Principal®

# Imputed interest tax reporting for Loan Split Dollar Plans

Under a typical loan split dollar plan, a key employee or business owner (the participant) purchases (and owns) a life insurance policy insuring his or her own life, and names a beneficiary to receive the death proceeds. The business pays the policy premiums, but these payments are treated as loans to the participant because he or she is obligated to repay these amounts to the business.

Normally, the policy is collaterally assigned to the business to help ensure the repayment obligation will be fulfilled. If the agreement will be terminated while the participant is living (e.g., due to retirement), the participant/policyowner may withdraw from the policy's cash value (and/or use other funds) to repay the loan obligation, whereupon the business will release the collateral assignment. The participant may then keep the policy for personal needs as originally intended. Or, if the insured participant dies while the policy and agreement are both in force, the collateral assignment ensures the business will be paid its share of the death benefit first – a portion of the death benefit equal to the loan obligation will be paid to the business -- with any excess paid to the participant's named beneficiary.

## Interest is imputed when below-market rate is charged

When the business *lends* premiums to the participant/policyowner, the premiums (the amounts lent) are not taxable because they are not transferred -- they are owed back.

However, the loan itself – the act of making money available for use by another – has a value, and this value is measured by an interest rate. Because lending money provides value to the borrower, the interest amount can constitute a taxable transfer. Taking cognizance of this fact, Internal Revenue Code (IRC) § 7872 applies to most loans whenever the arrangement does not charge at least a market rate of interest to the borrower (this most commonly occurs when the lending employer charges no interest at all).[1]

If such a "below-market" loan is made, IRC § 7872 imposes tax (imputes interest) as if two transfers are occurring:

- payment of an interest amount from the lender to the borrower, and
- payment of an interest amount from the borrower "back" to the lender.[2]

To avoid the imputed transfers of interest under I.R.C. § 7872, the lender must charge a minimum interest rate that is determined monthly by the Internal Revenue Service (IRS) and is known as the "Applicable Federal Rate" (AFR). The relevant initial AFR is determined the month that the loan is made. In situations where a lending employer charges zero interest on the loan, the imputed interest amount that is income taxed to the participant is determined by the AFR.

## Demand loans vs. term loans

A loan split dollar plan can use either of two types of loans: a demand loans or a series of term loans.

- A demand loan is payable in full whenever the lender (the business) demands repayment.
- Term loans are defined in the negative – they are any loans that are not demand loans. But generally, term loans are to be repaid after a stated time period or upon the insured's death. With split dollar loans, it is generally unwise to impute interest when the loan period is simply a stated term unrelated to death.[3]

Under split dollar demand loans:

- The relevant AFR (used to calculate imputed interest) is the "blended annual rate" for loans outstanding at least a year.
- The blended annual rate is published by the IRS in July each year (and thus is subject to change annually). The blended annual rate is equal to one-half of the January semi-annual short-term AFR multiplied by one-half of the July semi-annual short-term AFR.[4] (See below for definition of short-term loan).
- With demand loans, the blended annual rate applies to the entire outstanding loan balance (cumulative loaned premiums plus any accrued interest).

Under split dollar term loans:

- The relevant AFR (used to calculate imputed interest) differs depending on whether the loan is:
    - short-term (not over three years),
    - mid-term (more than three years but not over nine years), or
    - long-term (more than nine years).

In contrast to demand loans, with term loans each loaned premium is treated as a separate loan with its own AFR that remains "locked-in" at that loan's relevant rate for that loan's entire duration. Therefore, with a split dollar plan that uses term loans with a series of premiums paid, there will be multiple outstanding parallel loans with different AFRs.

With many split dollar loans, the lending business does not charge or accrue interest, so the interest amount that is imputed is determined by the AFR. The split dollar regulations tell us that the relationship between the lender and borrower dictates the nature and taxation of these imputed transfers of interest (compensation, dividend, gift, or otherwise).[5]

## Principal reports demand loan imputed interest amounts to the business

As part of our complimentary administrative services, Principal's Business Market Administration (BMA) department provides support for demand loan arrangements (but not for term loans). As such, BMA will track demand loan balances and will calculate and report the AFR interest amounts (i.e., the imputed interest). BMA provides these reports to businesses each January in anticipation of the April tax reporting season but can provide these reports at some other time if so requested.

## Tax reporting by the parties

Although Principal provides annual imputed interest amounts to the business, Principal does not tax report these figures to the IRS. Rather, it's the responsibility of the business to ensure appropriate tax reporting occurs for each of the key employees or business owners participating in the loan split dollar plan.

Unfortunately, there does not seem to be any federal government guidance that specifically addresses how to report imputed interest under a *loan split dollar plan* in particular.

One thought is that the business could report the imputed interest relating to a split dollar loan on a Form 1099-R, "Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc." The instructions for Form 1099-R state it should be used to report "premiums paid by a trustee or custodian for the cost of current life or other insurance protection," and that the taxable amount should include the cost of "current life insurance protection." But Form 1099-R seems an ill-fit, as the benefit provided by the business under a loan split dollar plan is not really life insurance protection, but instead is the interest-free use of money. That's why it is measured by an interest rate and not by an insurance term rate.

Given that the split dollar regulations state that the tax effects of any split dollar plan depend upon the relationship between the parties involved, it seems that the *tax reporting* should follow. As such:

- If the business lends premiums to a participant/policyowner due to that individual's role as an *employee*, the imputed interest would be treated and reported as *compensation*.

- If the business lends premiums to a participant/policyowner due to that individual's role as an *owner of the business* (partner or shareholder), the imputed interest would be treated and reported as a *distribution* or *dividend*.[6]

**Interest-free split dollar loan to employee**

Presumably, where the participant/policyowner is an employee, the business would report the imputed interest amount for federal income tax purposes on a Form W-2, in Box 1 (wages, tips, and other compensation). In line with this treatment of the value of imputed interest being compensation to an employee, it seems the value would also be placed on the W-2 in:

- Box 3 with regard to Social Security Tax,
- Box 5 with regard to Medicare Tax, and
- Box 16 and 18 with regard to State and Local Tax (if applicable).

**Interest-free split dollar loan to business owner**

Similarly, where the participant/policyowner is a business owner, federal tax reporting presumably would be as follows:

- If a C corporation lends premiums to a shareholder, it seems reasonable to report the imputed interest as a dividend on a form 1099-DIV.
- Along the same vein, if an S corporation lends premiums to a shareholder, it seems reasonable to report the imputed interest as a distribution on a Schedule K-1 of Form 1120-S.
- And if a partnership lends premiums to a partner, it seems reasonable to report the imputed interest as a distribution on a Schedule K-1 of Form 1065.

## Conclusion

As described above, Principal provides annual imputed interest amounts as a complimentary service to the business that sponsors the split dollar loan. But as can be discerned from the discussion above, tax law guidance is not entirely clear about how the business should in turn tax report the imputed interest amounts to the participant/borrower. Ultimately, the parties involved in the loan split dollar plan will have to rely on their own legal and tax counsel when determining how to tax report the benefits that are provided.

[1] Interest is charged either by having the borrower pay the interest amount to the lender, or by annually adding (compounding) interest to the loan amount.

[2] Even when interest is imputed, it generally has no net tax effect for the business if the benefit is provided to individuals due to their employee status (as opposed to status as an owner). This is because any income to the employer is generally offset by a compensation deduction amount equal to the imputed interest.

[3] It is generally unwise because, when interest is imputed on a pure term loan (e.g., a period of years without regard to when death occurs), the determination of the imputed interest amount is carried out under a somewhat complicated present value calculation that results in the participant individual having a very large up-front income tax hit in the first year of the loan. See Treas. Reg. § 1.7872-15(e)(4).

[4] Rev. Rul. 86-17, 1986-1 CB 377.

[5] See Treas. Reg. § 1.7872-15(a) and (e).

[6] Given that no portion of the premium paid (loaned) by the business is deductible, split dollar loan plans provided by *flow-through tax entities* (S corporations and partnerships) to their *owners* are very rare, as the policyowner borrower would just be shifting the cost of paying for the policy to the business owners – including to the insured himself or herself – via the business. Furthermore, in S corporations, distributions must be made equally to all owners, proportionate to their relative percentages of ownership.

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