THE TOP 20 INSURANCE PLANNING MISTAKES IN ESTATE PLANNING (AND, HOW TO AVOID, OR AT LEAST FIX THEM)*

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THE TOP 20 INSURANCE PLANNING MISTAKES IN ESTATE PLANNING (AND, HOW TO AVOID, OR AT LEAST FIX THEM)

1. Avoiding the three-corner life insurance policy – a different owner, insured, and beneficiary – the Goodman problem.

In personal insurance planning, any time an insurance policy has three parties involved as owner, insured and beneficiary, there is a potential for an inadvertent gift by the policy owner of the entire policy proceeds at the insured's death.

In what was a typical situation, a husband might be the insured, his wife the owner, and their children the policy beneficiaries.[1] Under the holding of the Goodman case,[2/] at the insured's death, in this situation, the wife would be considered to have made a gift of the entire policy death proceeds to the children, because, as the owner, she could have made herself the beneficiary – obviously an unanticipated and undesirable result. If the beneficiary were a trust in which the wife had an interest, the gift would be the actuarial value of the remainder, assuming the wife's retained interest was a "qualified interest" under Section 2702 of the Code; otherwise it would be a gift of the entire proceeds.[3/] If the beneficiary were a skip person from the wife's point of view, or a trust for skip persons, the wife would also have made a generation-skipping transfer of the proceeds at the insured's death.

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1 Because of the unlimited Federal estate tax marital deduction for US citizen spouses, this fact pattern is less likely today, but the issue could still occur if the owner were a non-citizen spouse or a child.

2/ Goodman v. Commissioner, 156 F.2d 218 (2nd Cir. 1946).

3/ If she had a power of appointment over the trust, her gift would be incomplete, depending on the terms of the trust, it could be includible in her estate.

The problem can be solved by being sure that, if the policy owner is not the insured, the policy owner is always the policy beneficiary.

2. Creating phantom income by surrendering a policy (or letting a policy lapse) which was subject to an outstanding loan.

Any amount received in a single sum under a life insurance contract on its complete surrender, redemption, lapse, or maturity is includible in the gross income of the policy owner, as ordinary income[4/] to the extent that that amount exceeds his or her "investment in the contract,[5/] a basis-like concept. Investment in the contract is the aggregate amount of premiums or other consideration paid for the contract, less any amount received under the contract, to the extent that amount was excludable from gross income (such as dividends received on a participating policy or withdrawals from a universal life policy, so long as they don't exceed basis).[6/]

Accordingly, investment in the contract will be aggregate premiums paid by the taxpayer, reduced by any dividends, unrepaid loans, accumulated interest on loans, and any other amounts received under the contract, such as withdrawals, which were not previously includible

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4/ Since there is no sale or exchange to support capital gains treatment; however, for the reasons discussed below, there is an argument under Section 1234A that the surrender or lapse would qualify for capital gain treatment in any event.

5/ Section 72(e)(5)(a) and (3); Treas. Reg. Sec.1.72-11(d)(1).

6/ Section 72(c)(1), 72(e)(6). Note that, unlike basis in a policy, there is no reduction in the investment in the policy for the cost of insurance protection provided under the policy (because it has already been deducted from cash surrender value); see Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, discussed below, dealing with basis in a policy sold in a life settlement transaction to someone without an insurable interest in the life of the insured, and requiring reducing that basis by the cumulative cost of insurance.

in gross income.[7/] If dividends are received in cash or are used to reduce premiums, they will reduce the investment in the contract; presumably, dividends used to purchase term riders will also reduce investment in the contract, but dividends used to purchase paid-up additions will not (since they will be retained inside the policy and its cash value and therefore would first reduce investment in the contract and then increase it, resulting in no change). Any part of the premiums attributable to other benefits, such as a disability income benefit, also reduces investment in the contract.

The common mistake in surrendering a policy (or letting a policy lapse) is not taking account the effect of an outstanding policy loan on the taxation of the surrender or lapse. Under Regulation Section 1.1001-2(a), the amount realized from a sale or other disposition of property (including a life insurance policy) includes the amount of any nonrecourse liabilities from which the transferor is discharged (such as the policy loan) as a result of the sale or disposition.

Accordingly, any policy loan will be a part of the consideration received by the taxpayer on a policy surrender or lapse, generating ordinary income[8/] – without generating any

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7/ Note again the different issues raised on a sale of a policy, where, as discussed below, basis – not investment in the contract – is the relevant concept, under Rev. Rul. 2009-13, above.

8/ See the discussion regarding the capital gain treatment of a policy sale under Rev. Rul. 2009-13, above, and the possible application of Section 1234A to a policy lapse or, perhaps even a surrender, to provide capital gain treatment, as discussed below.

See Barr v. CIR, T.C. Memo 2009-250, involving a surrender of a policy subject to a loan, in which the Tax Court rejected the taxpayer's argument that gain on surrender should be capital. See also Reinert v. CIR, 2008-163 T.C. Summary Opinion, holding that gain on cancellation of a policy (lapse) was ordinary.

But note Hunt v. CIR, a Tax Court Case which was settled, without an opinion, on the basis that gain on the lapse of a policy subject to a loan was capital under Section 1234A, discussed below.

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cash in the case of a lapse, or potentially not enough cash to pay the tax, in the case of a surrender.

3. Exchanging a policy under Section 1035, which is subject to a loan, for a new policy, not subject to a loan in the same amount.

Under Section 1035 and Regulation Section 1.1035-1, a life insurance policy can be exchanged for another policy without recognition of gain or loss, if the policies exchanged "relate to the same insured." If a policy with a loan on it is exchanged for another policy, the amount of the loan on the first policy which is discharged in the transaction will be treated as "boot," money or other property received in the exchange generating taxable income in an otherwise non-taxable exchange without generating any cash to pay the tax.[9/]

To avoid recognition of the gain in such a situation, the new policy has to be issued with a loan equal to the loan on the policy exchanged;[10/] alternatively, of course, the loan on the first policy could be repaid before the exchange.

4. Borrowing against or withdrawing from a modified endowment contract (a "MEC"), or using such a policy as collateral for a third party loan.

A modified endowment policy is any insurance policy issued after June 21, 1988, under which the cumulative premium payments in any of the first seven years exceeds the sum of

9/ Treas. Reg. Sec. 1.1035-1, referring to Treas. Reg. Sec. 1.1031(b)-1(c) for the taxation of "boot" (presumably from the phrase "and something to boot") received in an otherwise tax-free exchange.

10/ PLRs 860433 and 8816015.

net level premiums which would have been paid to provide a paid-up policy after the payment of seven level annual premiums (the so-called seven pay test).[11/]

Distributions from modified endowment contracts are subject to the same rules as distributions from deferred annuity contracts – income rather than return of premiums comes out first as a result of any withdrawal or distribution.[12/] In addition, loans against the cash value of a modified endowment contract are treated as distributions for this purpose.

Finally, there is a 10% penalty tax (actually, an additional tax) on any withdrawal from or loan against a MEC if the "taxpayer" – not necessarily the insured – is under 59-1/2. It is unclear as to who the taxpayer is in the case of a trust owned policy; if it is a grantor trust, presumably the "taxpayer" is the grantor (there isn't any direct authority for that, but it is the only logical conclusion, since the trust is not a separate taxable entity).

The pledge of a Modified Endowment Contract as collateral for a third party loan (or even – apparently – the agreement to pledge a MEC for such a loan) is treated as a loan against or withdrawal from the Modified Endowment Contract, in order to avoid what would otherwise be an end-run around the policy loan or withdrawal provisions of Section 7702A, by merely using the policy as collateral for that third party loan.[13/]

[11/] Section 7702A. Once a policy becomes a MEC, no modification to the policy nor exchange to another policy can change that result.

[12/] Section 72(e)(10).

[13/] Whether or not pledging a MEC as collateral for a split-dollar arrangement would be treated as using the policy as collateral for a third party loan is not clear, but it appears that collateral assignment split-dollar is a different economic transaction, since no cash is received by the "borrower" at the time of the transaction.

Accordingly, many commentators feel that pledges of a MEC as collateral for a split-dollar arrangement (either economic benefit or loan regime) to a third party (such as an employer) should not be treated as a loan against or withdrawal from a Modified

Accordingly, any time lifetime loans against, withdrawals from, or using the policy as collateral for a loan are contemplated, or just to preserve flexibility to do so on an income tax-free basis, the policy should be designed to avoid MEC treatment.

5. Borrowing against a policy in excess of the owner's income tax basis and then transferring the policy subject to the loan as a gift to a new owner.

In many cases, when an existing policy is to be transferred to a new owner, the insured will borrow against the policy to reduce its gift tax value on the subsequent transfer. Loans against policy cash values are normally income tax-free, even if in excess of basis, since they are not distributions under Section 72(e), so long as the policy isn't a MEC (as discussed above).

However, if the loan exceeds the insured's income tax basis in the policy[14/] – the transfer will be treated as a sale, with the loan proceeds treated as the amount realized.[15/] That will have two adverse income tax effects – there will be gain to report on the transfer, and, perhaps more importantly, the transfer will be subject to the transfer for value rules (discussed below) at the insured's death (since the normal exception for gift transfers from those rules – the carryover basis exception – will not be applicable, unless, as noted below, the transfer is to a

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Endowment Contract (although there is no authority for either position). In any event, using the unsecured documentation method (where the policy is not assigned as collateral for the advances) should avoid this issue. If the arrangement were between the insured and his or her grantor trust, the pledge would be ignored for income tax purposes.

14/ Presumably, basis in a policy for purposes of determining gain on a withdrawal is not reduced by the cost of insurance protection under Rev. Rul. 2009-13, above, because the amount which can be withdrawn is based on cash surrender value, which has been reduced by the cost of insurance. Alternatively, perhaps it is investment in the contract under Section 72, rather than basis, which is relevant in this situation, which already reflects deductions for the cost of insurance.

15/ Rev. Rul. 69-187, 1969-1 C.B. 45.

grantor trust), or the transferee is otherwise exempt from the transfer for value rule, as a "proper party" (as also discussed below).

As an alternative, in a universal-type policy, the insured could withdraw from the policy, tax-free, up to investment in the contract,[16/] to reduce the value of the policy prior to the gift, with no such concerns.

Finally, if the gift were to a grantor trust, from the insured's point of view, any gain on the transfer would go unrecognized for income tax purposes,[17/] and, because of that, the carryover basis exception to the transfer for value rule would apply.[18/]

6. Surrendering a policy for its cash value without checking the life settlement market.

A policy owner who or which no longer wishes to continue a policy traditionally had one choice – to surrender the policy to the insurance carrier for the cash surrender value since there was only one buyer – the insurer – which offered only one standard price.

However, the advent of the life settlement market[19/] has meant that, at least for older insureds (probably age 70 and above), with relatively large policies, where the insured's health has declined since he or she took out the policy, a life settlement company may be willing

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16/ Section 72(e)(5).

17/ Rev. Rul. 85-13, 1985-1 C.B. 184.

18/ Section 101(a)(2)(B). In addition, the transfer would be treated as an exempt transfer to the insured under the transfer for value rule. See Rev. Rul. 2007-13, 2007-1 C.B. 684.

19/ Which grew out of the viatical settlement market for terminally or chronically ill insureds.

to pay more than the policy's cash surrender value to acquire the policy during the insured's lifetime.[20/]

Accordingly, advisors need to be careful that their older, less healthy clients don't inadvertently surrender a policy which is no longer needed without checking the availability of a life settlement, assuming the insured is comfortable with a third party owning a policy on his or her life,[21/] the risk of a death shortly after the sale, (in some settlement sales, the seller retains some part of the death benefit, to offset that risk) and the fact that the sold policy will "count" against his or her ability to acquire additional insurance – this is sometimes referred to as a sale of future insurability.

7. Calculating the amount and character of the gain on a policy sale in the settlement market.

A life insurance policy is a capital asset (since it is not expressly excluded from the Section 1221 definition of a capital asset). As noted above, if a policy is cancelled or surrendered to the insurance carrier in exchange for cash surrender value, any gain on the policy is ordinary income, despite the fact that the policy is a capital asset, because the transaction does not qualify as a "sale or exchange" of the policy.[22/]

20/ The policy may be worth more to a life settlement company than to the insurance carrier because the life settlement company will be able to get updated medical information about the insured in order to evaluate the policy, and to obtain a life expectancy study, estimating the insured's likely expectancy, while the insurance carrier can't and won't.

21/ Arguably, not an irrational concern.

22/ But note the argument that Section 1234A (which eliminates the sale or exchange requirement for capital gain treatment for the cancellation, lapse, expiration, or other termination of a right with respect to property which is a capital asset) applies to a policy lapse, (which is a cancellation of a right with respect to capital gain property) and would arguably eliminate the requirement for a sale or exchange to support capital gain treatment for a lapse, or, arguably, even a surrender.

However, if the policy is sold in the life settlement market (and perhaps in other sale transactions), since it is a capital asset and since the sale would qualify as a sale or exchange, any gain on the sale, in excess of basis, should be capital. Note, however, that based on the substitution of income theory of cases such as CIR v. P.G. Lake, Inc.[23/], gain above basis up to the policy's cash surrender value at the time of the sale is ordinary, since it is, in effect, a payment in lieu of interest earned on policy cash values.[24/] Accordingly, under Rev. Rul. 2009-13, above, gain on a sale of a policy in the life settlement market over basis (or, presumably in any other context) up to cash value is ordinary income and any gain over cash value is capital.

In Rev. Rul. 2009-13, above, the IRS also – controversially – held that in a policy sale in the life settlement market,[25/] basis (as opposed to investment in the contract, which is

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Rev. Rul. 2009-13, above, without citing any authority, said it did not apply; see also TAM 200452033, holding that despite the application of Section 1234A to the surrender of a policy, the substitution of income theory, discussed in the text above, requires gain based on cash surrender value (an ordinary income item) to be treated as ordinary. Note again, the settlement reached in Hunt v. Cir., described above, treating gain on a policy lapse caused by the extinguishment of a policy loan as capital, based on Section 1234A.

There seems to be a distinction under these authorities between a lapse of a policy subject to a loan and a surrender of a policy, because in a surrender, the surrender proceeds are based on an ordinary income item – cash values – while in a lapse, there is no cash value and the gain is based solely on the loan forgiveness.

[23/] 356 U.S. 260 (1958).

[24/] Rev. Rul. 2009-13, above. Query as to the effect of the policy sold being a variable policy – there, any gain is not attributable to interest but to capital value increases – should that produce a different result?

[25/] Query as to whether the basis reduction rule of Rev. Rul. 2009-13, above, applies to sales or deemed sales outside the life settlement market, where the buyer does have an insurable interest in the life of the seller – such as intra-family sales or sales to trusts – or even to deemed sales of policies purchased by a grantor trust when grantor trust status terminates (if the trust has any outstanding liabilities or to withdrawals in excess of basis) or to loans in excess of basis where the policy is thereafter transferred. See PLR 200945032, extending the reduction of basis by the cost of insurance rule to policies surrendered (not sold) at a loss.

applicable in the case of policy surrenders or lapses, not sales, as discussed above) was reduced by the cost of insurance protection provided to the insured[26/] (without any guidance on how to measure it[27/]).

8. Determining adequate and full consideration for the sale of a policy to an ILIT or a spouse (prior to a gift to an ILIT) to avoid the three year rule of Section 2035.

If the insured transfers an insurance policy on his or her life to an ILIT, the Section 2035 three year rule for including the death proceeds in the insured's gross estate will apply, should the insured die within three years of the transfer.[28/] However, there is an exception to Section 2035 if the policy is sold pursuant to a bona fide sale for "adequate and full consideration".[29/]

The issue is what is "adequate and full consideration" for such sales. If the sales price is as little as one dollar under adequate and full consideration, the entire death proceeds, reduced by the inadequate consideration paid, would be included in the insured's gross estate

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26/ It had been widely assumed that basis in a policy was premiums paid minus non-taxable dividends (in participating whole life policies). In PLR 9443020, the IRS took the position, without citing any authority, that basis in a policy was also reduced by the "value" of the death benefit provided; but see Gallun v. CIR, 327 F. 2d 809 (7th Cir. 1964), in which the court calculated basis on a policy sale without any such reduction.

In the PLR, the IRS assumed that, absent other proof, the value of the death benefit was measured by the difference between premiums paid and cash surrender value – however, that difference, of course, is made up of more than just the cost of insurance.

27/ See Section 7702(g)(1)(D) for one possible statutory definition of that cost – the lesser of the Table 1 cost (determined under the group term table in Treas. Reg. Sec.1.79-(3)(d)(2)), or the mortality charge stated in the contract; in whole life policies, that charge is not separately stated (and may be hard to obtain).

28/ Id.

29/ Section 2035(b)(1).

should the insured die within three years of the sale/gift. There are three possible problems to consider.

The first is that the valuation of policies is not always clear, as discussed in more detail below. The value of an existing cash value policy with future premium payments is the interpolated terminal reserve plus the proportionate part of gross premiums paid before the transfer applicable to the time after the transfer (the "unused premium").[30/] However, interpolated terminal makes sense with whole life policies, but not with universal life policies which debuted after the Regulations were issued. Furthermore, the word "reserve" is not defined by the Regulation; for universal life policies, accordingly, insurance carriers use state law reserves, Federal income tax reserves, cash value or accumulation reserves, with widely varying results.[31/] If there is uncertainty about the value of the policy, the insured may want to obtain a policy appraisal to determine the fair market value and accordingly the sales price.

The second is that, for sales of policies to avoid Section 2035, the IRS has taken the position that adequate and full consideration for the policy is its face value and not its gift tax value, based on its interpolated terminal reserve. TAM 8806004 ruled that the adequate and full consideration under Section 2035 is the amount that would be excluded from the gross estate because of the sale – the full face value of the policy. However, it isn't clear that the IRS is still be taking this position, since it has issued two private letter rulings after the TAM, holding that

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30/ Treas. Reg. Sec. 25.2512-6(a) and ex. 4. Also see Treas. Reg. Sec. 20.2031-8(a)(2) and (3) ex. 3.

31/ However, the interpolated terminal reserve formulation may not be used if the contract is of an unusual nature; Treas. Reg. Sec. 25-2512-6(a), with no indication of what that means nor should be used instead.

adequate and full consideration under Section 2035 was received in a sale of policies for their gift tax value, rather than their death proceeds.[32/]

In an analogous area under Section 2036, where a remainder interest in a trust was sold for what was argued to be adequate and full consideration while retaining the income interest, a majority of the courts have held that adequate and full consideration was the value of the remainder interest and not the entire value of the property, including the income interest.[33/]

The third is the Pritchard case "near death" exception to the use of gift tax values as adequate consideration in such sales. Estate of Pritchard v. Commissioner,[34] held that since the insured was "near death" at the time of the sale (he died 32 days later), adequate and full consideration for the policy to avoid Section 2035 was its face amount, not its gift tax value. There are no other Federal tax cases dealing with this concept. Note that the Pritchard "near death" concept related to a sale of a policy to avoid Section 2035, but is often confused by applying it to more general gifts of policies – see PLR 9413045 in footnote 32.

32/ PLRs 9413045 (the policy gift tax value was adequate consideration, so long as the insureds were not "near death") and 199905010 (which assumed gift tax value was adequate consideration, without discussion).

33/ D'Ambrosio v. Commissioner, 101 F.3d 309 (3rd Cir. 1996), Wheeler v. United States, 116 F.3d 309 (5th Cir. 1997), Estate of Magnin v. Commissioner, 184 F.3d 1074 (9th Cir. 1999). Contra Gradow v. United States, 897 F.2d 516 (Fed. Cir. 1990).

34 4 T.C. 204 (1944),

9. **Avoiding the transfer for value rule where the policy is sold to an ILIT to avoid the three year rule of Section 2035.**

As noted, if the insured owns a policy on his or her life, a gift of the policy to an ILIT of his or her incidents in ownership in the policy will result in the inclusion of the death proceeds in the insured's gross estate should the insured die within three years of the gift.[35/]

As discussed in detail below, the sale of the policy to the ILIT has to qualify for an exception to the transfer for value rule of Section 101(a)(2), otherwise the death proceeds in excess of the transferee's policy basis would be ordinary income to the beneficiary.

If the insured sells the policy to the insured's ILIT which is a grantor trust, it is treated as a sale by the insured to himself or herself, and accordingly as a non-taxable event. Thus, the insured's basis in the policy becomes the grantor trust's basis, qualifying for the carryover basis exception to transfer for value under Section 101(a)(2)(A).[36/] If the ILIT is not a grantor trust, the ILIT must be a transferee which is exempt from the transfer for value rule, such as where the ILIT is a partner of the insured.[37/] However, a sale to a non-grantor trust, even though within a transfer for value exception, would be a taxable event and could result in a gain to the insured seller.

10. Transferring a policy from the insured to a third-party owner (such as an ILIT) without obtaining the policy's gift tax value from the carrier, in advance.

35/ Section 2035.

36/ Rev. Rul. 2007-13, 2007-1 C.B. 684, in addition, situation 2 of the Ruling, the sale would be treated as if made to the insured, qualifying for another transfer for value exception.

37/ Section 101(a)(2)(B).

Under the Section 2512 Regulations,[38/] the gift tax value of a policy transferred during the insured's lifetime is determined by its "replacement" cost, the cost of a "comparable policy". However, the Regulations recognize that for a policy that has been in force for some time (an undefined term) on which future premiums are due, obtaining the cost of a comparable policy would be difficult; accordingly, the Regulations provide that, in this situation, the cost of a comparable policy <u>may</u> be (not <u>must</u> be)[39/] <u>approximated by</u> the so-called interpolated terminal reserve formula – the policy's interpolated terminated reserve plus any prepaid premiums.[40/]

This valuation convention eliminates the need to determine the effect of the insured's health or his or her life expectancy which would determine the willing buyer/willing seller "real-world" value of the policy.

While technically only traditional whole life policies allow for the calculation of an interpolated terminal reserve (because only they have stated cash values which increase at stated rates and fixed premiums), the ITR formula is used by carriers in reporting the gift tax values of policies transferred during the insured's lifetime, on a Form 712, for universal and variable policies (which don't have fixed premiums or stated cash values which increase at stated rates).

Historically, carriers reported a policy's ITR value as its gift tax value on a Form 712, when requested to do so. More recently, some carriers have begun to report a series of

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[38/] Reg. Sec. 25.2512-6.

[39/] Accordingly, as noted above, in an appropriate case, consideration should be given to obtaining an appraisal to determine a policy's fair market value, based on a willing buyer/willing seller analysis.

[40/] Policy loans are deducted from that result; surprisingly, the Regulations don't provide for that deduction, but there is a line on the Form 712 showing the deduction of policy loans from the ITR value.

possible values for a policy transferred during the insured's lifetime, including the policy's cash or accumulation value, its cash surrender value, its interpolated terminal reserve value and its PERC value (a calculation required for transfers of policies in some income tax situations by the 2005 regulations issued under Section 83).[41/] Most carriers have determined that a policy's "fair market value" is a legal issue to be determined by counsel for the policy owner and its only role is to provide the range of values for counsel.

The warning here is that the fair market value of a policy for gift tax purposes may be significantly higher than its cash surrender value – for example, both no-lapse guarantee universal life policies and level term policies may literally have a zero cash surrender value but a very large ITR value[42/] – the only way to know what the policy's potential gift tax value is to request a Form 712 from the issuing carrier, before the policy is transferred.[43/]

11. Transferring a policy during the insured's lifetime without considering the transfer for value rule and its exceptions.

Under Section 101(a), the general rule is that life insurance proceeds received "by reason of death of the insured" are excluded from the beneficiary's gross income (even if the policy is a MEC).

There is, however, an exception to that general rule for transfers of the policy for value during the insured's lifetime. If a policy is transferred for value during the insured's

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41/ They don't, of course, report a policy's possible life settlement value (since they won't know it), but that value may be the best measure of its fair market value.

42/ As is true with many level term policies.

43/ It may be possible to discuss the issuance of the Form 712 in advance with the carrier's legal department, since there are several possible reserves which can be used to value a policy, and the effect of a withdrawal or a loan prior to the transfer on the reserve value could be discussed.

lifetime, unless one of the exceptions to the transfer for value rule (described below) applies, the only portion of the death proceeds which will be excludable from the beneficiary's gross income are equal to the amount paid by the transferee for the policy plus any future premiums paid by the transferee. The "value" for a transfer which might subject it to the transfer for value rule need not be a cash payment – the mutuality of a contractual agreement to transfer the policy has been held to be enough to support the application for the transfer for value rule.[44/]

Fortunately, there are a number of helpful exceptions to the transfer for value rule applicable in an estate planning context.[45/] Those exceptions include transfers to one of the four "proper party" transferees:

1. A transfer to the insured (including, for this purpose, a transfer to a trust which is a wholly grantor trust from the point of the insured);[46/]

2. A transfer to a partner of the insured;

3. A transfer to a partnership in which the insured is a partner (including for this purpose an LLC taxed as a partnership); and

4. A transfer to a corporation in which the insured is an officer or a shareholder.

In addition, a transfer in which the transferee's basis is determined, in whole or in part, by the transferor's basis (including, for this purpose a transfer to the insured's spouse, or former spouse, if incident to a divorce), is also exempt from the rule.[47/]

44/ See, e.g., Monroe v. Patterson, 197 F. Supp. 146 (N.D. Ala. 1961) and PLR 7734048.

45/ Section 101(a)(2).

46/ See Rev. Rul. 2007-13, above.

The warning here is that, any time a policy is transferred during the insured's lifetime, caution must be exercised to consider whether the transfer for value rule might apply to the transfer, and if so, whether one of the exceptions to its application would be available.

12. **Failing to restrict the insured's power to remove and replace the ILIT trustee by requiring any appointed successor trustee not be the insured nor a related or subordinate party to the insured.**

Some practitioners avoid giving the insured the power to remove or replace the ILIT trustee, in order to prevent any question of attribution of the removable trustee's incidents of ownership to the insured. However, the IRS has blessed such removal and replacement powers if certain restrictions are met.

In Revenue Ruling 95-58,[48/] dealing with Sections 2036 and 2038, the IRS ruled that the grantor's power to remove and replace a trustee did not give the trustee's discretionary powers to the grantor of the trust, if the successor trustee cannot be the grantor nor any person who is related or subordinate to the grantor within the meaning of Section 672(c). In PLRs 9607008 and 200314009, the IRS extended the rationale of Revenue Ruling 95-58 to powers of removal possessed by a beneficiary under Section 2041 and to powers of removal possessed by the insured under Section 2042(2).

There is some question as to whether the related and subordinate party restriction is correct, since it is an income tax concept and not an estate tax concept. The Estate of Wall v.

47/ Section 1041(b)(2).

48/ 1995-02 C.B. 191.

Commissioner,[49/] did not require a Section 672(c) restriction on the appointment of a successor trustee in holding that the grantor did not possess the powers of the trustee because of the power to remove and replace the trustee. However, that issue was not raised by the IRS, since at that time it was arguing that the power to remove and replace the trustee always resulted in inclusion of the policy in the insured's estate. Obviously, it is easier to include the related or subordinate party restriction in order to avoid an argument with the IRS; however, a court might not agree with the IRS even if the language is omitted.

13. **For ILITs with Crummey withdrawal powers, not drafting the ILIT so that the Crummey power is triggered by both direct and indirect premium gifts to the ILIT.**

If the Crummey power is drafted to apply to gifts to a ILIT, the IRS could argue that premium payments directly to the life insurance carrier, while constituting an indirect taxable gift to the ILIT, do not trigger the Crummey power, since the premium was not given to the ILIT so that the trustee could pay the premium to the carrier.

Examples of indirect premium gifts to the ILIT by direct payment of premium to the life insurance carrier are employer pay all split-dollar, group term insurance and a grantor paying premiums directly to the life insurance carrier.

At least for ILITs funded with group term policies, where the employer paying the premium directly to the insurance company, the IRS has approved Crummey powers which expressly applied to indirect gifts of premiums to the ILIT.[50/]

49/ 101 T.C. 300 (1993), cited in Revenue Ruling 95-58.

50/ PLR 813074 ("contributions directly or indirectly transferred"). PLR 8138102 ("premiums…which are paid, by the settlor or any other person, rather than being paid to

In Turner v. Commissioner,[51/] the insured paid life insurance premiums for cash value policies directly to the life insurance company. The IRS claimed that the Crummey withdraw right was illusory since this was an indirect gift without notice to the beneficiaries. The Tax Court held the Crummey withdraw power effectively made indirect premium gifts a present interest gift, since the ILIT expressly provided that the power applied to "each direct or indirect transfer to the trust."

The takeaway is that premiums, if at all possible, should be funneled through the ILIT. In any event, the ILIT should be drafted to apply the Crummey withdraw power to "direct and indirect gifts" in case the premium is paid directly to the insurance carrier by someone other than the trustee (such as for group term policies owned by the ILIT or by insureds who inadvertently pay premiums directly to the carrier, to avoid having to create a bank account for the ILIT).

14. Post-Final Regulation loan regime split-dollar arrangements that don't state adequate AFR interest, which are treated as term loans, especially those involving gift term loans.

Under the Final Split-Dollar Regulations, other than donor/donee or employer/employee non-equity split-dollar arrangements, collateral assignment arrangements (where the policy is not owned by the premium provider) must be treated under the loan regime, governed by Section 7872, rather than the economic benefit regime, governed by Section 61.[52/]

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the trustee"). PLR 8138170 ("contributions…including…any premiums…that are paid by the taxpayer or any other person directly to the insurance company").

[51/] T.C. Memo 2011-209.

[52/] Treas. Reg. Sec. 1.61-22(b)(3).

Under Regulation Section 1.7872-15, for loans that don't provide for adequate AFR interest, both the determination as to which applicable Federal rate must be used to impute the interest and, more importantly, when the interest imputed under the arrangement is treated as received by the lender, is determined by whether the loan is classified as a demand loan, a term loan, or a hybrid loan.

For a demand loan, the interest rate is based on the short term AFR, which changes every month, and the interest is treated by the lender as received on an annual basis. For a hybrid loan, including for this purpose, a loan payable at the death of an individual, the interest rate is determined based on the term of the loan (the insured's life expectancy, under the IRS Tables), but the interest is treated as received by the lender on an annual basis.[53/] Importantly, however, gift term loans are treated as hybrid loans only for income tax purposes; accordingly, while for both income and gift tax purposes, the AFR is based on the term of the loan, for gift tax purposes, all of the interest during the expected term of the loan, discounted back to present value, is treated as received in the year the loan is entered into (bunching the discounted value of all of that interest in the first year of the loan for transfer tax purposes).

If a term loan has gift tax consequences, because, for instance, it is between an employer and an employee's trust or is between a donor and his or her trust, that bunching rule applies for gift tax purposes (as well as generation-skipping tax purposes, if applicable), making them impractical .

53/ Loans payable at the death of an insured are only treated as hybrid loans under the Split-Dollar Regulations, not for other Section 7872 purposes.

15. Related party loan regime arrangements which could violate provisions of the Final Split-Dollar Regulations.

Under the Final Split-Dollar Regulations, a premium financing transaction (a loan with interest paid or accrued at the AFR) will meet the very broad definition of a "split-dollar arrangement," because it is a transaction in which one party advances money to a second party to acquire a life insurance policy, and the loan is either repayable out of the policy cash value or its death proceeds (or both) or is secured by the policy.[54/]

There are a number of provisions of the final Split-Dollar Regulations which, when applied to premium financing transactions between related parties, can pose special problems.

In the first place, if the arrangement is "non-recourse" (an undefined term in the Regulations), unless each of the parties to the premium financing transaction attaches to his, her, or its income tax return in each year a loan is made under the arrangement, a statement that a "reasonable person" would expect the loan to be repaid, the loan is treated as if it provided for contingent interest, meaning that merely paying or accruing the applicable Federal rate will not avoid the application of Section 7872 to a portion of the loan.[55/]

Secondly, if the lender were to ever forgive any interest due on the loan, that forgiveness would be treated as income or a gift (depending on the relationship of the parties),

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54/ Reg. Sec. 1.61-22(b).

55/ There are as number of unrelated benefits to filing those statements – the Regulations provide such a loan will be respected for tax purposes (even if it wouldn't otherwise be respected under general tax principles, because, for instance, the policy cash value is less than the amount loaned in the early years), the penalty described below would not apply if the interest charged were less than the appropriate AFR and would also not apply if interest due were forgiven or waived.

plus, unless the statement described above is filed, there would be a penalty equal to three percentage points over the interest rate provided for underpayments of Federal tax.

Next, if the lender is "to pay" the borrower the interest due under the loan, then, despite the borrower's actual payment of interest to the lender, the loan is treated as if it were a Section 7872 loan.[56/] There is no formal definition of the phrase "to pay", so that any time there is an arrangement (explicit or implicit) that the lender will provide the borrower with funds to pay the interest, that provision would apply. As an example, in a donor/donee premium financing arrangement that required the payment of interest on an annual basis, the donor's annual gift of the amount of the interest to the donee would presumably qualify as a "to pay" transaction.[57/]

Finally, the Regulations provide strict "ordering" rules for the application of loan repayments – they must be repaid in the order they were made.

16. Terminating a private pre-Final Regulation economic benefit, collateral assignment split-dollar arrangement without considering the risk that any policy equity on termination would be a transfer for transfer tax purposes.

A private pre-Final Regulation split-dollar arrangement which hasn't been "materially modified" (as discussed below) after the effective date of the Regulations, is governed by Notice 2002-8.[58/]

56/ It's unclear what the effect of this provision is – do we ignore the actual payment of interest and treat this as a Section 7872 transaction, or is the payment recognized and then Section 7872 applied as well?

57/ How "un-related" the gifts and the interest payments have to be to avoid this rule isn't clear; perhaps making a large, upfront gift which could be used over time to pay the interest due would be unrelated enough.

58/ 2002-1 C.B. 398.

Under Notice 2002-8, so long as the arrangement is in effect and the parties are reporting or paying the economic benefit costs, there will be no other transfer tax consequences of the arrangement, even if policy values owned by the policy owner exceed the donor's advances.

However, under that Notice, by negative inference, on termination of the arrangement during the insured's life, the IRS will take the position that any such policy equity was a gift by the donor to the owner, subject to the Notice's so-called "no inference" provision. Under that provision, the IRS will not be able to assert those policy values were transferred for transfer tax purposes based on the Notice nor the Proposed or Final Split-Dollar Regulations.

It, however, isn't clear that the IRS wouldn't attempt to trust the equity as transferred on termination under prior law;[59/] accordingly, any such termination has to take that possibility into account.[60/]

17. Entering into a post-Final Regulation private economic benefit split-dollar or loan regime arrangement for a single life policy without checking the other as an alternative, or, in either case, without having an exit strategy.

Whether premium financing (a loan with interest, either paid or accrued at the applicable Federal rate) or a split-dollar arrangement using the economic benefit regime makes the most sense in a given post-Final Regulation private premium funding transaction depends

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[59/] Best practices would indicate making full disclosure of the termination on any applicable income and/or gift tax returns(s) to start the respective statute(s) of limitations and avoid any potential penalties.

[60/] What if the policy value on termination were less than what was owed the premium provider; is there any forgiveness of indebtedness issue?

upon whether the policy is a single life or a survivorship policy, and, if it is a single life policy, both the age of the insured and the relative level of interest rates.

In general, for survivorship policies, private, non-equity split-dollar arrangements using the economic benefit regime will continue to make sense, because the extremely low economic benefit for survivorship policies (at least while both insureds are alive).[61/]

With a single life policy (or a survivorship policy after the first death), private premium financing may make more sense if the insured is older, if interest rates are relatively low, and if the insurance carrier does not have alternative term rates which qualify to be used in lieu of the Table 2001 rates. Such a loan may make even more sense if all (or a substantial portion) of the premiums can be loaned to the owner at the outset, to lock in the interest rate for the term of the loan (perhaps even if the lender has to borrow from a third party to lend those premiums). The amount loaned can create the side fund, out of which premiums are paid as due to avoid creating a MEC.

In either case, entering into such an arrangement without an effective exit strategy to unwind the arrangement during the insured's lifetime is problematic. Over time, economic benefits continue to increase as the insured ages; in a survivorship policy, at the first death, the attractive term rates are no longer available; and a loan arrangements get increasingly expensive as more premiums are advanced and more interest is due on those advances (especially if interest is accrued). In any such case, the longer the arrangement continues, the smaller the death benefit which will remain payable to the policy beneficiary, unless the policy death benefit can be

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61/ Although there is a gift involved (even though small, unless the economic benefit is contributed); however, in an AFR interest-accrued private premium financing arrangement, there is no gift at all.

planned to increase by the use of riders to track the advances or loans (perhaps including accrued interest).[62/]

Exit strategy planning contemplates creating a side fund to be owned by the policy owner, which can, over time, be used to repay the premium advances under the split-dollar arrangement or the premium loans under the premium financing transaction. If the owner is an irrevocable trust, creating the side fund needs to be done on a transfer tax leveraged basis, perhaps including additional policy loans to the trust (with interest paid or accrued at the AFR), having the trust become the residuary beneficiary of a grantor retained annuity trust (if the insurance trust does not have generation skipping implications) or the purchaser in an installment sale.[63/] In addition, consideration should be given to arranging for the policy death benefit to increase, to keep the proceeds payable to the owner constant (for an additional premium).

18. Not checking the availability of the insurer's alternative term rate (in lieu of the Table 2001 rate) for private post-Final Regulation economic benefit split-dollar arrangements for a single life policy.

At least until the IRS publishes what the Final Regulations call "uniform term rates" for determining the measure of the economic benefit in private, non-equity post-Final Regulation split-dollar arrangements, the economic benefit can be measured by the lower of the Table 2001 rates or the insurance company's "qualifying" alternative term rates.[64/] For post-

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62/ Of course, the rider providing that extra death benefit requires additional underwriting capability and an additional premium.

63/ For loans or installment sales, the insurance trust should be an intentional grantor trust, so that any gain on the sale and any interest on the deferred payments on the loan would be ignored for income tax purposes under Rev. Rul. 85-13, above.

64/ Otherwise, there is nothing in the Final Regulations dealing with (nor restricting) the use of alternative term rates that otherwise qualify under Notice 2002-8, above.

January 28, 2002 arrangements, under Notice 2002-8,[65/] qualifying term rates must be published, generally available rates for one year term insurance, which must be made known to proposed insureds who are sold insurance through the carrier's normal distribution channels and, importantly, must be "regularly sold by the carrier" (an undefined term).

While some carriers take the position that their term rates do not qualify under these more stringent rules, some (although a limited number) carriers have taken the position that their rates continue to qualify, and some carriers (an increasing number) have taken the position that this has become a legal issue and all they can do is provide the proposed insured and his or her advisors with the facts, but that the decision about whether their rate qualifies has to be made by legal counsel.

19. Changing a pre-Final Regulation equity, collateral assignment private split-dollar arrangement without considering whether it could be considered a "material modification" of the arrangement.

As noted above, a private pre-Final Regulation split-dollar arrangement which hasn't been "materially modified" after the effective date of the Regulations, is governed by Notice 2002-8.[66/] Conversely, a private pre-Final Regulation arrangement which has been "materially modified" after the effective date of the Final Regulations will no longer be governed by Notice 2002-8, but by the generally less favorable rules of the Final Regulations.

The Final Regulations do not contain a helpful definition of the phrase "materially modified" – they contain a so-called "angel list", a non-exclusive list of non-material

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65/ Above.

66/ Above.

modifications.[67/] In addition, the IRS has indicated that this is an area in which they will not issue private letter rulings.[68/]

Accordingly, any change to a private pre-Final Regulation split-dollar agreement, the terms of the economic "deal" between the parties, or even a change to the underlying policy needs to be approached as a potential material modification to the arrangement, subjecting the arrangement to the rules of the Final Split-Dollar Regulations from the date of the change. Since most pre-Final Regulation private arrangements were equity, collateral assignment arrangements (where the premium provider was only entitled to recover his or her premium advances), applying the rules of the Final Regulations to that arrangement would require that it be treated under the loan regime (measuring tax consequences of the arrangement by the foregone interest under Section 7872, as described above and creating a gift term loan, with unfavorable tax consequences) rather than the economic benefit regime (measuring the benefit by the term costs, under Section 61).[69/] In addition, this "switch" would likely be treated as a termination of the arrangement under Notice 2002-8, treating any policy equity as having been transferred, subject to its no inference provision.

Accordingly, where it is important for a non-tax reason to change the arrangement or the underlying policy and it is important to be able to continue to be able to use term cost to measure the benefit of the arrangement, the agreement would need to be amended to convert it into a non-equity arrangement (where the premium provider would be entitled to the greater of his or her advances or policy cash values), which would then qualify for one of the very narrow

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67/ Reg. Sec. 1.61-22(j)(2).

68/ See Rev. Proc. 2015-3 §3.01(8), 2015-1 I.R.B. 129.

69/ Reg. Sec. 1.61-22(b)(3).

exceptions to the general rule of the Final Regulations that collateral assignment arrangements must use the loan regime to measure the benefit.[70/]

20. Creating a non-equity, economic benefit collateral assignment spilt-dollar arrangement after the Final Regulations which isn't either a donor/donee nor a service provider/service recipient arrangement.

Under the Final Split-Dollar Regulations, the general rule is that any collateral assignment arrangement – that is, one where the policy is not owned by the premium provider – must be treated under the loan regime of Regulation Section 7872-15, rather than under the economic benefit regime of Regulation Section 61-22. The only exceptions to that general rule are arrangements between a donor and a donee or between a service provider and a service recipient; those arrangements – and only those arrangements – treat the premium provider as the deemed owner, allowing use of the economic benefit regime.

Accordingly, any post-Final Regulation non-equity collateral assignment split-dollar arrangement which is neither between a donor/donee nor a service provider/service recipient, must be treated as a loan regime arrangement under the Section 7872-15 Regulations.

70/ But note that each change requires the policyowner (normally an ILIT) to give up any existing or future cash value interest in the policy, which would pose fiduciary duty issues for an ILIT trustee.