insurance for Tax Purposes

The owner of a life insurance contract is taxed in accordance with the provisions discussed above only if the contract complies with the statutory definition of life insurance contained in IRC section 7702. This provision denies the preferential tax treatment to arrangements that are overly investment oriented. Specifically, the owner of a contract that does not satisfy the requirements of IRC section 7702 must include in gross income the sum of: (1) the increase in the net surrender value during the year and (2) the cost of insurance protection provided during the year, reduced by (3) the premiums paid during the year. This approximates the amount of investment

income credited under the policy. The amount paid on account of the insured's death in excess of the cash value is treated as proceeds of a term life insurance policy and is therefore excluded from income.

IRC section 7702 adopts two alternative actuarial tests to identify overly investment-oriented contracts: (1) the cash value accumulation test and (2) the guideline premium/cash value corridor test. These tests were designed to accommodate the principal models of life insurance sold in the market. The cash value accumulation test reflects the structure of the traditional cash value life insurance contract, which specifies a fixed pattern of premium payments and a fixed death benefit (or a death benefit determinable based on the accumulated cash value). The guideline premium test reflects the distinguishing characteristics of the universal life insurance policy design.

A life insurance contract satisfies the cash value accumulation test if, under the terms of the contract, the contract's cash value can never exceed the current "net single premium." For any specified age of the insured, the net single premium is defined as the amount needed, in present value terms, to generate the cash values and pay the mortality charges for the death benefit specified in the contract. The cash value accumulation test denies life insurance status to a contract that, by its terms, permits accumulation of any additional cash value.

The alternative test that a contract may satisfy to qualify as life insurance for tax purposes is the guideline premium/cash value corridor test. This alternative test incorporates two requirements. First, the cumulative dollar amount of premiums actually paid under the contract can never exceed the guideline premium limitation.⁵ Second, the ratio of the death benefit to the cash value of the policy cannot, at any time, fall below specified percentages. The minimum amount of current insurance protection for a given death benefit constitutes the cash value corridor.

IRC Section 7702A: Modified Endowment Contracts

Congress enacted IRC section 7702A out of concern that investors were purchasing single premium life insurance as a tax-sheltered investment rather than for life insurance protection. Under this provision, adverse tax consequences apply to life insurance contracts characterized as "modified endowment contracts." This characterization applies if the contract fails to satisfy the "seven-pay-test." Under this test, the premiums paid during the first seven years that the contract is in effect are compared to the premiums that would be required under a hypothetical contract with the same death benefit. In the hypothetical contract, premiums would be payable on a level basis for only seven years. The contract is a modified endowment contract if the premiums actually paid exceed the premiums that would be paid with respect to the hypothetical contract.

⁵ The guideline premium limitation is generally determined at the time the contract is issued and is computed under the provisions of IRC section 7702(c), including the specified IRS regulations of reasonable mortality charges.

If a contract is characterized as a modified endowment contract, withdrawals of cash from the contract are not taxed in the manner discussed above. Rather, the distributions are taxed under IRC section 72(e) in the same manner as distributions from a deferred annuity contract. Consequently:

- The “stacking rule” applicable to distributions is reversed: amounts withdrawn from a modified endowment contract are first characterized as income, rather than as a nontaxable return of the taxpayer’s investment in the contract.
- A policy loan is treated as a taxable distribution rather than as a nontaxable loan.
- The portion of any distribution included in income is subject to an additional 10% tax.

General Tax Policy Issues

Exclusion of the Death Benefit From Income Taxation

The death benefits paid following the death of an insured have been excluded from taxation since the enactment of the income tax in 1913. Economically, the death benefit is attributable to the following three sources:

- the portion of the premiums paid that exceeds charges for current insurance protection (and other expenses) and was added to the cash value during the insured’s life;
- the investment income credited to the cash value during the insured’s life; and
- the term insurance protection provided under the contract at the time of the insured’s death.

Following is an evaluation of the income tax exclusion of the death benefit, considering each of these three sources of the death benefit.

To the extent that the death benefit is attributable to the premiums paid during the insured’s life, the death benefit represents a transfer of property that takes effect upon the insured’s death. Consequently, this portion of the death benefit is quite similar to property passing to the beneficiaries of a deceased individual’s will. Under the Internal Revenue Code, property received as bequests is not subject to the income tax.

In terms of the investment income credited to the cash value during the insured’s life, the tax-free treatment to beneficiaries has some similarities with the transfer of other assets. If the life insurance contract is surrendered prior to death, amounts in excess of the premiums paid for the insurance are included in gross income. If the contract is held until the death of the insured, the investment build-up is not included in gross income for the beneficiary. Consistent with this treatment, under current law through 2009, the basis for an asset’s value transferred to a beneficiary is the asset’s

fair market value at the time of death, not the value at the time the asset was acquired.⁶

The portion of the death benefit attributable to the term insurance protection provided at the time of the insured's death represents an accretion to wealth. The Internal Revenue Code treats similar types of income in a somewhat inconsistent manner. For instance, amounts that an individual receives under an accident or health insurance policy purchased by the insured is excluded from income. One rationale for this result is that, in aggregate, no income is generated with respect to term insurance. The economic gain that the beneficiaries of life or health insurance realize is offset by the economic loss incurred by policy owners who purchase insurance and receive nothing. As an example to the contrary, gambling winnings are treated as income for purposes of the income tax despite that fact that, in aggregate, gambling winnings are offset by gambling losses. On the individual level, however, a taxpayer is allowed to subtract any wagering losses from any gains to determine her tax liability.

Two additional universal justifications for excluding the death benefit may be historic. One plausible rationale might have been that it was undesirable to impose a tax on widows and orphans who received life insurance proceeds, which were often modest in magnitude and represented the principal financial asset available to the insured's survivors. Another possible rationale might originate from the view that the accumulation of wealth and its passage to heirs is viewed by some as a benefit to society.

Taxation of Investment Earnings Credited to Cash Value Life Insurance

The tax treatment of investments made in the form of cash value life insurance stands in contrast to the treatment of some other financial investments. The interest (or other investment income) credited to life insurance contracts is not taxed until (and unless) cash or other property is distributed to the policy owner prior to the death of the insured. Current interest income, however, generally is included in income for taxation purposes presently. Although Congress has enacted tax-preferred savings vehicles, such as qualified pension plans, 401 (k) plans, IRAs, and section 529 plans to encourage savings to pay for retirement and college tuition, as discussed below these arrangements are subject to numerous requirements and limitations. Consequently, some question the justification for treating interest credited under a life insurance contract differently from both taxable and tax-preferred forms of income from savings.

Alternatively, investment gains from other forms of appreciating assets are not taxed until those gains are realized. Examples of this tax treatment include capital

⁶ This "step-up" basis for inherited assets will be replaced with a modified carryover basis in 2010 as a result of the repeal of the estate tax included in P.L. 107-16, EGTRRA. For more information on the taxation of estates, see CRS Report RL31061, *Estate and Gift Tax Law: Changes Under the Economic Growth and Tax Relief Reconciliation Act of 2001*, by Nonna A. Noto.

gains from the investment in equities or real property. Further, even at the time these investment gains are realized, they are subject to lower tax rates than other forms of income.

The nontaxable status of the investment earnings, or “inside build-up” dates back to 1913. Although this provision was not explicitly included in law, floor discussions of the bill made it clear that the investment earnings were not taxable.⁷

Supporters of the current income tax treatment of investment income credited to life insurance contracts have advanced several rationales. The first two focus on the fundamental tax policy issue: whether the current exclusion of this investment income is justified. The third considers a subsidiary tax policy issue: the limits on investment oriented uses of life insurance contained in IRC sections 7702 and 7702A.

Treatment of Life Insurance Compared to Other Tax-Preferred Forms of Savings. The broadest exceptions to the general tax treatment of interest income involve interest income credited to qualified pension plans (including 401k plans), individual retirement accounts (IRAs), deferred annuities and section 529 educational savings plans.⁸ Some who endorse the preferential tax treatment of investment income generated in cash value life insurance assert that this income should be taxed in the same manner as these other tax-preferred savings vehicles.

There are significant differences, however, between investments made using cash value life insurance and the other tax-preferred forms of investment. First, the favorable tax rules applicable to other savings vehicles were enacted to encourage individuals to save to meet specific financial goals. For example, the tax rules governing qualified pension plans and IRAs are designed to encourage savings to meet the needs of individuals during their retirement years. Similarly, the section 529 plans encourage individuals to save in order to pay for their children’s higher education expenses. In both of these arrangements, laws limit the dollar amounts that can be invested to meet these needs.

Unlike these identified investment vehicles, individuals invest in cash value life insurance for many different purposes. For example, many individuals purchase cash value life insurance to provide a replacement for the insured’s wage income to support the insured’s spouse and young children in the event of the insured’s death. Others purchase cash value life insurance as a means of transferring assets out of their estates to reduce estate tax liability. Similarly, corporations purchase cash value life insurance to generate funds to protect against the financial loss associated with

⁷ U.S. Senate, Committee on the Budget, United States Senate, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, 107th Cong., 2nd Sess. (Washington: Dec. 2002).

⁸ Interest income paid with respect to state and local bonds is exempt from federal income taxation. This exemption is designed to reduce the borrowing cost of the bond issuers rather than benefit the investors who purchase the bonds. For this reason, it may not be comparable to the tax provisions that primarily benefit investors.

the loss of key workers, to pay for business expenses, or to provide compensation packages for executives.

Term insurance, on the other hand, offers no tax benefits. Although providing tax preferences to life insurance products may encourage parents to purchase life insurance protection for their dependents or companies to effectively plan for future liabilities, the existing tax incentives may not always achieve these results. If this individual replaces a term life insurance contract with cash value life insurance, the individual may obtain less insurance protection. The premium charged for a level-premium cash value life insurance contract is generally much larger than the initial premium for a term contract with an identical death benefit. Unless the individual increases the amount spent for life insurance, the amount of insurance protection will decline. Thus, in terms of tax incentives, current law may encourage some families to reduce, rather than increase, the financial protection of their dependent children. Further, the largest tax benefits are available to taxpayers who can afford to purchase the more investment-oriented cash value life insurance contracts, although they arguably may have less need for life insurance protection. This, of course, is true for many other tax-preferred forms of investment.

Some argue that cash value life insurance is used to generate funds that serve as a source of retirement income for the policy owner. The perceived need to encourage savings for retirement also underlies the preferential tax treatment of qualified pension plans. However, if an individual covered by a qualified pension plan seeks to save additional amounts for retirement, these benefits are subject to very strict limitations.⁹ To the extent that the current tax treatment of cash value life insurance is viewed as a source for, and is integrated with, post-retirement savings, critics might argue the premiums payable should be subject to limitations comparable to, and integrated with, those imposed on individual retirement accounts.¹⁰

Taxation of Interest Credited Under a Life Insurance Contract: A Tax on Unrealized Appreciation? Supporters of the current tax treatment of cash value life insurance argue that the increase in the cash value represents unrealized appreciation and the interest credited should not be subject to tax until the gain is realized. Unrealized appreciation generally represents changes in the value of an asset caused by market forces. In an economic sense, appreciation in an asset's value constitutes income whether or not the asset is sold. Under the current income tax, however, changes in the market value of assets are not taxed until "realized" through a sale or other taxable disposition. For example, an investor owning real estate or stock is not taxed on any appreciation in value of these assets until the gain is "realized."

⁹ Beginning in 2002, the maximum annual benefit under a qualified pension plan was \$160,000, indexed to inflation, and the annual compensation that can be considered under such a plan was \$200,000, also indexed to inflation.

¹⁰ Notwithstanding certain catch-up provisions, the maximum annual contribution to an individual retirement account (IRA) for 2003 is \$3,000. For more information on the monetary limits associated with retirement plans, including both defined contribution and defined benefit plans, see CRS Report RS20629, *Pension Reform: The Economic Growth and Tax Relief Reconciliation Act of 2001*, by Patrick Purcell.

Amounts that represent compensation paid for the use of an asset (such as interest) are generally taxed when credited to the taxpayer's account. An individual who invests in a certificate of deposit is taxed when interest is credited notwithstanding the fact that the interest may remain on deposit with the bank. In other situations, property owners are taxed on investment income that is not received. Partners in a partnership and shareholders of S corporations are taxed currently on their shares of income earned and retained by the business entity. Similarly, interest accruing on debt instruments having original issue discount is included in income despite the absence of a sale of the instrument.

The cash value of a life insurance contract is a financial asset. The owner of the contract receives compensation for the life insurance company's use of the policy's cash value when the company credits interest to the cash value. As presented above, the lack of actual receipt of the interest may or may not justify postponement of the interest credited to cash value of life insurance contracts. Congress has deemed that the interest income should not be considered the policyholder's income since the owner would have to forgo insurance protection to obtain the interest.

Current Limits on the Use of Life Insurance as an Investment Vehicle. Supporters of the status quo with regard to the taxation of cash value life insurance state that Congress dealt with inappropriate uses of life insurance when it enacted IRC sections 7702 and 7702A. As discussed below, these two statutory provisions create actuarial limitations on the use of cash value life insurance. In general, these provisions compare the amount of term life insurance protection to the investment components of a life insurance contract. If, in relative terms, the term life insurance protection is too small, these provisions limit, or eliminate, the tax preference. Critics argue that unlike the limitations applicable to IRAs and pension plans, however, IRC sections 7702 and 7702A do not limit the amounts that can be invested in cash value life insurance. Nor, say opponents, do these provisions limit the uses to which the investment returns can be expended, unlike the limitations applicable to section 529 plans.

The following discussion of IRC sections 7702 and 7702A evaluates the limitations currently imposed by Congress.

The Section 7702 Limitations. Congress enacted IRC sections 7702 and 7702A in response to the marketing of life insurance contracts that provided minimal amounts of current insurance protection. IRC section 7702's definition of life insurance was designed to deny life insurance status to overly investment-oriented products without altering the preferential tax treatment for traditional uses of cash value life insurance. To achieve this result, IRC section 7702 uses the single premium contract design as the maximum limit of investment orientation.

Life insurance performs a unique risk shifting function: most directly, it can provide resources to replace the insured's income following the death of the insured. Parents of dependent children are often concerned that the death of one or both parents would leave their children without adequate means of support. Many argue that society should encourage parents to provide the resources to take care of their dependent children in the event of their death.

Given this specific rationale for favorable tax treatment, these limitations seem appropriate if the tax revenue forgone generates an adequate amount of pure insurance protection. From this perspective, the tax revenue that the Treasury forgoes (as a result of not taxing the interest income credited) should not exceed the cost of current insurance protection provided. Otherwise, it arguably would be cheaper for the government to provide the insurance without charge to families with young dependent children.

Consider the \$100,000 single-premium life insurance contract discussed above. The single premium for this contract is \$25,000. As explained previously, during the first year that the contract is in effect, the life insurance company credits interest of \$994 and the charge for pure insurance protection totals \$150. For many subsequent years, the interest credited will greatly exceed the charges imposed for current insurance protection. For a number of years, the tax revenue forgone due not taxing the interest credited under a single premium policy exceeds the cost that the government would incur if it purchased the insurance protection and provided it to the policy owner without charge.

This suggests that IRC section 7702 treats arrangements that generate a substantial amount of investment income relative to the insurance protection obtained as life insurance. This illustration may raise questions about limitations contained in IRC section 7702 and suggest a broader analysis of the benefits and costs of providing life insurance protection would be useful.

The IRC section 7702A Limitations — Modified Endowment Contracts. As discussed previously, IRC section 7702A characterizes life insurance contracts as modified endowment contracts if the premiums paid exceed the premiums that would have been paid under a hypothetical “seven premium” contract. The tax treatment of distributions from modified endowment contracts differs from the treatment of distributions from other life insurance contracts. Specifically, (1) amounts withdrawn from a modified endowment contract are first characterized as income rather than as a nontaxable return of the taxpayer’s investment, (2) policy loans are treated as taxable distributions rather than as nontaxable loans, and (3) the amount included in income is subject to an additional 10% tax.

In effect, distributions from modified endowment contracts are treated identically to distributions from other tax-preferred savings vehicles, such as IRAs and annuities. The distribution rules are also similar to the rules applicable to pre-retirement distributions from qualified pension plans.¹¹ When a taxpayer withdraws money from these tax-preferred savings vehicles prior to retirement, some argue it demonstrates that the policy justification for the preferential tax treatment no longer exists. To the extent that the distributions represent previously untaxed income, Congress has decided to require immediate taxation. In addition, it imposed the 10%

¹¹ A portion of a pre-retirement distribution from a qualified pension plan is included in income and is subject to the 10% additional tax. In general, loans from qualified pension plans are also included in income when received. IRC section 72(p)(2), however, treats certain loans totaling not more than \$50,000 as nontaxable loans.

additional tax to eliminate the unjustified deferral benefit that the taxpayer obtained from not paying tax on the investment income during the years in which income was earned. Similar rules apply to distributions from Section 529 plans to the extent that the distributions are not used to pay for “qualified higher education expenses.”

In conclusion, under IRC section 7702A distributions from contracts that are classified as modified endowment contracts are taxed in the same manner as distributions from other tax-preferred forms of savings, such as pension plans, IRAs, annuities, and Section 529 plans. Distributions from life insurance contracts that are not characterized as modified endowment contracts are taxed more favorably.

Corporate-Owned Life Insurance¹² (“Janitors Insurance”)

Corporate-owned life insurance (COLI) is an arrangement in which a business purchases life insurance contracts on the life of one or more of its employees. Traditionally, life insurance utilized as part of a COLI arrangement was purchased on the life of the business’ top executives and owners. Also known as “key person” insurance, these life insurance arrangements generally insured the life of a small number of employees.

In recent years, however, large corporations have purchased life insurance contracts that insure the lives of large numbers of their employees. Reports in the *Wall Street Journal* and other newspapers referred to these arrangements as “janitors insurance.” According to these reports, some employees were not notified that their employer had purchased life insurance on their lives.¹³ When the insured employees died, the employers did not pay the proceeds from the life insurance to the employees’ surviving family members or other designated beneficiaries. Rather, consistent with the typical COLI arrangement, the employer is the beneficiary of the contract. Consequently, the employers receive the proceeds of the policies for their use. It is frequently claimed that the employers use the life insurance proceeds to pay for employee benefits, including health insurance for retired employees of the company.¹⁴

¹² For additional background information on COLI policies and a broader discussion of related state and federal legislative activity, see CRS Report RS21304, *COLI: Corporate Owned Life Insurance*, by S. Roy Woodall, Jr. For further discussion of the taxation of COLI, see CRS Report RS21498, *Corporate-Owned Life Insurance: Tax Issues*, by Don C. Richards.

¹³ Two examples of such articles include: Ellen E. Schultz and Theo Francis, “Valued Employees: Worker Dies, Firm Profits — Why? — Many Companies Insure Staff, Yielding Benefits on Taxes, Bottom Line — Where to Put Dead Peasants,” *The Wall Street Journal*, April 19, 2002, Sec. A, p.1 and Kim Clark, “Better off Dead?,” *U.S. News & World Report*, May 6, 2002, p. 32.

¹⁴ See C. David Buckalew and Don R. Teasley, “Financing Employee Coverages Can Spur Big Dividends,” *Risk Management*, December 1990, pp. 36-40, and Bryn Mawr, John T. Adney, Kirk Van Brunt, and Bryan W. Keene, “COLI Reconsidered,” *Journal of Financial Service Professionals*, vol. 56, Nov. 2002, p. 41-58.

Two distinct tax policy issues arise in connection with COLI arrangements. Under current law, the investment income that a corporation earns in connection with a COLI arrangement is not taxed if it is paid to the employer on account of the death of the insured. The first tax policy question is whether it is appropriate that a corporation can benefit from these arrangements. One of the main justifications for the exclusion of investment income from taxation is to provide the insured's family with life insurance proceeds to replace the income that the insured would have earned if she had survived. Some would argue, therefore, that the life insurance proceeds that a corporation receives should be free of tax only if the employer distributes the proceeds to the employee's family or other designated beneficiary. Others would point out that corporations have been allowed to shelter income in insurance policies for years.

In many circumstances, however, corporations purchase life insurance to obtain a tax-free investment return. Rather than making the proceeds available to the employee's family to replace the employee's income, the corporations use the proceeds to meet their general business needs (including the payment of benefits to other employees).¹⁵ In these circumstances, the policy justification for exempting the life insurance proceeds from taxation is unclear.

The second, and distinct, tax policy issue arises in connection with what has been termed "leveraged" COLI arrangements. In a leveraged COLI arrangement, the corporate owner of the life insurance contract borrows to pay a substantial portion of the insurance premiums. This is a form of "tax arbitrage" in which a taxpayer incurs tax deductible interest while earning tax-free investment returns. The combined effect of this arrangement is similar to many other corporate tax shelters: the tax savings may exceed the costs incurred in paying for the life insurance.

The economics of a "leveraged" COLI arrangement can be illustrated by examining the facts of *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254 (1999) *aff'd* 254 F.3d 1313 (11th Cir. 2001). In this case, it was projected that the taxpayer would purchase life insurance on the lives of 38,000 of its employees. In the first year of this arrangement, it was projected that the taxpayer would pay aggregate premiums of \$114 million. The cash values for the life insurance policies would total approximately \$120 million at the end of the first year. The taxpayer would take out loans from the policies in the aggregate amount of almost \$108 million, and the taxpayer would pay interest of approximately \$12 million on these loans. After taking into account the projected net \$2 million payable to the company as a result of deaths of its employees, the taxpayer was projected to incur a pretax loss of more than \$4 million.

After taking into account the purported tax benefits arising from these transactions, however, the taxpayer was projected to realize a slight after-tax profit.

¹⁵ Recently, *The Wall Street Journal* reported that large corporations are purchasing cash value life insurance contracts with the intent of donating the proceeds of the contracts to charity. It is claimed that the tax benefits are sufficient to generate the contributions to charity at no net cost to the corporations. T. Francis and E. Schultz, "Dying to Donate: Charities Invest in Death Benefits," *The Wall Street Journal*, Feb. 6, 2003.

The difference between the pretax loss and the after tax profit was attributable to the following two factors: (1) the tax savings arising from the deduction of the interest and fees; and (2) the nontaxable nature of the loan proceeds and the death benefits. In subsequent years, the taxpayer was projected to realize much larger pretax losses and after-tax profits. During the period from 1993-2052, it was projected that the taxpayer would realize after-tax earnings in excess of \$2.2 billion, while incurring pretax losses aggregating more than \$750 million.

The Tax Court concluded that this arrangement was a sham transaction. Under the sham transaction doctrine, tax benefits are disallowed if the transaction lacks economic effects or substance other than the generation of tax benefits. As a consequence, the court determined that the taxpayer was not entitled to the claimed tax benefits.

The life insurance industry asserts that any unjustified tax benefits arising from the use of corporate-owned life insurance were fully addressed in legislative changes enacted in 1996 and 1997. These changes limited the interest deduction allowed in connection with certain COLI arrangements.

First, IRC section 264(e) establishes limits on the amount of deductible interest paid “with respect to” life insurance contracts insuring the lives of corporate employees. This provision limits the deductible interest in an indirect manner-it specifies that deductions are allowed only on interest paid on a limited amount of indebtedness incurred “with respect to” life insurance contracts. Specifically:

- the maximum amount of indebtedness that may give rise to deductible interest is limited to \$50,000 per insured “key person” and
- at most, 20 insured individuals are characterized as key persons.

Under this provision, at most \$1,000,000 of indebtedness could give rise to deductible interest payments. This limitation would eliminate most of the tax benefits claimed in connection with transactions structured in the same manner as the transaction in the *Winn-Dixie Stores* case discussed above. Specifically, this provision limits tax benefits arising under those COLI arrangements in which the corporate owner of the life insurance contracts uses the contracts as security for the loans. This limitation, however, appears limited to interest arising under life insurance policy loans. If a taxpayer borrows from other unrelated sources, it is possible that this limitation would not apply.

In 1997, Congress expanded the limitations contained in IRC section 264(e). The popular press reported that the Federal National Mortgage Association (“Fannie Mae”) planned to enter into a COLI arrangement covering the lives of the individuals who had borrowed money to purchase homes. To address this situation, Congress enacted IRC section 264(f). This provision disallows a portion of a corporation’s interest deduction. The magnitude of the disallowance depends upon the aggregate cash value of the corporation’s life insurance contracts and the aggregate adjusted basis of its other assets. For example, consider a bank that owns life insurance contracts with an aggregate cash value of \$1 billion and assets with an aggregate

basis of \$10 billion. The unborrowed cash value represents 10% of the bank's assets. Consequently, IRC section 264(f) disallows 10% of the bank's interest expense.

It is likely that this provision achieves its goal — to eliminate the tax benefits of bank-owned life insurance (BOLI) arrangements in which financial institutions purchase life insurance contracts on the lives of individuals who borrow from the bank. By its terms, however, this interest disallowance provision does not apply to COLI arrangements that involve individual life insurance contracts on the lives of a corporation's officers, directors, employees and certain shareholders. Consequently, unless the interest is treated as incurred with respect to life insurance contracts, a corporation would not lose its interest deduction when it continues to borrow funds (other than policy loans) at the same time that it pays the life insurance premiums on the lives of its employees.

In the 108th Congress, there have been a number of attempts to impose restrictions on corporate-owned life insurance or remove tax advantages. Representative Gene Green introduced H.R. 414, Life Insurance Employee Notification Act, which would require that employers who purchase corporate-owned life insurance notify the covered employee of the policy. Representative Rahm Emanuel introduced H.R. 2127, which would repeal the tax-free treatment of death benefits for certain COLI policies as well as require disclosure to and provide objection rights for employees upon whom insurance contracts are purchased. In the Senate, Senator John Edwards offered an amendment to the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA; P.L. 108-27) that would have similarly eliminated the exclusions of death benefits from income tax for many COLI policies. The amendment was ruled not germane pursuant to the Congressional Budget Act of 1974.¹⁶

¹⁶ Rollcall Vote No. 175 Leg. to amendment numbered 662, *Congressional Record*, May 15, 2003, p. S6441.

Split Dollar Life Insurance — Compensatory Arrangements for Corporate Executives and Other Tax Planning Goals

Introduction: The Structure of Split Dollar Arrangements

Recently, “split dollar life insurance” has received a great deal of attention. Corporations and highly compensated executives have utilized this arrangement as a form of non-qualified deferred compensation.¹⁷ According to the press, the cash value on a split dollar life insurance arrangement for one corporate executive will total \$18 million, while another corporation reportedly paid \$3 million per year on premiums under a split dollar arrangement.¹⁸ Parents (or grandparents) have used split dollar life insurance to transfer wealth to their children (or grandchildren). The press has reported arrangements in which wealthy individuals have utilized split dollar life insurance to transfer wealth to their children and grandchildren while purporting to avoid both the gift tax and the estate tax.¹⁹

“Split dollar life insurance” is not a special type of life insurance contract. Rather, it describes an arrangement in which several parties “split” the beneficial interest in the economic rights arising under a cash value life insurance contract. When an employer uses split dollar life insurance as a form of compensation, it will pay most or all of the premiums. In addition, the employer is entitled to receive a portion of the death benefit paid following the death of the insured.

In a “traditional” split dollar arrangement, the employer is not obligated to pay the entire premium. Rather, its obligation is limited to the anticipated increase in the life insurance contract’s cash value. The employee is obligated to pay the remaining portion of the premium. Under the economics of a typical cash value life insurance contract used in split dollar arrangements, the employee’s share of the premiums declines rapidly and frequently disappears within a few years. In this traditional arrangement, the employer is entitled to receive the *greater* of: (1) the cash value of the contract; or (2) the aggregate amount of premiums that it paid. The remainder of the death benefit is paid to the beneficiary that the executive designates. In effect the employee enjoys the benefit of term insurance protection for the remainder of his life.

¹⁷ The term “nonqualified deferred compensation” refers to a wide variety of compensation arrangements between employers and employees. Typically, an employer transfers money (or other property) to a third party, and the employee will become entitled to receive the money (or property) years later. Most often, these arrangements benefit senior executives and other highly compensated employees. There are two essential characteristics of nonqualified deferred compensation. First, these arrangements do not satisfy the requirements of “qualified” retirement plans (such as pension plans, 401(k) salary reduction plans, 403(b) plans for employees of nonprofit organizations or Individual Retirement Accounts). Second, taxation of the employees is deferred until some future year.

¹⁸ Tracie Rozhon and Joseph B. Treaster, “Insurance Plans of Top Executives May Violate Law,” *New York Times*, Aug. 29, 2002, p. A-1.

¹⁹ David Cay Johnson, “I.R.S. Loophole Allows Wealthy to Avoid Taxes,” *New York Times*, July 28, 2002.

For example, the annual premium on a policy with a death benefit of \$1 million may be \$20,000 per year. If the executive dies during the 10th year in which the policy is in effect, the employer would receive \$200,000 and the executive's beneficiary would receive the remaining portion of the death benefit — \$800,000. The employer receives no payment (such as interest) to compensate it for the premium payments.

The economic rights and obligations in a split dollar arrangement are incorporated into an agreement between the parties. The agreement will specify which party is designated as the legal owner of the life insurance contract. If the agreement designates the employer as the owner of the life insurance contract, the life insurance contract will contain a provision called an “endorsement” which specifies the rights of the employee to proceeds from the contract. This type of split dollar arrangement is called an “endorsement method” arrangement.

Alternatively, the parties may agree that the employee will own the life insurance contract. In this case, the life insurance contract is used as collateral for the employer's right to receive an amount equal to the aggregate amount of premiums paid. This type of split dollar arrangement is called a “collateral assignment” arrangement.

Under many of the contemporary (or “equity”) split dollar arrangements, employers (or wealthy older relatives) pay all of the premiums and the executives (or younger relatives) become entitled to a substantial portion of the contracts' cash values. In cases reported in the press, certain executives become entitled to millions of dollars of cash value. Because the executives' rights with respect to the cash values are attributable exclusively to premium payments made by their employers, the arrangements have the same effect as other deferred compensation arrangements. Similarly, under split dollar arrangements utilized by families, younger relatives become entitled to millions of dollars of cash value that is attributable to premiums that their wealthier relatives paid. Consequently, these arrangements produce the same economic results as inter-vivos gifts.

The remainder of this report discusses the tax treatment of split dollar arrangements. First, the tax treatment of the “classic” or “traditional” split dollar arrangement is summarized. Second, the developments that led the Internal Revenue Service (and the Department of the Treasury) to reconsider the early analysis is reviewed. Third, recent Internal Revenue Service (IRS) guidance on the taxation of these arrangements is discussed.

The Tax Treatment of Split Dollar Arrangements

Early IRS Analysis of Traditional or Classic Arrangements. The Internal Revenue Service published revenue rulings that, for many years, governed the tax treatment of split dollar arrangements. Initially, the IRS characterized the employer's premium payments as interest free loans from the employer to the employee. At that time, an interest-free loan from an employer to an employee did not create any taxable compensation.

In 1964, the Service revoked this interpretation and issued Revenue Ruling 64-328, which governed the treatment of split dollar arrangements for the next three decades. In this ruling, the Service reasoned that:

- the employer provided the funds needed to generate the cash value of the life insurance contract;
- in an arm's length arrangement, the employer would enjoy the benefit of the earnings on the cash value;
- the investment earnings that the cash value generates are applied to provide current life insurance protection without cost to the employee.

The net effect of this arrangement was that the investment earnings (or a portion of the employer's premium payment) was used to provide term life insurance protection for the employee. The IRS concluded that the use of the employer's investment income (or premium payments) to provide the insurance protection created additional compensation each year. The amount of income equals the value of the current life insurance protection provided under the split dollar arrangement during the year (reduced by any amount that the employee paid for this insurance). In addition, the Service stated that taxpayers could use the insurance rates set out in a published table of term insurance rates (the "P.S. 58" rate table) to determine the value of the life insurance protection. In a later ruling, the Service determined that taxpayers could value the cost of current life insurance protection using the actual cost of 1-year term life insurance charged by the issuer of the split dollar life insurance contract if these rates were available to all "standard risks."

Under Revenue Ruling 64 — 328, the employees received only one economic benefit: the executives enjoyed term life insurance protection without paying the full cost of this protection. Also under the same ruling, the executives had to treat the value of this benefit as additional taxable compensation. Moreover, the methods used to value this benefit incorporated an objective methodology that, in most instances, reached reasonable results.

Concerns Leading to Reconsideration. In 2001 and 2002, the Department of the Treasury and the IRS reconsidered the tax treatment of split dollar life insurance arrangements to reflect at least four significant developments that either occurred or became more significant in the years subsequent to the issuance of the original revenue rulings.

Development of Equity Split Dollar Arrangements. The first, and most significant, development was that split dollar arrangements were marketed incorporating significantly different economic terms. Unlike the traditional split dollar arrangement, in which an employee enjoys only the benefit of current term life insurance protection, an "equity" split dollar arrangement generates additional economic benefits for the employee. Specifically, under an "equity" split dollar arrangement, the cash value of the life insurance contract is also split between the employer and the employee. When the arrangement terminates (either on account of the death of the employee or by agreement), the employer receives an amount equal to the aggregate amount of premiums that it has paid. When the life insurance contract's cash value exceeds the aggregate premiums paid, this "equity" in the

contract belongs to the employee. This equity represents a vested economic benefit accruing to the employee which was generated by the employer's premium payments.

The following example illustrates the economic benefits arising from an equity split dollar arrangement. Corporation A and its chief executive officer, P, enter into the following agreement:

- P will own the life insurance contract with a death benefit of \$1 million.
- Each year, Corporation A will pay a premium of \$20,000; Executive P does not make any premium payment.
- Upon the death of Executive P, Corporation A is entitled to receive the cumulative amount of premiums that it paid with respect to this contract.
- Executive P (or the beneficiary that Executive P designates) receives the remainder of the \$1 million death benefit.
- If the life insurance contract terminates or is transferred to Executive P, Corporation A is also entitled to receive the aggregate amount of premiums that it paid with respect to this contract. Executive P keeps the remaining cash value if the contract is terminated.

As with the other types of split dollar life insurance arrangements, Executive P receives the benefit of the current life insurance protection, and the value of this protection is included in P's income for tax purposes. In addition, to the extent that the life insurance contract's cash value exceeds the cumulative premiums paid, Executive P enjoys an additional economic benefit. To illustrate, assume that the cash value of the contract at the end of the first year equals \$21,000. Because Corporation A is entitled to receive the \$20,000 that it paid as the premium, Executive P has vested ownership rights with respect to the remaining \$1,000 of cash value. Assume further that the cash value equals \$45,000 at the end of the second year. Again Corporation A is entitled to receive the \$40,000 that it paid as premiums during the two years that the contract is in effect. Consequently, Executive P's has vested ownership rights with respect to \$5,000 of the cash value.

Enactment of IRC sections 83 and 7872 and Their Application to Equity Split Dollar Arrangements. Subsequent to the issuance of Revenue Ruling 64-328, Congress enacted IRC sections 83 and 7872. These provisions establish statutory rules that apply to deferred compensation arrangements and interest-free loans. As discussed below, application of these statutory provisions result in an employee having more income arising from her interest in an equity split dollar arrangement than under a traditional split dollar arrangement.

IRC Section 83 applies when cash or property is transferred by an employer in connection with the performance of services by an employee. The property need not be transferred to the employee; if it is transferred to a third party, the employee has income in an amount equal to:

- the fair market value of the such property; minus
- the amount (if any) that the employee pays for such property.

Under IRC section 83, the employee has income when, and only to the extent, that the employee acquires nonforfeitable rights to the property.

IRC Section 83 applies in a different manner to traditional and equity split dollar arrangements. The only nonforfeitable right that an employee acquires in a traditional split dollar arrangement is the right to term insurance protection. Consequently, under IRC section 83 an employee would be required to include in income the fair market value of this protection. This is also the tax treatment that Revenue Ruling 64-328 mandates. In an equity split dollar arrangement, however, the employee also acquires a nonforfeitable right to an increased portion of the life insurance contract's cash value. Under section 83, the employee could be required to include both the value of the term insurance protection and the increase in the employee's share of the cash value.

Congress enacted comprehensive statutory rules governing the federal income tax consequences resulting from the creation of interest-free loans when it enacted IRC section 7872 in 1984. Prior to the enactment of IRC section 7872, taxpayers utilized interest-free loans to transfer economic benefits to employees or family members while avoiding income and transfer taxes. Under IRC section 7872, a taxpayer who lends money on an interest-free basis may be treated as having paid compensation or having made a gift. The following two examples illustrate how IRC section 7872 operates:

- Example 1: Corporation lends \$1 million to an executive which is repayable in 10 years. Assume further that the present value of the amount that the executive must repay equals \$600,000 if no interest is payable on this loan. Under IRC section 7872, the executive is treated as having \$400,000 of compensation when this interest free loan is created.
- Example 2: Corporation lends \$2 million to an executive that is repayable whenever Corporation requests repayment (i.e., the loan is repayable "on demand"). Assume further that no interest is payable on this loan. Under IRC section 7872, the executive is treated as having income from compensation each year. The amount of income equals the amount of forgone interest on this loan, which in this case would equal the outstanding balance on the loan (\$2 million) multiplied by the "applicable federal rate."

For IRC section 7872 to apply to split dollar arrangements, there has to be a loan and forgone interest. In certain split dollar arrangements, (1) the employee is treated as the owner of the life insurance contract, (2) the employer pays the premiums, and (3) under the terms of the arrangement, the total amount of premiums paid must be repaid to the employer. One characterization of the arrangement that comports with the economic terms is that the employer's payment of each premium constitutes a loan to the employee. Under IRC section 7872, the "forgone interest" would be taxed as compensation paid to the employee. In the traditional split dollar arrangement, the employer is entitled to all increases in the life insurance contract's cash value. A portion of the interest that the cash value generates is credited to, and

increases, the life insurance contract's cash value. The remainder of the interest earned is used to pay for the cost of term insurance protection.

The portion of the interest that increases the cash value accrues to the benefit of the employer/lender. Consequently, IRC section 7872 would not treat this portion as forgone interest. The remaining interest (i.e., that portion that is used to pay for the cost of current insurance protection) would be characterized as forgone interest for purposes of IRC section 7872, and therefore treated as taxable compensation. As is evident, the amount of income generated under Revenue Ruling 64-328 and IRC section 7872 is approximately equal: in both cases, the amount of compensation approximates the cost of the annual term life insurance protection.

Once again, different tax consequences result when equity split dollar arrangements are analyzed. In an equity split dollar arrangement, the employer is not entitled to receive the entire cash value; rather it has the right to receive a lesser amount — the aggregate amount of premiums that it paid with respect to the contract. In this case, all of the interest credited to the cash value accrues to the benefit of the employee. Under IRC section 7872 this larger amount of interest is characterized as forgone interest. As a result, the employee realizes more income than is generated under Revenue Ruling 64-328.

In sum, in equity split dollar arrangements under Revenue Ruling 64-328, employees have economic income arising from their employment relationship that avoids tax. If section 83 and section 7872 properly apply to these newer arrangements, then the employee would have additional taxable income.

Use of Improper Valuation Methods. Two concerns with the methodology used to value current insurance protection also led the IRS to reconsider the tax treatment of split dollar arrangements. First, taxpayers could value life insurance protection using the actual cost of one-year term life insurance charged by the issuer of the life insurance contract if these rates were available to all applicants for life insurance who qualified as “standard risks.” In recent years, the IRS learned that some life insurance companies claimed that low term insurance rates were available when, in fact, these rates were not available to all standard risks.²⁰ Consequently, some taxpayers may have understated the value of the current insurance protection provided to employees under split dollar arrangements.

Second, the mortality tables, upon which the term insurance charges within P.S. 58 are based, no longer relate to the present market for term insurance.²¹ As a result, the term insurance charges set forth in the P.S. 58 rate table overstate the actual value of term insurance protection for most taxpayers. Consequently, taxpayers who used this table to value the current life insurance protection provided under a split dollar arrangement generally included an excessive amount in income.

²⁰ U.S. Department of the Treasury, Internal Revenue Service, *Internal Revenue Bulletin*, Bulletin No. 2001-5, Jan. 29, 2001, p. 461.

²¹ U.S. Department of the Treasury, Internal Revenue Service, *Internal Revenue Bulletin*, Bulletin No. 2001-5, Jan. 29, 2001, p. 460.

Further “Product” Development: “Reverse” Split Dollar Arrangements. The fourth development results from the use of the P.S. 58 term insurance rate table to create a problematic tax-avoidance vehicle: the so-called “reverse” split dollar arrangement. In a reverse split dollar arrangement, the parties reverse the traditional allocation of interests in a cash value life insurance contract. As with a conventional split dollar arrangement, the employer pays the premium. Unlike the conventional arrangements, the employee becomes entitled to the cash value of the life insurance contract; the employer receives the remainder of the death benefit. Employers computed the employee’s compensatory economic benefit in an indirect manner: the employer compared the employer’s premium payment to the value of current life insurance protection that it retained. In making this comparison, taxpayers utilized the P.S. 58 rate table, thereby overstating the value of the benefits allocable to the employer. As a result, taxpayers have claimed that the premium payment produces little or no benefit to the employee.

The following example illustrates the claimed benefits arising from a reverse equity split dollar arrangement. Corporation C and its chief executive officer, E, enter into the following agreement:

- Executive E will own the life insurance contract with a death benefit of \$10 million.
- Each year, Corporation C will pay a premium of \$200,000; Executive E does not make any premium payment.
- If the life insurance contract terminates or is transferred to Executive E (or his designate), Executive E is entitled to receive the aggregate amount of premiums that Corporation C paid with respect to this contract.
- Upon the death of Executive E, Executive E (or the beneficiary that Executive E designates) is entitled to receive the cumulative amount of premiums that the employer paid with respect to this contract.
- Corporation C receives the remainder of the \$10 million death benefit.

The actual cost of term insurance protection charged by the life insurance company in connection with this arrangement might be \$60,000. Using the rates specified in the P.S. 58 rate table, however, the value of the term insurance protection may exceed the \$200,000 annual premium. Taxpayers claimed that Corporation C received an economic benefit at least equal to the premium that it paid. Based on this conclusion, taxpayers claimed that Executive E did not have any income despite the fact that Executive E had vested rights to the cash value (plus all interest credited to the cash value).

Taxpayers also utilized reverse split dollar arrangements as a device to transfer wealth from parents (or grandparents) to children (or grandchildren) while purporting to avoid estate and gift tax. The parent pays the entire premium. The child becomes entitled to the life insurance contract’s cash value. The parent is entitled to the remainder of the death benefit. In this transaction, the parent makes a gift to the child. For gift tax purposes, there is no gift to the extent that the parent receives value as a result of making the premium payment. Again, some taxpayers computed the value of the current life insurance protection utilizing the P.S. 58 rates. Because

these rates overstate the fair market value of the current life insurance protection, taxpayers have understated the magnitude of the gift.

Recent IRS Guidance on Taxation of Split Dollar Arrangements. In 2001 and 2002, the IRS issued proposed regulations and several notices that address the tax treatment of split dollar life insurance. In these proposed regulations and notices, the IRS addressed the developments discussed above. Under the proposed regulations,²² the tax treatment of split dollar arrangements will depend on the identity of the owner of the life insurance contract. If the employer is the owner of a split dollar life insurance contract, then the employee is taxed on all of the economic benefits provided to her under the arrangement. If, however, the employee is the owner of the contract, the employer's premium payments are characterized under IRC section 7872, which governs the tax treatment of interest-free loans.²³

The following examples illustrate how the proposed regulations would apply in several basic types of split dollar arrangements. Each example discusses a split dollar arrangement that incorporates the follow common terms:

- Corporation C and Executive E enter into an agreement that specifies their rights with respect to a life insurance contract.
- The death benefit of the life insurance contract is \$3,000,000.
- Corporation C pays the entire annual premium of \$100,000; Executive E does not make any premium payment.
- Corporation C will receive an amount equal to the total amount of premiums paid. Thus, if Executive E dies at the end of his life expectancy of 15 years, Corporation A will receive \$1,500,000.
- If the life insurance contract terminates or is transferred to Executive E (or his designate), Corporation C is also entitled to receive the aggregate amount of premiums that it paid with respect to this contract.
- The remainder of the death benefit will be paid to the beneficiaries that Executive E designates.

Example 1 — Employee Ownership of Life Insurance Contract. In addition to the common terms discussed above, Executive E is designated as the owner of the life insurance contract. The proposed regulations characterize each premium payment as an interest-free loan made from Corporation C to Executive E. In effect, IRC section 7872 would bifurcate this \$100,000 loan into two components. First, the present value of Executive E's obligation to repay \$100,000 at the end of the 15-year period is treated as a bona fide loan. Second, the remainder of the \$100,000 payment is treated as compensation paid by Corporation C to Executive E.

²² U.S. Department of the Treasury, Internal Revenue Service, "Split-Dollar Life Insurance Arrangements," *Federal Register*, vol. 67, no. 131, July 9, 2002, p. 45414.

²³ These proposed regulations would also govern the tax consequences arising from split dollar arrangements involving corporations (and their shareholders) and wealthy individuals (and their relations). In these arrangements, the ownership of the life insurance contract determines which approach to taxation will apply.

Assuming that the computation of present value utilizes a 6% interest rate, the present value of Executive E's obligation to repay the first \$100,000 payment equals \$41,726. Under IRC section 7872 and the proposed regulations, Executive E is treated as having received compensation for the remainder of the \$100,000, or \$58,274.

Example 2 — Employer Ownership — Equity Arrangement. In contrast to Example 1, Corporation C, rather than Executive E, is designated as the owner of the life insurance contract. In formal terms, no loan has been made from the Corporation to the Executive so that IRC section 7872 does not apply to this arrangement. Consequently, the proposed regulations specify that Executive E has income to the extent of the fair market value of all economic benefits provided under the arrangement.

Under the proposed regulations, the acquisition of this equity interest arising from Corporation C's premium payments is characterized as a taxable economic benefit. Consequently, the increase in Executive E's vested right with respect to the cash value is included in Executive E's income for federal income tax purposes. The proposed regulations do not specify how this vested interest should be valued. The IRS has requested comments from the public concerning the proper valuation of this equity interest.

Under the proposed regulations, Executive E enjoys an additional economic benefit: the value of the current life insurance protection. In determining the value of the current life insurance protection, Executive E may use the rates contained in Table 2001. This table of term life insurance rates reflects the decline in term life insurance rates that has occurred in recent decades. Alternatively, Executive E may determine the value of the current life insurance protection using the insurer's lower published premium rates. To use these lower rates, however, the insurer must make these rates known to individuals who apply for term insurance and the insurer must sell term insurance at those rates.

Example 3 — Employer Ownership — Non-Equity Arrangement. As in Example 2, Corporation C is designated as the owner of the life insurance contract. In addition, Corporation C's entitlement to receive cash is not limited to the aggregate amount of premiums paid. Rather, it is entitled to receive the entire cash value of the contract upon the death of Executive E or upon the surrender of the life insurance contract.

In formal terms, no loan has been made from the Corporation C to Executive E in this arrangement, so that IRC section 7872 does not apply. Consequently, Executive E has income to the extent of the fair market value of the economic benefit provided to him. In this transaction, the only economic benefit provided to Executive E is the value of the current life insurance protection. Thus, the proposed regulations prescribe the same tax treatment as existed under the earlier IRS revenue rulings.

In determining the value of the current life insurance protection, Executive E may use the rates contained in Table 2001. This table of term life insurance rates reflects the decline in term life insurance rates that has occurred in recent decades. Alternatively, Executive E may determine the value of the current life insurance

protection using the insurer's lower published premium rates. To use these lower rates, however, the insurer must make these rates known to individuals who apply for term insurance and the insurer must sell term insurance at those rates.

Reverse Split Dollar Arrangements. The IRS has announced special limitations to restrict the abusive use of reverse split dollar arrangement. As discussed above, in a reverse split dollar arrangement, the employer (or a donor) utilized P.S. 58 rates to determine the value of current life insurance protection that it retained. Because these taxpayers overstated the value of the benefits allocable to the employer (or a donor), they claimed that the premium payment produces little or no benefit to the employee (or a donee). In Notice 2002-59 and in the proposed regulations, the IRS announced that taxpayers may not use either the P.S. 58 rates or the Table 2001 rates in a reverse split dollar arrangement to calculate the value of the interest of an employee or a donee.

Additional Reading

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- L. Brody, L. Richey, W. Thater and R. Baier, “Insurance-related Compensation” Tax Management Portfolio #386, 2nd.
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- A. Pike, “Reflections on the Meaning of Life: An Analysis of Section 7702 and the Taxation of Cash Value Life Insurance” 43 *Tax Law Review* 491 (1989).
- S. Simmons, “Practical Guide to the Use of Split Dollar Life Insurance Plans” 47 U.S.C. Annual Institute on Federal Taxation (1995).
- “Split Dollar Life Insurance Arrangements — Notice of Proposed Rulemaking” 67 Federal Register 45414 (July 9, 2002).

Related CRS Reports:

- CRS Report RS21304. *COLI: Corporate Owned Life Insurance*, by S. Roy Woodall, Jr.
- CRS Report RS21498. *Corporate-Owned Life Insurance: Tax Issues*, by Don C. Richards.
- CRS Report RS20923. *Taxes and the ‘Inside Build-Up’ of Life Insurance: Recent Issues*, by David L. Brumbaugh.