XI. LIFE INSURANCE

Life insurance has long played a critical role in fulfilling many estate planning needs. Life insurance is used as an income replacement mechanism for surviving spouses, to provide liquidity to estates, to facilitate purchases under buy-sell agreements, to help "carry" small businesses through the transition phase after the loss of a "key person" and as a vehicle to transfer wealth to future generations. Through careful planning, all of these estate planning needs can be satisfied without causing the insurance proceeds to be included in the gross estate of the insured. Nevertheless, to avoid estate tax inclusion, practitioners must navigate through the unique tax rules that apply to life insurance policies. The planning process is further complicated by the fact that as many as four different parties may be involved in any insurance contract: the owner, the insured, the beneficiary and the individual or entity paying the premium. As a result of this complexity, there are many "traps" and "pitfalls" that practitioners must avoid to successfully match the life insurance death benefit proceeds with the estate planning "need" without triggering unnecessary transfer taxes.

This Chapter provides an overview of planning with life insurance, including a discussion of the following topics:

- Estate tax inclusion rules;
- Gifts of life insurance;
- Viatical and life settlements;
- Split dollar life insurance; and
- Use of insurance in buy-sell agreements

A. Estate Tax Inclusion Rules

In general, life insurance proceeds will be included in an insured's estate if: (1) the life insurance proceeds are payable to the insured's estate; (2) the insured possesses any incidents of ownership in the policy at the time of death; or (3) the insured transferred his or her interest in an insurance policy within three years of his or her death.

1. Insurance Proceeds Payable to the Insured's Estate

Life insurance proceeds from insurance policies on the decedent's life will be included in a decedent's estate under Internal Revenue Code ("IRC") § 2042(1) if the insurance proceeds are receivable by the executor of the decedent's estate. Moreover, Treas. Reg. § 2042-1(b)(1) provides "if under the terms of an insurance policy the proceeds are receivable by another beneficiary but are subject to an obligation, legally binding upon the other beneficiary, to pay taxes, debts, or other charges enforceable against the estate, then the amount of such proceeds required for the payment in full … of such taxes, debts, or other charges is includible in the gross estate." Thus, insurance proceeds will be included in the decedent's estate under IRC § 2042(1) whenever insurance proceeds are payable to the decedent's estate or for the benefit of the decedent's estate.

➔ **<u>Planning Point</u>:** If the decedent has created an Irrevocable Life Insurance Trust ("ILIT") and has named the ILIT as owner and beneficiary of the policy, the ILIT should never require the trust to pay obligations of the

decedent's estate, because such a provision will cause inclusion in the decedent's estate under IRC § 2042. Treas. Reg. § 20.2042-1(b)(1). In PLR 200147039, the Internal Revenue Service ("IRS") ruled that a provision in a trust giving the trustee *discretion* to use trust assets to pay taxes and expenses due on the death of the insured would not cause inclusion in the decedent's estate, because there was no legally binding obligation to do so. One should note, however, that the IRS did not rule on what the result would be had the trustee in fact exercised his discretion to pay such taxes or expenses. The regulations under IRC § 2042 do not preclude the IRS from taxing insurance proceeds under other Code sections that might apply. The ILIT, rather than distributing property to the estate to enable it to pay taxes and expenses, could use the insurance proceeds to purchase assets from the decedent's estate (at fair market value) as a means of providing liquidity to the decedent's estate without risking estate tax inclusion. Typically, the step-up in basis rules for assets included in the decedent's estate will prevent the estate from incurring a capital gain upon the sale of assets to the ILIT. Alternatively, the ILIT can be drafted so that the trustee is permitted to lend money to the estate for a commercially reasonable amount of interest.

➔ **Planning Point:** Should you discover that an ILIT impermissibly requires the trustee to use the insurance proceeds to pay obligations of the decedent's estate, one means of rectifying the problem is to have the "defective" ILIT sell the policy to a new ILIT that does not contain the offending provision. As long as both trusts are grantor trusts with respect to the insured, there should not be a taxable event for income tax purposes. The new trust would acquire an income tax basis in the life insurance policy equal to the basis that the "defective" ILIT had in the policy. In addition, the carryover basis from the "defective" ILIT to the new ILIT should exempt the sale from the transfer-for-value rule under IRC § 101(a)(2).

2. Incidents of Ownership

Life insurance proceeds will also be includible in the decedent's estate under IRC § 2042(2) if the decedent possessed any "incidents of ownership" in the policy, either alone or in conjunction with any other person, at the time of the decedent's death. Treas. Reg. § 2042-1(c) provides that "the term 'incidents of ownership' is not limited in its meaning to ownership of the policy in the technical sense…. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc."

➔ **Planning Point:** The Regulation quoted above clarifies that even if the insured does not own the policy and the insurance proceeds are paid to someone other than the insured's estate, the insurance proceeds will be includible in the decedent's estate if the decedent held any "incidents of ownership" at the time of his or her death. Practitioners should plan carefully to avoid the application of IRC § 2042 because any incident of

ownership held directly by the insured will cause inclusion of the *entire* proceeds in the decedent's estate, even if the right can only affect a *portion* of the policy (See Treas. Reg. § 20.2042-1(a)(3)).

> **EXAMPLE:** Insured pledges a policy on his life to a bank to secure a loan. The insured is personally liable on the loan. Subsequently, the insured transfers ownership of the policy, subject to the loan, to an ILIT and the ILIT is named the beneficiary of the policy. The insured dies while the loan is outstanding. The insured has retained an incident of ownership, because he continued to benefit from the use of the policy as security for his loan. Accordingly, the *entire* proceeds of the life insurance would be includible in the insured's estate under IRC § 2042.

There is a split in authority regarding whether the retention by an insured of a right to elect a settlement option that affects the timing of payments to the beneficiary, but not the total amount that the beneficiary will receive, is an incident of ownership. See *Lumpkin v. Comm'r*, 474 F.2d 1092 (5th Cir. 1973), where the court held that a right affecting the timing of the payment was an incident of ownership. See also *Connelly v. U.S.*, 551 F.2d 545 (3d Cir. 1977), where the court held that an identical right did not constitute an incident of ownership. The IRS has indicated that it will follow *Lumpkin*, except in the Third Circuit in cases involving identical facts to *Connelly*. In addition, the following rights have been deemed to be "incidents of ownership:" (i) an option to repurchase a policy from an assignee (see TAM 9128008); and (ii) a right to veto any change in beneficiary designation, assignment or cancellation of the policy (see *Schwager v. Comm'r*, 64 T.C. 781 (1975)). Rights that have been deemed *not* to be "incidents of ownership" include the following: (a) the right to substitute a policy of equivalent value (see *Jordahl v. Comm'r*, 65 T.C. 92 (1975)); (b) the payment of premiums and the receipt of policy dividends (because a dividend represents a refund of premium payments) (see *Jordahl*, *Bowers Est. v. Comm'r*, 23 T.C. 911 (1955), and *Old Point Nat'l Bank v. Comm'r,* 39 B.T.A. 343 (1939)); and (c) the right to convert a group term life insurance policy to an individual policy if the insured ceases to be employed (see Rev. Rul. 84-130).

3. Incidents of Ownership in Corporate Owned Insurance

Treas. Reg. § 20.2042-1(c)(6) provides that if a corporation owns life insurance on the life of the insured and "the decedent is the sole or controlling stockholder, the corporation's incidents of ownership will not be attributed to the decedent through his stock ownership to the extent the proceeds of the policy are payable to the corporation." Conversely stated, where the decedent is the controlling shareholder of a corporation and the corporation owns insurance on the decedent's life, the corporation's incidents of ownership in the policy at the time of the decedent's death will be attributed to the decedent to the extent the proceeds are payable to anyone other than the corporation.

> **EXAMPLE:** Decedent is a controlling stockholder in a corporation. The corporation owns an insurance policy on the decedent's life. The life insurance proceeds are payable 40% to the decedent's spouse and

> 60% to the corporation. Only 40% of the proceeds are includible in the decedent's estate under IRC § 2042. Note that this rule is an exception to the general rule that any *direct* incident of ownership held by the insured (*i.e.*, that is not attributed to him through the corporation), will cause inclusion of the *entire* proceeds in the insured's gross estate, even if it only affects a portion of the policy.

Thus, even if the insured is a controlling shareholder, if the entire proceeds are payable to the corporation or to a third party for a valid business purpose (*e.g.,* in satisfaction of a valid business debt), none of the proceeds will be included in the insured's gross estate. This is due to the fact that the insurance proceeds will be reflected in the value of the decedent's stock (*i.e.*, because the insurance proceeds will increase the value of the company).

The insured is deemed a "controlling" stockholder if, at the time of his or her death, the decedent owned stock possessing more than 50% of the total combined *voting power* of the corporation (see Treas. Reg. § 20.2042-1(c)(6)). Note that owning more than 50% of the value of the stock will not cause the insured to be a "controlling" shareholder, if the decedent does not own 50% of the voting power. Stock is considered owned by the decedent if legal title, at the time of the decedent's death, is owned by: (a) the decedent (or his agent or nominee); (b) the decedent and another person jointly (but only to the extent of the pro rata number of shares that corresponds to the proportion of the total consideration considered to have been furnished by the decedent under IRC § 2040); or (c) by a trustee of a voting trust (to the extent of the decedent's beneficial interest therein) or any other trust with respect to which the decedent was treated as an owner under IRC §§ 671-679 (*i.e.*, the grantor trust rules).

> **EXAMPLE:** Decedent owns 60% of the combined value of both the outstanding voting and non-voting stock, but only 20% of the voting power in a corporation. The corporation owns an insurance policy on the decedent's life. The life insurance proceeds are payable 40% to the decedent's spouse and 60% to the corporation. None of the proceeds are includible in the decedent's estate under IRC § 2042 because the decedent is not a "controlling" shareholder under Regulation § 20.2042-1(c)(6).

In PLR 200214028, the IRS addressed this issue in a partnership context. In that ruling, the decedent was a one-third partner in a general partnership at the time of the partner's death. Under the terms of the partnership agreement, on the death of a partner, the partnership was required to purchase the deceased partner's interest in the partnership from his or her estate. The partnership was required to maintain life insurance policies on the partners to fund the purchase of the partnership interest. The insurance proceeds were paid to the partnership upon the decedent's death. The IRS sought to determine the estate tax treatment of these insurance policy proceeds under IRC § 2042.

In Rev. Rul. 83-147, 1983-2 C.B. 158, a partnership owned a life insurance policy on the life of a partner and paid the premiums. The beneficiary was the partner's son. The IRS ruled that because the proceeds were payable other than to or for the benefit of the partnership, the

proceeds were includable in the partner's estate under IRC § 2042(2).

The IRS stated that incidents of ownership held by a partnership over a policy insuring the life of a general partner should be attributable to the insured unless the proceeds are paid to the partnership itself. Because in this case the insurance proceeds were necessary to purchase the interest of a deceased partner without liquidating the partnership assets, the IRS ruled that the proceeds of the life insurance policies held by the partnership on a deceased partner's life were payable for the benefit of the partnership. Consequently, the proceeds were not includable in the deceased partner's gross estate under IRC § 2042.

4. The Three-Year Rule - IRC § 2035(d)(2)

Transfers by an insured of incidents of ownership in a life insurance policy within three years of the insured's death are included in the insured's gross estate under IRC § 2035.

> **EXAMPLE:** Insured purchases a $1,000,000 term life insurance policy on his life, and names his wife as beneficiary of the policy. He transfers ownership of the policy to an ILIT and the ILIT is, in turn, named beneficiary of the policy. The insured dies two years after the transfer. The insurance proceeds are included in the insured's gross estate under IRC § 2035, because he transferred incidents of ownership in a life insurance policy within three years of his date of death.

➔ **Planning Point:** The result in the above example could be avoided simply by having the trustee of the ILIT purchase the insurance policy directly, rather than having the insured acquire the insurance and then transfer it to the ILIT. The 3-year rule will not apply if the transaction is structured in this manner because the decedent will never hold any incidents of ownership in the policy. Accordingly, the life insurance proceeds will be excluded from the insured's gross estate, even if the insured makes annual exclusion gifts to the ILIT to cover the costs of the annual insurance premiums (See *Leder Est. v. Comm'r*, 893 F.3d 237 (10th Cir. 1989) and *Headrick Est. v. Comm'r*, 918 F.2d 1263 (6th Cir. 1990), *acq. recommended*, AOD 1991-012). Nevertheless, the ILIT should be drafted to provide that the trustee may use these future contributions, but is not required to do so, to pay premiums.

Just as incidents of ownership in a controlled corporation are attributed to the controlling shareholder, so too is the transfer of an insurance policy within three years of the insured's death. In Rev. Rul. 82-141, the insured was the "controlling" shareholder of X corporation, which possessed all the incidents of ownership in an insurance policy on the insured's life. The corporation assigned all of its incidents of ownership in the insurance policy to A and there was no valid business purpose for the assignment. The insured died within three years of the transfer and the insurance proceeds were paid to A. The IRS held that the insurance proceeds were includible in the decedent's gross estate, noting that the principle underlying the attribution rule or Treas. Reg. § 20.2042-1(c)(6) mandates that the incidents of ownership possessed by X corporation

be attributed to the insured for purposes of IRC § 2035.

The three-year rule can also cause problems when an employee assigns his group term life insurance coverage in order to remove the proceeds from his gross estate, and the employer later changes group term carriers (thereby acquiring a new policy). In this situation, the employee will have to assign his coverage under the new policy, which will start the beginning of a new three-year period.

➔ **Planning Point:** To avoid having to survive a new three-year period if an employer switches group-term life insurance carriers, the employee should, when assigning his rights in the initial policy, assign not only his rights in the existing policy, but also his rights in any replacement policy. In Rev. Rul. 80-289, the IRS approved such an anticipatory assignment, but limited it to situations "where the assignment was necessitated by the change of the employer's master insurance plan carrier and the new arrangement is identical in all relevant aspects to the previous arrangement with the first insurance carrier." Thus, if the replacement policy is significantly different from the original policy, the insured may have to survive an additional three years in order to avoid inclusion in his or her gross estate.

B. Gifts of Life Insurance

Persons with estates of less than $3,000,000 are often reluctant to transfer assets during their lifetime, because they may need the assets to maintain their own standard of living. Such clients believe they cannot afford irrevocably (for life or at least for a term of years) to relinquish control over large amounts of property in order to reduce taxes or to protect their assets from creditors. Life insurance, however, is often viewed as an asset that is designed to replace earnings that are lost upon an individual's untimely death, rather than as an income-producing asset. As a result, whether a client's estate is large or small, most clients are usually very willing to transfer life insurance in order to remove the insurance proceeds from their estate for estate tax purposes. In addition, although life insurance in certain circumstances can be an excellent income-producing asset, such as when it has a cash or investment component, most individuals allow the investment component to be maintained within the policy because most policies are structured so that the investment component is constantly being substituted for an ever decreasing term insurance component. This feature may make an insurance policy an ideal gift by the insured.

➔ **Planning Point:** One should note that this section deals with gifts of life insurance and, thus, assumes the insured already owns the life insurance. Gifts of life insurance by the insured, however, are subject to the three- year rule under IRC § 2035. If a practitioner is in the planning stage (*i.e.*, insurance has not yet been purchased), the preferred approach is to have the would-be donee purchase the life insurance directly. The insured could then make annual exclusion gifts of cash to help fund the premium payments. This approach will avoid the application of IRC § 2035.

Additional reasons for making gifts of life insurance (*i.e.*, in addition to removing the life

insurance from the insured's estate) include: (1) removing the policy and the eventual proceeds from the reach of the donor's creditors; (2) the client can transfer the policy at its significantly lower lifetime value, thereby reducing transfer tax costs; and (3) creating a source of liquidity from which the donee can draw to help pay the insured's estate taxes.

1. Donees of Life Insurance: Individual vs. Trust

The key to removing life insurance from an individual's estate is to make sure that the individual does not possess any incidents of ownership. This is accomplished by giving the life insurance to a third party (and by the insured surviving the three-year rule). The question that arises is who is the appropriate donee of the life insurance (*e.g.*, an individual vs. a trust)?

a. **Spouse as Donee vs. ILIT**. If the insured intends for the life insurance proceeds to benefit his or her spouse, then an ILIT will almost always be preferable.

> **EXAMPLE:** Insured owns a $1,000,000 whole life policy on his life, with a cash value of $500,000 and his wife is named as beneficiary. The insured decides to transfer ownership of the policy to his wife. If the insured predeceases the spouse, the effect of this transfer is estate tax neutral, because there would be no estate tax due regardless of whether or not the transfer occurred. Assuming the insured survived the transfer by three years, the policy is removed from his estate; had the transfer not occurred, the proceeds would qualify for the estate tax marital deduction. In either case, the proceeds are still taxable in the surviving spouse's gross estate (unless dissipated by the surviving spouse). If, on the other hand, the insured transferred the policy to an appropriately designed ILIT, he could prevent the proceeds from being taxed in both his and his spouse's estate, while allowing his spouse to enjoy the benefits of the insurance proceeds as a trust beneficiary.

The outright transfer to the spouse in the above example, however, could be beneficial if: (1) the spouse predeceased the insured; and (2) the spouse had only a small estate of her own. The benefit, under these circumstances, is that the cash value of the policy would be included in the donee spouse's gross estate, thereby enabling him or her to make greater use of his or her applicable credit.

b. **Children as Donee vs. ILIT**. If the spouse will not be a beneficiary of the insurance proceeds and the insured's children (or other beneficiaries) are adults, transferring the policy directly to the children may be simpler than using an ILIT. Assuming the insured survives the transfer by three years, no part of the insurance proceeds should be includible in the insured's gross estate. In addition, if the insured pays the policy premiums by making gifts to the children, the gifts should automatically qualify for the IRC § 2503(b) gift tax annual exclusion.

Nevertheless, transferring ownership of the policy to a trust and naming the trust as beneficiary is definitely preferable if the children are minors, because the insured's spouse (or another trusted relative or friend) could act as trustee of the trust and thereby exercise a tremendous amount of control over the transferred property. In addition, transferring the insurance policy to a

trust for the benefit of children provides numerous other advantages that are associated with trusts in general (*e.g.*, creditor protection, protection from a divorcing spouse, the client can control timing of outright distributions to descendants, and can determine who will manage the trust property (*i.e.*, the client appoints the trustee) in the event the children lack the financial acumen to do so themselves, etc.).

➔ **Planning Point:** If you decide to name children as beneficiaries of an insurance policy, the transaction should never be structured where the husband is the insured and the wife is the owner of the policy (or vice-versa), because, in this situation, upon the death of the husband (*i.e.*, the insured), the wife will be treated as having made a gift of the insurance proceeds to the children (see *Goodman v. Comm'r*, 156 F.2d 218 (2d Cir. 1946)). In fact, there is the potential for an inadvertent gift in any situation where three different parties are involved as owner, insured and beneficiary. To avoid this problem whenever the insured is not the policy owner, the policy owner should always be named as the policy beneficiary.

c. Irrevocable Life Insurance Trusts. As noted above, transferring the insured's insurance policy to an ILIT (and naming the trust as beneficiary) has a number of advantages over an outright transfer to an individual, including the following:

- If properly drafted, the ILIT will remove the life insurance from the insured's estate (assuming the insured survives the transfer by three years);
- The trust provides a flexible tool for the management and distribution of assets. For example, without causing inclusion in the surviving spouse's estate, the trust can provide that the surviving spouse and children are entitled to so much or all of the income and/or corpus as the trustee shall determine in the trustee's discretion (the spouse, however, should not be the trustee, unless distributions to the spouse are limited to an ascertainable standard);
- Ownership of the policy by an ILIT will permit the use of a "back-up" marital deduction provision, which will allow the proceeds to qualify for the estate tax marital deduction if the insured is married and the proceeds are includible in the insured's estate (because, for example, the insured dies within three years of assigning the policies);
- The ILIT can provide the insured's estate with liquidity to pay taxes and administration expenses, if the ILIT is drafted to provide the trustee with authority to purchase assets from the insured's estate or loan money to the insured's estate; and
- The insurance proceeds will be protected from the beneficiaries' creditors and from claims of spouses.

While use of an ILIT has a number of advantages, it also creates additional complexity. The main cause of the additional complexity is the need to structure the ILIT to avoid incurring gift tax on (i) the transfer of the life insurance policy to the trust and (ii) the transfer of cash to pay the annual policy premiums. In order to qualify these transfers for the gift tax annual exclusion, it is necessary to grant the beneficiaries Crummey powers (*i.e.*, a right to withdraw the beneficiary's

pro rata share of the property contributed to the trust).

2. Valuation of Life Insurance for Gift Tax Purposes

As will occur with the transfer of any other type of asset, the transfer of a life insurance policy for less than full and adequate consideration will result in a taxable gift. (See IRC § 2512(b)). Similarly, the payment by the insured of premiums on a life insurance policy owned by another person (*e.g.*, the insured's children or an ILIT) will be considered a gift by the insured to such other person (see Treas. Reg. § 25.2511-1(h)(8)).

The value of the life insurance policy for gift tax purposes will differ depending on the type of policy being transferred. The following material discusses how to value various types of policies for gift tax purposes.

a. Single Premium or Paid-Up Policy. A gift of a single premium or paid-up policy is essentially the replacement cost that the same company would charge, as of the date of the gift, for a contract of the same specified amount on the life of a person of the same age as the insured (see Treas. Reg. § 25.2512-6(a), Ex. (3)). Thus, if the insured's health is much worse on the replacement cost date (thereby increasing the cost of a replacement contract), the value of the gift will be greater than if the insured had been in excellent health.

b. Cash Value Policies. A gift of a cash value policy on which further premiums will be due (*i.e.*, a cash value policy that is not a single premium or paid-up policy) will equal the sum of the interpolated terminal reserve (the terminal reserve is the reserve that an insurance company must set aside each year to meet its contractual obligation to the policy owner and is approximately equal to the cash surrender value of the policy) at the date of the gift, plus any unexpired premium, less any policy loans and plus any accumulated dividends (See Treas. Reg. § 25.2512-6(a)).

EXAMPLE: P has owned a whole life insurance policy for nine years and 4 months. P transfers the policy to C by gift four months after the last premium due date. The policy has a gross annual premium of $2,811. The gift is calculated as follows:

Terminal reserve at end of 10th year	$14,601.00
Terminal reserve at end of 9th year	12,965.00
Increase in terminal reserve	$ 1,636.00
Interpolation of the terminal reserves, equals 1/3 (4 months divided by 12 months) multiplied by the $1,636 increase in the terminal reserve	$ 545.33
Terminal reserve at end of 9th year	12,965.00
Interpolated terminal reserve at date of gift	$13,510.33
Unexpired portion of gross premium (2/3 multiplied by $2,811)	1,874.00
Value of the gift	$15,384.33

c. **Term Insurance**. The value of term insurance is equal to the unexpired premium as of the date of transfer, because term insurance has no interpolated terminal reserve. Thus, the value of a term insurance policy decreases by 1/365 for each day of the policy year.

> **EXAMPLE:** H purchased a term life insurance policy on January 1, 2008. The policy has an annual premium of $2,000. If H transfers the policy on June 30, 2008, the amount of the gift is $991.78 (181/365 x $2,000). Had H transferred the policy on December 31, 2008 (*i.e.*, the day before the next premium payment is due), no taxable gift would occur.

d. **Group Term Insurance**. The value of an employee's assignment of his or her interest in group term insurance is, like regular term insurance, dependent on the date of the gift. If the transfer occurs on the premium due date, the policy will have no ascertainable value and, thus, there will be no gift (See Rev. Rul. 76-490, 1976 C.B. 300). If the gift occurs on any other day, however, the value of the gift will equal the unexpired premium.

➔ **Planning Point:** Group term life insurance coverage expires at the end of each month and a new premium is paid for the following month. Accordingly, to avoid a gift, group term insurance should generally be transferred on the premium due date (or close enough thereto to exclude the gift by reason of the insured's annual exclusion).

Following the assignment of the employee's group term insurance, each of the employer's future premium payments is an indirect gift from the employee to the assignee (See Rev. Rul. 76-490). In terms of valuing these indirect gifts, Rev. Rul. 84-147, 1984-2 C.B. 201, provides that if the group term plan is not discriminatory, or if the plan is discriminatory but the insured is not a key employee (See IRC § 416(i), for definition), the value of the gift is the lower of (i) the amount taxable as income under the Table I of IRC § 79, or (ii) the actual cost of the group term coverage. If, on the other hand, the insured is a key employee and the group term plan is discriminatory, the actual cost of the coverage must be used to measure the value of the indirect gift.

e. **Valuation Where Insured has Limited Life Expectancy**. Treas. Reg. § 25.2512-1 indicates that "[a]ll relevant facts and elements of value as of the time of the gift shall be considered" when valuing property. Accordingly, where an insured is terminally ill, the gift is not to be calculated using normal valuation principles (*e.g.*, with a cash value policy, the value of the gift would not merely be the interpolated terminal reserve plus unearned premium). This principle is illustrated in *Pritchard Est. v. Comm'r*, 4 T.C. 204 (1944), where a terminally ill insured sold insurance policies on his life with an aggregate face amount of $50,000 to his wife for $10,482.55 (approximately the cash surrender value of the policies). The Tax Court held that the wife did not pay adequate and full consideration for the policies, noting that "the value [of the policy] rises in inverse ratio to the length of life expectancy."

C. Viatical and Life Settlements

With the rapid improvements in the healthcare industry, life expectancies for the average individual have been increasing. A corollary of longer life expectancies is that older individuals

will need more money to sustain their accustomed standard of living and may need to access the value contained in life insurance policies to satisfy this need. Accordingly, it will be increasingly important to ensure that policy holders can access the value of life insurance that they own either directly or indirectly. In response to this need, viatical and life settlements have become important vehicles that enable policy holders to reach the value embedded in life insurance contracts.

A viatical settlement involves the purchase by a third party of a life insurance policy from a policy holder who is terminally or chronically ill. The sale price will be more than the cash value of the policy but less than the policy's face value, and will depend on such factors as the policy holder's life expectancy, the annual premiums, interest rates and the amount of any outstanding loans.

The market for life settlements has experienced tremendous growth in a short period of time. In 1990, only six companies comprised the secondary market. They purchased about 500 policies with a face value of between $40 million and $50 million. By 1999, the face amount of policies that were the subject of a viatical or life settlement grew to about $1 billion. This amount increased to $10 billion in 2004 and $13 billion in 2005. The industry is expected to continue this rapid growth over the next decade.

1. Product Utilization

Generally, a policy holder who enters into a life settlement has the following characteristics:

- The policy holder is at least 70 years of age. Elderly policy holders are more appropriate for life settlement transactions because this reduces the variability of the length of time that the investor will have to wait to collect the death benefits.
- The policy holder owns a high face-value policy, oftentimes $1,000,000 or more, that may have increasing premiums.
- The policy holder typically experiences a decline in health since the policy was originally issued.
- The policy holder considers surrendering the policy, or allowing it to lapse, because of a change in circumstances, which is discussed in more detail below.

The percentage of existing life insurance policies meeting the above-discussed age and size criteria is very small. Smaller size policies have also been successfully used in some cases, although the transactional costs in smaller size policies could make the settlement of these policies somewhat less profitable. However, as the industry matures, and more precise tables and techniques for determining the life expectancy of seniors are developed, life settlements may become available to more policy holders.

A policy holder will enter into a life settlement only if he or she receives incremental value for the policy over and above the cash surrender value offered by the insurer for the surrender of the policy. For a very large policy, this difference could amount to millions of dollars in incremental proceeds. The price gap could be especially large if the policy holder's health has deteriorated significantly since the policy was originally issued.

2. Why Sell a Policy? Changing Circumstances[1]

Typically, a life insurance policy is purchased for reasons such as the following: (1) a policy on the life of the head of a household may have been purchased as an income replacement vehicle; (2) the policy will be used to fund a trust or for other estate planning reasons; (3) a policy on a key person in a closely-held business may be purchased to ensure the company's survival following such person's death; or (4) a policy may be purchased solely as an investment vehicle.

Sometimes, however, circumstances change, and the policy becomes unnecessary for a variety of reasons, such as:

- The head of the household has accumulated enough wealth so that he or she is essentially "self-insured." Conversely, extra cash is needed for expenses such as increased health care costs or to purchase long-term care insurance.
- The key-person policy is no longer necessary because the business has matured to the point where its fortunes are no longer dependent on any one person or the business has been sold. The business owners may be embroiled in litigation, and a life settlement may facilitate the settlement of the dispute. The policy may be sold to raise needed funds for the operation of the business, such as funding deferred compensation, acquiring another business, repaying debt or buying an interest back from an interest holder.
- The policy holder's estate has substantially decreased in size through lifetime transfers, the estate has become sufficiently liquid or Congressional and IRS action has alleviated the potential estate tax burden such that a life insurance policy is no longer necessary (or thought to be necessary) to generate funds pay estate taxes.
- The premiums on the "investment" policy have become so expensive and/or the investment performance has become so poor that it is no longer economically feasible to continue funding it. The policy holder may wish to purchase a more efficient, more affordable policy with the life settlement proceeds.
- The beneficiary for whom the policy was originally purchased is now deceased or no longer has a need for the policy proceeds.
- A policy holder is divorced and no longer needs a second-to-die policy.
- The policy holder wishes to make cash gifts or donate highly appreciated assets to charity but would be faced with liquidity constraints resulting from such a donation or will be unable to pay gift taxes.

3. The Mechanics of a Viatical or Life Settlement

The life settlement process is similar to applying for an insurance policy. Generally, a broker or agent representing the policy holder will contact various life settlement companies, provide them with appropriate medical information about the policy holder and will assist the policy holder in collecting, comparing and eventually choosing among various settlement offers. After accepting an offer, the owner will be required to execute several instruments to transfer the policy and to change beneficiary designation. After the policy is transferred and the beneficiary designation is changed, the proceeds from the settlement are paid to the seller.

a. <u>Who is Eligible</u>? As discussed above, settlement providers will purchase policies from persons who are either terminally or chronically ill (*i.e.*, viatical settlements). Additionally, at least three commercial life settlement providers are currently purchasing policies from seniors whose health has declined but who are not classified as either terminally ill or chronically ill (*i.e.,* life settlements). The definition of "seniors" varies depending on the company; some companies will only enter into settlements with seniors who are over age 65, while others require the senior to be at least age 70.

b. <u>What Types of Policies May Be Subject to Viatical or Life Settlements</u>? Virtually any type of policy may be sold, including whole life, universal, split dollar, and even term life policies, notwithstanding the fact that term life policies have no cash value. The only potential roadblocks to the sale of a policy are (i) if the contestability period (typically two years) has not yet expired or (ii) if the terms of the policy prohibit it from being assigned. Fractional interests in a policy (*e.g.*, one-third of the policy) may also be sold.

c. <u>Overview of the Application, Due Diligence and Offer Process</u>. In order to enter into a viatical or life settlement, the seller must fill out an application that provides basic demographic data and complete consent forms that give the settlement company authority to obtain the policy holder's medical records and to verify that the insurance policy is currently in force. If the seller is not the same person as the policy holder (*e.g.*, the seller is the trustee of a trust), the seller will have to request that the policy holder provide the settlement company with the necessary information and consent forms. The life settlement provider's own medical experts use this information to independently determine the policy holder's life expectancy.

The settlement offer depends largely upon the results of the settlement provider's independent determination of the policy holder's life expectancy, the estimate of the future premiums it will have to pay to keep the policy in force, and the policy's cash value, if any. A reasonable estimate of amounts paid in settlement of a contract is 50% to 80% of the face value of the policy for viatical settlements and 10% to 40% of the face value of the policy for life settlements.

d. <u>Assignment, Payment and Rescission</u>. Once the seller accepts an offer, he will be required to sign an instrument assigning his rights in the policy to the life settlement provider. After the policy has been assigned and the beneficiary designation has been changed, the settlement company will pay the agreed amount. Generally, the process from application to payout takes two to eight weeks, although it could take longer depending on how long it takes the policy holder's physicians to provide the settlement company with the necessary information. A seller is allowed a set period of time to rescind a life settlement after he or she receives the settlement proceeds.

e. <u>Settlement Options</u>. Some settlement providers offers a number of payment options, including the following: (1) a lump sum payment; (2) installment payments; (3) treating the proceeds as a tax-free loan; and (4) use of the proceeds to purchase an annuity.

➔ **<u>Planning Point</u>:** If a policy holder is classified as chronically ill, the maximum amount of the viatical settlement that may be excluded from gross income is generally $63,875 *annually* (adjusted annually for

inflation). Thus, when selecting a settlement option for a chronically ill policy holder, it will usually be better for the individual to receive the settlement proceeds in installments, so as to ensure that most (if not all) of the proceeds will be excludable from the seller's gross income under IRC § 101(g).

f. **Post Settlement Issues**. The seller may use settlement proceeds for any purpose, including paying for medical or day-to-day living expenses or engaging in estate planning. IRC § 6050Q requires viatical settlement providers to report the aggregate benefits they pay and certain other information on Form 1099-LTC, Long-Term Care and Accelerated Death Benefits or an acceptable substitute. The seller should provide a copy of this form to his or her tax return preparer.

4. Federal Taxation

a. **Income Tax Treatment Where Policy holder is Terminally or Chronically Ill**. Under IRC § 101(g)(2), if any portion of the death benefit under a life insurance contract on the life of a policy holder who is terminally or chronically ill is sold or assigned to a "viatical settlement provider," the amount paid for the sale or assignment of such portion is treated as an amount paid by reason of the death of the policy holder. Because a viatical payment is treated as paid by reason of the death of the policy holder, the amount received in the settlement is excluded from the policy holder's gross income in whole or in part under IRC § 101(a).

The classification of a policy holder as either terminally ill or chronically ill will impact the amount that the policy holder will receive income tax free.

(1) **Terminally Ill Individual**. An individual is terminally ill if he or she has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death in 24 months or less after the date of the certification. IRC § 101(g)(4)(A). If a policy holder is classified as terminally ill, the entire amount paid to the policy holder in the viatical settlement will be excluded from gross income.

(2) **Chronically Ill Individual**. An individual is chronically ill if he or she has been certified within the last 12 months by a licensed health care practitioner as (i) being unable to perform (without substantial assistance) at least two activities of daily living for a period of at least 90 days due to a loss of functional capacity, (ii) having a similar level of disability as determined under the regulations or (iii) requiring substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment. IRC §§ 101(g)(4)(A); 7702B(c)(2).

IRC § 101(g)(3)(A) states that the exclusion from income only applies to payments "for costs incurred by the payee (not compensated by insurance or otherwise) for qualified long-term care services." Further, the contract giving rise to such payment must not pay expenses that are reimbursable under Medicare. IRC § 7702B(b)(1)(B). Under IRC § 7702B(d), if a policy holder is classified as chronically ill, the maximum amount of the viatical settlement that may be excluded from gross income in 2007 is generally $98,550 annually (adjusted annually for inflation). Other conditions also apply. IRC § 101(g)(3).

b. **Income Tax Treatment if Policy holder is not Terminally or Chronically Ill.** If a policy holder is not terminally or chronically ill, the income tax treatment of life settlement proceeds is governed by IRC § 1001. Under that section, the amount realized on the sale of property is the fair market value of the consideration received, while the gain that must be recognized on the sale is the difference between the amount realized and the seller's adjusted basis in the contract. The gain is presumably considered ordinary income. *Gallun v. Comm'r*, 327 F.2d 809 (7th Cir. 1964); *Comm'r v. Phillips*, 275 F.2d 33 (4th Cir. 1960). It is not clear, however, whether the seller's basis in the insurance policy should be determined under IRC § 72(e)(6) or under IRC § 1001(a).

(1) **The Policy Holder's Basis in the Contract Under Internal Revenue Code ("IRC") § 72(e)(6).** IRC § 72(e)(6) determines the policy holder's basis in a contract where the policyholder surrenders or redeems the policy. Under that section, the policy holder's basis is equal to the aggregate amount of premiums paid, less the aggregate amount received under the contract that was not included in the recipient's gross income (e.g., nontaxable dividends, which are essentially the return of excess policy premiums).

(2) **The Policy Holder's Basis in the Contract Under IRC § 1001(a).** In PLR 9443020, a ruling that predates the enactment of IRC § 101(g), the IRS stated that the basis in a life insurance policy that is sold (as opposed to being surrendered or redeemed under IRC § 72(e)(6)) should be reduced by the cost of insurance protection provided through the date of the sale and any amounts (e.g., dividends) received under the policy that have not been included in gross income. There is no similar ruling or other precedent, however, suggesting that a policy holder's basis as determined under IRC § 72(e)(6) should be reduced by the "cost of insurance" as an amount received under the contract. Thus, an issue has arisen regarding which method is the correct method of calculating a policyholder's basis in an insurance policy for purposes of a sale of the policy.

The issue is confused further by a footnote in PLR 9443020 that cites IRC § 1016(a)(1) (which provides for basis adjustments for "expenditures, receipts, losses, or other items, properly chargeable to capital account") and then directs the reader to "see also" IRC § 72(e). The reference to IRC § 72(e) indicates that the IRS believes that IRC § 72(e)(6) applies, at least to some extent, in the sale context. Nevertheless, by citing IRC § 1016(a)(1) the IRS also implies that the basis as determined under IRC § 72(e) must be adjusted for "expenditures, receipts, losses, or other items, property chargeable to capital account" under IRC § 1016.

Whether a policy holder's basis in an insurance contract should be reduced by the "cost of insurance" for purposes of determining his or her gain on the sale of the policy is an important issue, as it will obviously have a significant impact on the amount of gain that must be recognized. Nevertheless, there is no case law squarely addressing the proper calculation of basis in determining *gain* on the sale of an insurance contract (in PLR 9443020 the IRS relied on cases that are distinguishable on their facts). As a result, the proper treatment of the amount received by a policy holder's in a life settlement (i.e., where the policy holder is not terminally or chronically ill) may not be finally resolved until this issue is squarely addressed by the IRS or a court.

5. Estate Planning Applications of Life Settlements

a. <u>Rethinking Current Techniques</u>. In light of the increasing popularity of viatical and life settlements, attorneys should reconsider the manner in which they structure some common estate planning techniques. With an eye towards the fact that clients may at some point desire to enter into life settlements with respect to their life insurance policies, attorneys should concentrate on building flexibility into any planning that is done with life insurance.

(1) <u>Irrevocable Life Insurance Trusts</u>. Estate planners traditionally have used two techniques to remove the value of a life insurance policy from a client's estate for federal estate tax purposes. Where a client already owns a policy, an attorney might suggest that the client transfer the policy to some other owner, such as the Trustee of an irrevocable life insurance trust ("ILIT"). While generally effective, if the client dies within three years of the transfer, the value of the policy will be brought back into his or her estate under IRC § 2035. Alternatively, where a client does not already own life insurance but is contemplating the purchase of a policy, attorneys should recommend that the policy be acquired by the Trustee of an ILIT. This second technique avoids the potential for inclusion under IRC § 2035 because the insured never makes a transfer of the policy.

While ILITs are an effective way of removing the value of a policy from an insured's gross estate, because the governing instruments must be carefully drafted to limit the insured's power over the policy and the beneficial enjoyment of the trust property, the insured typically will not have a means of obtaining access to the insurance policy or its proceeds. This is not generally problematic where the purpose of the trust and the policy is to provide for trust beneficiaries after the insured's death. However, if the insured has unanticipated cash flow needs during his or her life (<u>e.g.</u>, for substantial medical or long-term care expenses), a life settlement, which otherwise might seem an appropriate solution to this problem, may be unavailable because the governing instruments of ILITs generally do not provide a means for life settlement proceeds (or any trust assets) to be distributed to the insured.

To prevent this result, attorneys should seek to build flexible terms into the governing instruments of ILITs. One obvious way to increase flexibility is to name the insured's spouse as beneficiary of the trust during the insured's life. By using this approach, if lifetime settlement becomes desirable, the trustee can distribute either the policy or the settlement proceeds to the beneficiary spouse, who can then transfer the policy or proceeds to the client pursuant to the unlimited federal gift tax marital deduction (or use the proceeds for the benefit of the client). Another way to increase flexibility is to grant a special power of appointment to an individual and name the insured in the class of permissible appointees so that the insurance policy (or proceeds from a life settlement) may be appointed to the insured if necessary.

In addition, the terms of the ILIT should confer on the trustee express powers to sell any life insurance policy held in the trust and move the trust's situs to another jurisdiction. Such an approach will enable the trustee to engage in a life settlement that would otherwise be prohibited under the then applicable state law or to seek a jurisdiction that favorably regulates life settlements.

(2) <u>Family Limited Partnerships/Limited Liability Companies</u>. Practitioners should consider using family limited partnerships ("FLPs") or limited liability

companies (LLCs") as an alternative to ILITs because partnership agreements and operating agreements are freely amendable by the partners or members and thus provide greater flexibility than an ILIT. Moreover, an insured can retain substantially greater control of the FLP or LLC (even where, as will typically be the case in the FLP or LLC context, the insured is not the general partner or manager and is not in control of the general partner or manager) than he or she could with an ILIT. FLPs and LLCs, however, shelter only the value of the FLP or LLC discount from estate tax or gift tax, whereas an ILIT (if the governing instrument is properly drafted and the trust is properly administered) will shelter the full value of the policy from estate tax or gift tax.

> **EXAMPLE:** H has a portfolio of securities worth $2,000,000 that he wishes to transfer to a FLP. H plans to retain the limited partnership units and wants to structure the partnership so that his limited partnership interest will be discounted at the death of the survivor of his wife, W, and him. H and W form a corporation to act as the general partner of the partnership, and, in exchange for funding it with $20,000 cash, each receives one-half of the stock. Accordingly, neither H nor W has independent control of the corporation. The corporation contributes $20,000 in cash to the FLP in return for a 1% general partnership interest, and H contributes $1,800,000 of stock to the FLP in return for a 99% limited partnership interest. The FLP uses the $20,000 in cash to purchase insurance on H's life. Because H does not have a controlling interest in the corporation that is acting as the general partner, none of the incidents of ownership of the life insurance policy owned by the FLP are attributable to H. Each year, H and the corporation make additional capital contributions to the FLP to enable it to fund the insurance premiums, and each takes back his or its respective limited or general partnership interests. After several years of paying premiums, H decides that he wants to enter into a life settlement and have the proceeds transferred out of the FLP. The FLP sells the policy and distributes 99% of the proceeds to H. The remaining 1% of the proceeds is distributed to the corporation. The value of the limited partnership interests retained by H will be subject to estate tax at his death but should give rise to valuation discounts.

If the practitioner opts to use a FLP or LLC in lieu of an ILIT, the practitioner should verify that, under applicable state law, the FLP or LLC has an insurable interest in the insured. If not, then use of a FLP of LLC may not be feasible.

A disadvantage to the use of a FLP or LLC in the life settlement context is that the life settlement proceeds paid to a FLP or LLC will ordinarily be fully subject to income tax. This negative result occurs because, under IRC § 101(g), life settlement proceeds payable to a taxpayer other than the policy holder will not be eligible for exclusion from income if the taxpayer has an insurable interest with respect to the life of the policy holder by reason of having a business or financial relationship with the policy holder (as opposed to, for example, an insurable interest by reason of being the spouse of the policy holder).

(3) **Domestic Asset Protection Trusts**. Some clients create irrevocable trusts for family members, protecting trust assets from creditors and effectively transferring substantial wealth with little or no transfer tax costs. Other clients are reluctant to create such trusts and fund them with substantial assets unless they can be beneficiaries of their trusts. Under the laws of most U.S. and other common law jurisdictions, if an individual creates a trust, even one that is irrevocable, and retains a beneficial interest in the trust, his or her creditors can reach the trust property. As a result, the transfer to the trust is deemed to be revocable, and, therefore, at the settlor's death, the value of its assets is included in his or her estate for estate tax purposes under IRC § 2036.

In response to this concern, and out of a desire to attract trust business, several states have enacted legislation that gives a settlor the ability to establish what is commonly referred to as a "domestic asset protection trust" ("DAPT"). These trusts are established for the benefit of the settlor and his or her family but still have asset protection advantages and are designed with the intention of causing exclusion of the value of the trust property from the settlor's gross estate. Before such legislation was enacted, asset protection trusts could be established only in certain offshore jurisdictions. States that have enacted such legislation include Delaware, Alaska, Missouri, Utah, South Dakota, Rhode Island, Oklahoma and Nevada. Under the relevant DAPT statutes, presumably the settlor may be a discretionary beneficiary of an irrevocable trust without causing any transfer to the trust to be an incomplete gift or risking inclusion of the value of the trust property in the settlor's gross estate under IRC §§ 2036 or 2038. PLR 9837007 (transfer to an Alaska DAPT was a completed gift); Rev. Rul. 2004-64, 2004-27 I.R.B. 7 (indicating that trust assets will not be subject to federal estate tax at the settlor's death if state law, including the law of a DAPT state, does not subject the assets to the claims of the settlor's creditors).

After establishing a DAPT, the insured can transfer a policy of insurance on his or her life (or cash to fund the purchase of such policy) to the Trustee of the DAPT and retain a beneficial interest in the DAPT as a discretionary beneficiary. If the settlor/insured wishes to obtain cash, the Trustee could enter into a life settlement of the insurance policy held in the trust, and the settlement proceeds could be paid out to the insured as a discretionary beneficiary.

Despite the favorable IRS private letter ruling and a favorable revenue ruling cited above, many practitioners are cautious about this technique for legitimate reasons. DAPTs remain relatively new and thus are not "time tested."

(4) **Use of Life Settlements to Fund Gift Tax**. Even in this current climate of potential significant change in federal and state estate tax laws, making a taxable gift may be beneficial for a client because a client may be able to pass significantly more wealth to his or her descendants by making gifts during life and paying gift tax and/or reducing the client's applicable exclusion amount (assuming he or she survives the transfer by three years so the gift tax is not included in the estate tax base) than by leaving property to them at death which would be subject to the tax-inclusive estate tax. Most clients with a diminished applicable exclusion amount, however, are unwilling to pay gift tax, and those who are willing may not have sufficient liquidity to pay gift tax. A life settlement may enable a client with a diminished unified credit to make a large taxable gift and pay gift tax when he or she otherwise might not be able or willing to do so, thereby transferring greater wealth to his or her descendants.

<u>EXAMPLE</u>: H owns a $2,000,000 life insurance policy on his life with a basis of $500,000, which amount is greater than the policy's cash value. The beneficiaries of the policy are his three children. H's wealth is largely tied up in a closely-held business; he owns stock in the business with a non-discounted value of $3,000,000. H wants to make a taxable gift of non-voting stock in his business, which qualifies for a 40% valuation discount, to his children. However, his gift tax applicable exclusion amount has been eliminated by prior gifts, and he is concerned that he may not have significant liquidity to pay the gift tax. H should consider a life settlement.

Assume that H otherwise qualifies for a life settlement and receives a net, after-income tax settlement amount of $925,000 with which to pay gift tax. H can use part of the $925,000 to pay the $810,000 gift tax (assuming a 45% gift tax rate) that results from the gift of the closely-held stock that has a gift tax value of $1,800,000 (($3,000,000 x .60) = $1,800,000).

(5) **<u>Life Settlements Coupled With a Gift-Giving Program</u>**. Life settlements coupled with an annual exclusion gift-giving program should be considered as another alternative for removing the value of a policy from a policy holder's estate.

<u>EXAMPLE</u>: H, who is terminally ill, owns a $2,200,000 policy of insurance on his life. H could remove the policy from his estate by transferring it to another individual or to an irrevocable trust; however, by doing so he risks having the policy brought back into his estate under IRC §§ 2035 and 2042 if he dies within three years of the transfer. H chooses to sell his policy and use the proceeds to fund an annual exclusion gift-giving program. H has seven married children and twelve grandchildren. Assume that, after the payment of taxes, H has $1,200,000 in life settlement proceeds remaining. If, via gift- splitting with his spouse, H makes $24,000 in annual exclusion gifts to each child, each child's spouse and each grandchild, and then makes a second round of gifts early in the following calendar year, he could transfer all $1,200,000 in settlement proceeds to his descendants free of gift tax, whereas they may only receive $1,188,000 (net of estate tax at a rate if 46%) if H died owning the policy. H therefore benefited his children and grandchildren immediately and ultimately transferred more wealth to his family.

b. **<u>New Techniques to Consider</u>**. In response to the growing life settlement industry, attorney should not only rethink traditional techniques, but should also consider the following innovative estate planning uses for life settlements. The following examples, however, do not take into account subjective economic factors, such as disappointing investment performance, which may provide additional incentives for one to consider life settlements.

(1) **Private Life Settlements**. DAPTs offer a vehicle for clients to give away property, yet retain an interest in the trust as a discretionary beneficiary of the trust. As we have seen, however, many practitioners are reluctant to use these techniques due to the uncertainty as to whether they will withstand IRS scrutiny. Many clients, on the other hand, are reluctant to create irrevocable trusts for family members, even if the potential transfer tax savings are significant, unless the trust can be structured so that they can be named as a beneficiary of the trust. Clients with this concern might employ a "private viatication" strategy as an alternative way to access the assets in an irrevocable trust.

Under this strategy, the policy holder would sell an insurance policy on his or her life to an existing irrevocable trust for his family. The trust would pay exactly what a commercial life settlement provider would pay for the policy. Thus, the transfer should not constitute a taxable gift. The client will receive assets out of the trust, but, more importantly, the insurance proceeds will continue to benefit the client's family.

EXAMPLE: H created a dynastic trust for his family in 1991, fully GST exempt and fully utilizing both his and W's applicable exclusion amounts. The dynastic trust now holds roughly $3,000,000 that H wants to access. H owns a fully paid-up $2,000,000 life insurance policy on his life (in which he has a basis of $200,000, an amount in excess of the policy's cash surrender value). H's health has declined, and he now intends to sell the policy. Assuming that a commercial life settlement provider would pay 15% of the face value of the policy, the trustee of the trust purchases the policy for $300,000. H will have $285,000 net of income tax ($300,000 – (15% capital gain tax rate x ($300,000 - $200,000))), and the Trust will acquire the $2,000,000 policy and name itself as the beneficiary. If H dies two years after the sale, and if over that period the trust property grows at 8%, then, upon H's death, the dynastic trust will hold trust assets with a value of $5,482,080. By comparison, if H had retained the policy, at the end of two years his children would have received policy proceeds of $1,100,000 (net of estate tax), and the dynastic trust would hold $3,499,200, for a total of $4,599,200 for the benefit of H's descendants. By entering into a "private life settlement" with respect to the policy, H transferred approximately $902,880 more for the benefit of his descendants, and he transferred value from the policy to the GST exempt dynastic trust. In addition, H was able to use the $285,000 of net life settlement proceeds for other purposes.

(2) **Realizing Discounts Through the Use of Life Settlements**. Life settlements may be used to create discounts in a policy holder's estate, even if the policy holder has previously transferred the policy to an ILIT. As the following example illustrates, life settlement proceeds held by a client's ILIT can be used to purchase controlling interests in an entity previously controlled by the client, thereby creating minority interest discounts that can save significant estate taxes.

EXAMPLE: H is terminally ill and is the sole shareholder in a closely-

held business valued at $4,000,000. H is also the settlor of an ILIT, which owns a $2,600,000 face value policy on H's life. The trustee of the ILIT enters into a life settlement and receives $1,200,000 net of income taxes. The trustee can use the proceeds to buy a substantial minority interest in H's business. The interest should be valued at a discount to reflect both its lack of control and lack of marketability. Assuming that the interest is entitled to a 40% discount, the trustee can purchase a 49% interest in the company for $1,176,000 (($4,000,000 x .49) x (1-.40)). This transaction passes the amount of the discount attributable to the 49% interest (*i.e.*, $784,000=$1,960,000-$1,176,000) to the children free of tax.

H then owns 51% of the business. H gives 2% of his remaining stock to his children, valued for gift tax purposes at $48,000 (*i.e.*, a non-discounted value of $80,000). This generates a gift tax of approximately $21,600. If H has no unified credit left to absorb this tax, H can use the remaining $24,000 of life settlement proceeds to pay the gift tax.

After the gift, H owns only 49% of the stock, a minority interest. At H's death, this interest should also be discounted by 40%. Taking the discount into account, H's interest is now worth only $1,176,000 for estate tax purposes, rather than $1,960,000, thereby transferring an additional $784,000 (*i.e.*, $1,960,000 - $1,176,000) to his children free of tax.

The strategy of making gifts for the purpose of creating a minority interest is aggressive and, on the authority of *Murphy v. Comm'r*, T.C. Memo. 1990-472, may not succeed. In that case, the decedent had a lifetime general power of appointment over 51.41% of closely-held stock. Eighteen days before her death, she made gifts of 0.88% of this stock to each of her two children, reducing the percentage subject to her power to 49.56%. The court concluded, on these facts, that the transaction was entered into for the sole purpose of obtaining a minority discount and consequently denied the application of any valuation discount. See also TAMs 9842003, 9730004 and 9725002.

The *Murphy* decision, however, has been widely criticized in the estate planning community. Louis S. Harrison & Robert S. Held, "Sham Transaction Doctrine," Trusts & Estates (Feb. 2003), at 11; David A. Herpe, "Minority Discounts Revisited: The Estate of Murphy," Trusts & Estates (Dec. 1990), at 35. Furthermore, it may have been repudiated by the court's decision in *Frank Est. v. Comm'r*, T.C. Memo 1995-132, the facts of which are very difficult to distinguish from those of *Murphy*. In *Frank Est. v. Comm'r*, the Tax Court, without even mentioning *Murphy*, ignored any motive for the transfer and found the transfer to be valid, as all corporate formalities were followed. As a result, the current status of this issue is unclear and, thus, practitioners should proceed with caution when transferring a small percentage interest in an entity that results in a switch in the overall control of the entity.

(3) Using Life Settlements to Achieve Charitable Objectives. All things being equal, a client who intends to leave all or most of his estate to charity would typically

prefer to donate highly appreciated assets to a charity during life so that he or she could enjoy the goodwill and recognition resulting from his or her philanthropy and to obtain a current fair market value income tax deduction. Nevertheless, many clients hesitate to do so for fear of losing the income stream and security associated with retaining assets. A life settlement might facilitate a lifetime gift. After entering into a life settlement, the policy holder may donate an asset such as appreciated securities, obtain an income tax and gift tax charitable deduction, and use the life settlement proceeds to replace the income stream lost by the donation of the securities.

> **EXAMPLE:** H owns a $3,000,000 insurance policy on his own life (with a basis of $400,000), as well as publicly traded securities worth $450,000, which has a basis of $275,000. H sells his policy and receives a $480,000 settlement. Assuming that the basis in the contract is greater than the policy's cash surrender value, the difference between the settlement proceeds and the basis will be taxed as capital gain at 15%, resulting in H receiving $468,000 of the settlement proceeds after tax ($480,000 – (15% x ($480,000 - $400,000))). Having $468,000 in cash, H feels free to donate his securities to a public charity. As a result of the donation, H receives a full fair market value income tax deduction on the appreciated securities. Assuming a 35% marginal income tax rate, the deduction saves him approximately $157,500 in income tax ($450,000 x 35%).

Of course, in the above example, if the client is terminally ill, he could expect to receive a higher amount in settlement proceeds, perhaps $1,500,000 free of income taxes. In that case, he could afford to make a greater charitable contribution, either of additional appreciated securities, or of a portion of the settlement proceeds.

6. Best Practices Now Requires Analysis and Utilization of a Life Settlement in Certain Situations

To respond to this new development, agents, brokers, lawyers, trustees, financial planners and other insurance professionals should become well-versed in the mechanics of, and the planning opportunities involving, life settlements.

Clients have long viewed life insurance merely as a means of providing liquidity to pay estate taxes, to provide funds for the maintenance, support and education of surviving family members, to fund obligations under buy-sell agreements or to meet other business needs. Based on this narrow view, it's no wonder so many insurance professionals fall into the trap of agreeing to allow unneeded and/or burdensome policies to lapse or be surrendered for just their cash surrender values. However, given the growing market for life settlements, this may be bad advice.

An issue that these professionals should address is the nature of the fiduciary duties that various insurance professionals may owe to clients and the potential liability that may arise from recommending or not recommending a life settlement and, if a life settlement is recommended, what liability could arise from not properly evaluating a proposed life settlement transaction. Although there are no reported cases directly dealing with this issue, it is reasonable to postulate that any professional could incur liability for negligent advice given to a client who is considering

a life settlement. For example, a recent article stated that life insurance companies are prohibiting their life insurance agents from mentioning the life settlement alternative to their clients, regardless of the potential benefit to the client. This withholding of information could lead to liability for breach of fiduciary duty.

Regarding lawyers, the duty to consider life settlements may extend to a wide range of specialties beyond estate and tax planning. Lawyers who specialize in divorce should consider the utility of a life settlement when negotiating a property settlement agreement. Corporate lawyers may need to review business-owned life insurance policies and consider a life settlement. Such life insurance may be a source of much-needed cash after a merger, acquisition or reorganization. Furthermore, lawyers for charities or foundations that receive donations of life insurance policies should ensure that the charity or foundation can enter into a life settlement with the donated life insurance policy in the future. Also, bankruptcy lawyers may need to consider a life settlement for business-owned life insurance policies so that extra funds will be available to pay creditors.

If the insurance professional has considered and recommended to the client a life settlement, the professional may have the additional duty of finding the right life settlement for the client's situation. The following guidelines may be helpful in fulfilling this duty:

- Obtain multiple offers.
- Investigate a potential buyer to determine if there have been any complaints lodged against such buyer.
- Verify that the buyer has readily available cash to buy the policy.
- Determine if the life settlement proceeds will be held in escrow until the exchange in ownership closes.
- Make sure that the contract terms require timely payment from the escrow agent.
- Determine the tax consequences of the transaction and any effect the transaction may have on public assistance benefits.
- Determine the probate, dispositive and estate tax considerations arising from the transaction.

D. Split Dollar Life Insurance

1. The History of the Taxation of Split Dollar Life Insurance Plans

Split dollar life insurance plans are not an insurance product, but rather a system for financing the purchase of an insurance policy. In its classic configuration, an employer and an employee purchase an insurance policy on the employee's life, and agree to a method for splitting the premiums on the policy, the cash value of the policy and the death benefit. Commonly, the employer would agree to pay the entire premium with the exception of that portion of the premium that represented the economic value of the death benefit provided to the employee. The employee would contribute toward the premium (or be deemed to have received as taxable income) an amount equal to the economic value of the death benefit payable to the employee. The split dollar agreement would provide that on the termination of the agreement or the payment of proceeds under the policy, the employer would be reimbursed for all funds advanced for premium payments, or the cash value of the policy. The balance of the policy proceeds (if any) would be paid to the

employee. Often the split dollar agreement would be between the employer and an irrevocable life insurance trust established by the employee, so that the insurance benefits paid at the employee's death would escape estate taxation in the employee's estate. In that case, the economic value of the death benefit payable to the trust is also the measure of the employee's annual gift to the trust.

Split dollar plans have been popular for many years, particularly after the IRS ruled that the employer's payment of premiums under a split dollar life insurance arrangement did not constitute loans to the employee. (See Rev. Rul. 64-328, 1964-2 C.B. 11, Rev. Rul. 66-10, 1966-1 C.B. 12, and Rev. Rul. 67-154, 1967-1 C.B. 11.) Many variations have developed, including equity split dollar (in which cash value build-up within the policy in excess of premiums paid by the employer is the property of the employee); private split dollar (in which the parties are not employer and employee); and reverse split dollar (in which the burdens of premium payments and economic benefits are reversed from the traditional plan).

In the 1960's, when these rulings were issued, they were consistent with prevailing law, under which interest-free loans were not treated as taxable events for income or gift tax purposes. However, once IRC § 7872 was enacted, imposing gift and income tax consequences on interest-free or below-market loans, the tax treatment of split dollar insurance arrangements under these old rulings made less sense.

The IRS has made several attempts to address what it considers abuses in the split dollar arena. The first issue with which the IRS has been concerned is the failure to characterize premium payments by the employer under a split dollar arrangement as a loan. A second perceived abuse developed from the recognition that the economic benefit being provided to the employee by virtue of the employer's premium payments could include not only death benefit protection, but also any equity build-up within the policy that exceeded the amount required to be repaid to the employer. The third perceived abuse related to the insurance rates used to quantify the economic benefit being provided to the employee for death benefit protection. In Rev. Rul. 55-747, 1955-2 C.B. 228, the IRS provided that so-called PS 58 tables could be used to measure the economic value of the death benefit protection. However, the PS 58 tables are based on mortality statistics that are very outdated. As a result, it is more common for participants in split dollar arrangements to use tables provided by the insurance company issuing the policy. The difficulty with this alternative, originally permitted by the IRS, is that insurance companies have developed rates for this purpose that the IRS perceives as being artificially low. Often an insurance company will use single life term rates for split dollar products that are not available for any other products sold to the general public.

2. Split Dollar Regulations

On September 11, 2003, the Treasury released the final version of regulations governing the taxation of split dollar life insurance arrangements (T.D. 9092).

a. Background. The final regulations are the culmination of a series of rulings, notices and regulations issued by the IRS over the previous 8 years that cumulatively have modified the tax treatment of split dollar life insurance arrangements under Rev. Rul. 64- 328, 1964-2 C.B. 11, and Rev. Rul. 66-110, 1966-1 C.B. 12, discussed above. The following is a summary of the guidance concerning split dollar arrangements.

(1) **TAM 9604001**. This TAM applied for the first time the concept that increases in the cash surrender value of an equity split dollar arrangement, i.e., an arrangement in which an employer's interest in the cash surrender value of a life insurance contract is limited to the aggregate amount of its premium payments - are taxable annually under IRC § 83.

(2) **Notice 2001-10**. This notice provided "interim guidance" pursuant to which the taxpayer is offered a choice, "pending consideration of public comments and the publication of further guidance," of treating the equity split dollar arrangement either as a loan, taxable under IRC § 7872, or as a transfer of property (cash value build-up) upon "rollout" under IRC § 83. Notice 2001-10 also promulgated Table 2001, based on the mortality experience reflected in Table (i) under IRC § 79, with extensions for ages below 25 and above 70, and the elimination of the five-year age brackets. The Table 2001 rates replace the P.S. 58 rates set forth in Rev. Rul. 55-747, 1955-2 C.B. 228, and are materially lower than the P.S. 58 rates at all ages.

(3) **Notice 2002-8**. The notice revoked Notice 2001-10, and announced the government's intention to publish regulations providing comprehensive guidance concerning split dollar life insurance arrangements under which the taxation of the arrangement would depend on the parties' designation of the formal ownership of the insurance contract. This notice also provided interim guidance regarding the valuation of current life insurance protection and stated certain effective date and "safe harbor" rules with respect to existing arrangements.

(4) **2002 Proposed Regulations**. These regulations provided comprehensive proposed guidance, based generally on the principles announced in Notice 2002-8, for the income, gift and employment taxation of both equity and nonequity split dollar life insurance arrangements.

(5) **2003 Proposed Regulations**. Published on May 9, 2003, the proposed rules provided for the valuation of the economic benefits provided under an endorsement equity split dollar life insurance arrangement. The 2003 proposed regulations rejected the taxation of equity under IRC § 83 only on a rollout of the contract, and instead adopted a regime for current (annual) taxation of equity under IRC § 61.

b. **Scope**. The preface to the final regulations states specifically that they do not address the issues arising out of Section 402 of the Sarbanes Oxley Act, which falls within the jurisdiction of the SEC. The preface also states that the final regulations do not affect the estate taxation of split dollar life insurance arrangements, which will continue to be governed by IRC § 2042. Future guidance may be issued on the estate tax implications of "co-owned" policies.

The Treasury and the IRS released with these regulations Rev. Rul. 2003-105, obsoleting Rev. Rul. 79-50, 1979-1 C.B. 138, Rev. Rul. 78-420, 1978-2 C.B. 67, Rev. Rul. 66-110 (except as provided in Section III, Paragraph 3 of Notice 2002-8, regarding the permitted use of the insurer's alternative term rates - as modified in some cases - for arrangements in existence before September 17, 2003, and Notice 2002-59, 2002-2 C.B. 481, to the same effect, except with regard to certain reverse split dollar arrangements) and Rev. Rul. 64-328. TAM 9604001 is effectively obsolesced because the Revenue Rulings upon which it relied are obsolesced.

c. <u>Split Dollar Life Insurance Arrangement Defined</u>. A split dollar life insurance arrangement is defined as any arrangement (other than a group-term life insurance plan) between an "owner" and a "nonowner" of a life insurance contract, under which either party to the arrangement pays all or part of the premiums and one of the parties paying the premiums is entitled to recover all or any part of those premiums from the proceeds or cash surrender value of the contract. Employer/employee arrangements, corporation/shareholder arrangements and private (i.e., donor/donee) arrangements are all covered in the final regulations. In the context of employer/employee split dollar and corporation/shareholder split dollar, the arrangement is subject to the regulations even where the obligation of repayment is not secured by the policy or its proceeds, so long as the beneficiary of all or part of the death benefit is designated by the employee or shareholder or is someone whom the employee or shareholder would be reasonably expected to designate as a beneficiary. "Reverse" split dollar arrangements are not discussed, because they have been dealt with in Notice 2002-59. The final regulations retain the special rules from the 2002 proposed regulations that treat certain arrangements entered into either in connection with the performance of services or between a corporation and another person in that person's capacity as a shareholder in the corporation as split dollar life insurance arrangements regardless of whether the arrangements otherwise satisfy the general definition of a split dollar life insurance arrangement.

The regulations exclude arrangements in which one party to the transaction pays the premiums for the benefit of another party without expectation of repayment. In that case, the payment is taxable to the recipient under the general rules of IRC § 61, or, in a non- compensatory context, as a gift. The preamble to the final regulations also makes clear that definition of "arrangement" does not cover the purchase of an insurance contract in which the only parties to the arrangement are the policy owner and the life insurance company acting only in its capacity as issuer of the contract. The final regulations also make clear that key person insurance, where the employer or corporation owns the policy and all of its benefits, is outside the scope of the regulations.

The regulations do, however, appear to cover loans used to pay premiums that are secured by the policy, including, presumably, third-party (e.g., bank) premium financing arrangements. However, the effect of including premium financing arrangements in the definition is not clear, unless the parties have an employment, shareholder or gift relationship and the interest rate is less than the AFR (or issues of original issue discount ("OID") are involved). The final regulations also are silent on the effect of a guarantee of a third-party loan by a related party (employer or donor) who may later step into the original lender's position with respect to the collateral.

d. <u>Owner and Nonowner Defined</u>. As under the 2002 proposed regulations, the income and gift tax consequences of the split dollar arrangement follow (with two exceptions) the formal ownership of the policy, thus making the definition of "owner" and "nonowner" key to these rules. In general, payments made by an "owner" of the policy for the benefit of a nonowner in a split dollar life insurance arrangement (typically an endorsement arrangement) are taxed to the parties through the use of an "economic benefit" analysis, while payments made by a "nonowner" of the policy for the benefit of the owner (typically a collateral assignment arrangement) are treated as loans subject to the rules of IRC § 7872 (and the OID provisions).

(1) **General Rule**. The "owner" of the policy is defined as the person who is named as the owner of the policy. A nonowner is anyone (other than the owner) who has a direct or indirect interest in the policy.

(2) **Exceptions**. Notwithstanding the formal designation of ownership, the employer in an employer/employee arrangement and the donor in a private split dollar arrangement is treated as the owner of the contract where the arrangement is not of the "equity" variety. The purpose of these exceptions appears to be aimed, at least in part at allowing the use of the restricted collateral assignment method for estate planning purposes in a controlling (more than 50%) shareholder situation without requiring that the arrangement be reported as a loan.

(3) **Attribution**. The final regulations provide attribution rules (not present in the 2003 proposed regulations) for compensatory split dollar life insurance arrangements. Under these rules, the employer is treated as the owner of a life insurance contract owned by (i) a member of the employer's "controlled group," (ii) an IRC § 403(b) secular trust, (iii) a grantor trust of which the employer is treated as the owner (such as a "rabbi" trust) or (iv) an IRC § 419(e)(1) welfare benefit fund.

e. **Economic Benefit Regime**. Where the employer or donor is the owner of the contract, the following results, essentially the same as under the 2002 and 2003 proposed regulations, are prescribed:

(1) **Nonequity Arrangements**. The value of current life insurance protection paid for by an employer, corporation or donor (reduced by any amount contributed by an employee, shareholder or donee) is taxable - as compensation, dividend or gift, as the case may be - on an annual basis. The value of current life insurance protection is measured by reference to a premium factor (currently Table 2001) that will change from time to time in accordance with published guidance. The final regulations do not allow the continued use of the insurer's alternative term rates for arrangements entered into after September 17, 2003.

The timing of the measurement of current life insurance protection value is changed under the final regulations. The 2002 proposed regulations provided that the "average death benefit" during the taxable year be used to compute the value of current life insurance protection, while the final regulations, subject to an anti-abuse rule, permit the value to be determined on the last day of the nonowner's taxable year, unless the parties agree to use the policy anniversary date. The valuation date may be changed with the consent of the Commissioner.

(2) **Equity Arrangements**. Where the employer, corporation or donor is entitled to recover from the employee, shareholder or donee the lesser of its premium advances or the cash surrender value of the policy, the benefited party is required to take into income (or the donor is required to report as a gift) the value of the current life insurance protection, as described above respecting nonequity arrangements, and the amount of the annual increase in the value of his or her interest in the policy's equity to which the nonowner has "current access" (as described below). This increase must be taken into account on a current basis, and not just upon "rollout" of the policy. The nonowner also must take into account any other economic benefit provided by the owner. Thus, the final regulations ground the taxation of equity under the economic benefit regime

in the constructive receipt analysis of IRC § 61, not IRC § 83.

(3) <u>“Safe Harbors” for Pre-Final Regulations Arrangements</u>. A split dollar term loan is any split dollar loan, other than a split dollar demand loan, and thus is the default classification (as is the case for all below-market interest rate loans under IRC § 7872). If a loan has a stated maturity date, that will be binding with respect to the taxation of the arrangement.

For pre-final regulations arrangements that have not yet accumulated equity, the parties can convert to the loan regime (discussed below) even after 2003 and possibly avoid a detrimental tax effect. The IRS stated in Notice 2002-8 that it will not challenge "reasonable efforts to comply with" the regulations' imputed interest rules after a pre-final regulations has converted. This technique can preserve the presumably lower economic benefit costs right up to the point in which equity arises.

(4) <u>Measurement of Current Life Insurance Protection Under Pre-Final Regulations Arrangements</u>. The Table 2001 rates, published in Notice 2001-10, can be used for any arrangement entered into before September 18, 2003. For split dollar arrangements entered into before January 28, 2002, where required by the terms of an agreement between employer and employee, actual P.S. 58 rates can continue to be used in these arrangements to determine the value of current life insurance protection provided to the employee. However, a footnote in the preamble to the 2002 proposed regulations confirmed that P.S. 58 rates may not be used in reverse split dollar or other non-compensatory arrangements.

For arrangements entered into before January 28, 2002, old carrier alternative term rates that comply with prior IRS requirements can continue to be used to measure current life insurance protection, if lower than the Table 2001 rates. For these arrangements, the ability to continue to use old carrier alternative term rates combined with the safe harbor protections previously discussed results in maximum future flexibility and preserves the most favorable options for these split dollar arrangements. For arrangements entered into after January 28, 2002 and before September 18, 2003, old carrier alternative term rates can also continue to be used only if those rates meet the newer standards applicable to commonly sold term policies.

(5) <u>Modification</u>. This topic was reserved in the 2002 proposed regulations. The final regulations provide that a nonequity arrangement that becomes an equity arrangement will result (in the case of an existing endorsement arrangement) in the continued taxation of the arrangement under the economic benefit regime. Where the existing arrangement was a collateral assignment arrangement, the conversion to an equity arrangement will be treated as a transfer of the contract from the employer or donor to the employee or donee as of the date of the modification. At that point the loan regime becomes operative.

(6) <u>Loans, Withdrawals, Dividends, etc</u>. The nonowner (employee, shareholder or donee) will also be taxable on any amount received by him or her under a life insurance contract as a policy loan, a withdrawal or dividend, as if the amount had been just distributed directly to the owner (employer, corporation or donor) and then transferred to the nonowner. The constructive distribution to the owner is reportable under the rules of IRC § 72. The amount of the transfer is reduced by the amount previously paid or taken into taxable income

by the nonowner as the equity portion (but not the term coverage portion) of the economic benefit.

(7) **Basis**. No nonowner of a policy will receive a basis in the contract for any portion of the premium paid by, or taxed to, him or her under the split dollar arrangement, even though, as noted above, offsets against income recognition is, in part, permitted with respect to policy cash distributions.

(8) **Transfer of the Contract**. Where a contract (or an undivided interest in a contract) is transferred by an owner to a nonowner, the nonowner is taxable under IRC § 83 on the fair market value of the contract (defined, in general, as its cash surrender value) reduced by any consideration paid for the transfer or previously taken into account with respect to the equity portion of the contract. As with loans, withdrawals and dividends directly from the policy, no amount that was paid or previously taken into account for tax purposes by the transferee and was attributable to current life insurance protection may either (i) reduce the (former) nonowner's gain on the transfer or (ii) be added to the (former) nonowner's basis in the policy after the transfer. The employer, in a compensatory situation, may deduct the amount included in income by the employee as a result of the transfer of the contract to the employee.

(9) **Contributory Arrangements**. The final regulations reaffirm that any payment for life insurance protection made by the nonowner of a contract is treated as income to the policy owner. This is the case even in a private split dollar arrangement, where any contribution by the donee is taxable as income to the donor.

(10) **Death Benefits**. The final regulations provide that any amount paid to a beneficiary (other than the owner) of a life insurance contract by reason of the death of the insured is excludable from gross income under IRC § 101 only to the extent attributable to amounts previously paid or taken into account for tax purposes by the nonowner for life insurance protection. While this rule would appear at first blush to present the potential for taxation of any untaxed equity component of the death benefit, under the final regulations, all transfers of economic benefit of either a nonequity or equity variety should be fully accounted for and taxed during the insured's lifetime. The split dollar import of this rule thus should in most cases be minimal.

The final regulations omit the statement in the 2002 proposed regulations that amounts received by a nonowner in his, her or its capacity as a lender (such as the employer or donor in an equity split dollar arrangement that is treated as a loan under the principles described below) by reason of the death of the insured will not be treated as an amount received by reason of the death of the insured for purposes of IRC § 101. However, the repayment of a loan usually does not result in tax consequences to the lender, unless the repayment includes accrued interest not previously taxed.

f. **"Current Access" and Constructive Receipt.**

(1) **Constructive Receipt, Economic Benefit and Cash Equivalence**. The final regulations, like the 2003 proposed regulations, provide that, in the case of an endorsement equity split dollar life insurance arrangement, the value of the economic benefits provided to the nonowner under the arrangement for a taxable year equals (i) the cost of any current

life insurance protection provided to the nonowner, (ii) the amount of policy cash value to which the nonowner has current access (to the extent that such amount was not actually taken into account for a prior taxable year) and (iii) the value of any other economic benefits provided to the nonowner (to the extent not actually taken into account for a prior taxable year).

The concept of "current access" to policy cash value is based on the income tax doctrine of "constructive receipt," i.e., income (whether or not actually received) is taxed at the time that it is either credited to the taxpayer's account, set apart for him, or otherwise made available to the taxpayer so that he may draw upon it at any time.

As broadly construed in the regulations, a nonowner is deemed to have current access to "any portion of the policy cash value that is directly or indirectly accessible by the nonowner, inaccessible to the owner, or inaccessible to the owner's general creditors." The term "access" includes any direct or indirect right of the nonowner "to obtain, use or realize potential economic value from the policy cash value." The right to withdraw from the policy, borrow from the policy or affect a total or partial surrender of the policy is considered "access."

➔ **Planning Point:** A practitioner should be aware that merely limiting access by the nonowner will not suffice to avoid adverse tax consequences, if the owner is also denied access to those cash values.

➔ **Planning Point:** Because of the rule that the cash value must not be inaccessible to the owner's general creditors to be considered inaccessible to the nonowner, care should be taken in those states in which life insurance cash value is not reachable by the creditors of the owner of a policy. For example, in Missouri the first $150,000 may not be accessible to creditors, Section 513.430 RSMo., and, in Pennsylvania all cash of life insurance policies are completely exempt from creditors in certain circumstances. 42 Pa.C.S.A. § 8124.

(2) Accessibility and Creditors' Rights. Policy cash value is deemed to be accessible to a nonowner if he or she can "anticipate, assign (either at law or in equity), alienate, pledge, or encumber the policy cash value," or if the policy cash value is subject to attachment, levy or other legal or equitable process by the nonowner's creditors. Policy cash value is deemed to be inaccessible to the owner if the owner does not have the full rights to policy cash value normally held by an owner of a life insurance contract. Policy cash value is inaccessible to the owner's general creditors if, under the terms of the split dollar life insurance arrangement or by operation of law of any contractual undertaking, the creditors cannot, for any reason, effectively reach the full policy cash value in the event of the owner's insolvency.

➔ **Planning Point:** In non-equity agreements, which are often entered into between corporations and unrelated employees, the nonowner is considered to have current access to policy cash value only if, under the arrangement, the nonowner has a current or future right to policy cash value. In a true non-equity arrangement, the nonowner will have no such right and, therefore, will not be taxable with respect to the cash value.

(3) Acceleration Rule/IRC § 457. The final regulations add an acceleration rule for those cases that may require a nonowner to include an amount in income earlier than would otherwise be required under the general split dollar rules. The regulations state that an equity endorsement split dollar life insurance arrangement constitutes a deferred compensation arrangement. Therefore, so the Treasury states, an employee of a tax-exempt organization or of a state or local government subject to IRC § 457 may have to include an amount in gross income attributable to an equity split dollar life insurance arrangement even if the employee does not have current access to the policy cash value under these regulations.

(4) Measurement of Policy Cash Value. In a change from the 2003 proposed regulations, the final regulations provide that, subject to an anti-abuse rule, policy cash values are to be determined on the last day of the nonowner's taxable year, unless the parties agree to use the policy anniversary date. Policy cash values are still determined, however, without regard to surrender charges or other similar charges or reductions. If any "artifice or devise" is used to artificially understate the value of any economic benefit, the date on which such value is determined is the date on which the amount of policy cash value is greatest during that taxable year.

g. Loan Regime. If the employee, shareholder or donee is formally designated as the owner of the contract and is obligated to repay the employer, corporation or donor, whether out of contract proceeds or otherwise, the premiums paid by the nonowner for the direct or indirect benefit of the owner is treated as a series of loans to the owner - i.e., each premium payment is a separate loan. Under this regime, such loans are subject to the principles, where applicable, of IRC §§ 1271-1275 (regarding the taxation of original issue discount or "OID") and IRC § 7872 (below-market interest rate loans). If only a portion of the premium payment made by the nonowner is repayable (or is reasonably expected to be repaid), the portion that is not repayable will not be considered to be a split dollar loan and is taxed to the owner under the general principles of IRC § 61.

➔ **Planning Point:** The loan regime should apply to all collateral assignment arrangements, except that a collateral assignment arrangement in which the employee or donee has no equity in the policy (i.e., a "non-equity" collateral assignment arrangement) may be treated as an endorsement arrangement and taxed under the economic benefit regime, regardless of who owns the policy. Presumably, this exception will allow for a non- equity corporate controlling stockholder or insured private split dollar arrangement that will avoid incidents of ownership in the insured for estate tax purposes.

(1) De Minimis Rules Not Applicable. The rules of IRC § 7872 are generally not applicable to "gift" loans, "compensation-related" loans or "corporate-shareholder" loans on any day on which the aggregate amount of indebtedness outstanding does not exceed $10,000. In the split dollar context, however, the IRC § 7872 rules will apply whether or not the $10,000 threshold is exceeded.

(2) Indirect Loans. The regulations recognize that many split dollar arrangements involve third parties, such as life insurance trusts, and provide that such transactions will be viewed, for purposes of IRC § 7872, as a series of back-to-back loans for income and gift tax purposes. Thus, where an employer/lender advances premiums to a life insurance

trust/borrower of which the employee (the "indirect participant") is the insured, any forgone interest is computed as if the employer made a compensatory below-market loan to the employee (likely generating income recognition), and the employee took the loan proceeds and made a second below-market gift loan to the life insurance trust (likely generating a taxable gift). The tax results of each deemed loan are determined in accordance with the relationship of the parties.

(3) Nonrecourse Loans/Written Representation. Where a split dollar loan is nonrecourse to the borrower, the payment is treated as a "contingent" payment. To avoid contingent payment treatment (which generally will result in the imposition of unfavorable assumptions when testing the loan for adequate stated interest), the parties to the loan must represent in writing (and must attach to the parties' returns) no later than the due date for the return of the borrower or lender for the year in which the first split dollar loan is made, that a "reasonable person" would expect that all payments under the loan will be made. The final regulations have eliminated a second requirement with respect to nonrecourse loans, - i.e., that the loan bear interest at a stated rate.

h. Demand and Term Loans. Loans subject to the foregone interest rules of IRC § 7872 are generally classified as demand loans or term loans.

(1) Demand Loans.

(a) Definition. A split dollar demand loan is any split dollar loan that is payable in full at any time on the demand of the lender - a circumstance that is characteristic of most split dollar arrangements.

(b) Taxation and Timing of Demand Loans. In each year that a split dollar demand loan is outstanding, the loan is tested for adequate stated interest under IRC § 7872. A split dollar demand loan is deemed to have adequate stated interest if the interest rate, which may be a variable rate, is no lower than the "blended annual rate" for the year (an average of the January and July short-term rates) based on annual compounding.

(2) Term Loans.

(a) Definition. A split dollar term loan is any split dollar loan, other than a split dollar demand loan, and thus is the default classification (as is the case for all below-market interest rate loans under IRC § 7872). If a loan has a stated maturity date, that will be binding with respect to the taxation of the arrangement.

(b) Taxation and Timing of Term Loans. A split dollar term loan is tested on the day the loan is made to determine if it has adequate stated interest. Interest is adequate if the face amount of the loan is equal to or greater than the "imputed loan amount." The "imputed loan amount" is the present value of all payments due under the loan, determined as of the date the loan is made, using the discount rate equal to the applicable federal rate (AFR) on that date. The AFR/discount rate must be appropriate to the loan's term: short-term (not over 3 years); mid-term (over 3 years, but not over 9 years) or long-term (over 9 years). A loan's term is the period from the date the loan is made to its stated maturity date.

The difference between the split dollar term loan's face amount and the imputed loan amount is taken into income as compensation or as a dividend by the borrower in the year that the loan is made. Special rules, described below, apply to gift loans and certain other types of loans. The amount treated as income to the borrower is treated as OID to the lender, and is taken into income by the lender ratably over the term of the loan, together with any other amount of OID on the loan (determined without reference to IRC § 7872).

➔ **Planning Point:** The required acceleration of income recognition, coupled with the higher interest rates that generally apply to term loans of any duration, will make their use unattractive in most situations. However, if adequate interest is charged, then IRC § 7872 generally does not apply. Accordingly, especially when interest rates are low, it has been suggested that the best course of action may be to arrange the transaction as a term loan that states adequate interest. Because adequate interest is stated, it can be paid annually, or even accrued until the end of the term, instead of treated as being transferred upon creation of the loan. However, if the employer directly or indirectly pays the interest to the employee, the stated interest will be disregarded, and the loan will be treated as a below-market loan under IRC § 7872.

(3) Exception to Upfront Taxation of Imputed Interest on Term Loans. Foregone interest on (1) split dollar term loans payable on the death of an individual, (2) gift term loans (which would be the norm in a private split dollar transaction) and (3) split dollar term loans conditioned on the future performance of substantial services by an individual, is determined annually, in a manner similar to a demand loan, but using an AFR that is appropriate for the loan's term and that is determined when the loan is issued (not annually, as would be the case in a true demand loan). The final regulations clarify this last point.

(4) Loan Terms. With exceptions, the terms of life expectancy loans, gift loans and loans conditioned on the performance of future services are determined as follows:

(a) Life Expectancy Loans. The loan's term in the case of a split dollar term loan payable on the death of an individual will be the individual's life expectancy determined under the appropriate table in the IRC § 72 regulations.

(b) Gift Loan. The loan's term in the case of a gift loan is the period from the date the loan is made to its stated maturity date.

(c) Loans Conditioned on the Performance of Future Services. The term of a split dollar term loan that is conditioned on the future performance of future services is based on its stated maturity date.

(5) Effect of OID Rules. The OID rules of IRC §§ 1271-1275 are very complicated. However, these rules (which are income tax rules and not gift tax rules) will, in general, tax interest that is accrued, but unpaid, to the lender in a split dollar transaction, even though the borrower is not entitled to a deduction for that interest. If unpaid interest is later forgiven, all or part of that interest, to the extent prescribed in the regulations (which in turn

depends on whether the loan is a term or demand loan and whether the loan bears adequate stated interest), is treated as transferred to the lender by the borrower on the date the interest is forgiven, and is treated as re-transferred by the lender to the borrower on that date. The amount deemed retransferred to the borrower is taken into income by the borrower in accordance with the relationship of the parties.

(6) **Other**. The proposed regulations contain other provisions with respect to split dollar loans, including provisions for variable interest rate loans, term loans containing unconditional options and contingent payment loans. In general, these rules respecting contingent payments assume that interest rates will apply and payments will be made in a manner that ascribes the lowest possible value to a contingent payment.

i. **Material Modifications**. As stated above, the regulations are effective for arrangements entered into after September 17, 2003, and arrangements entered into before that date that are "materially modified" after that date. The final regulations provide a "non- exclusive" list of changes that are "non-material modifications," as follows:

- A change solely in the mode of premium payment (for example, a change from monthly to quarterly premiums),
- A change solely in the beneficiary of the life insurance contract, unless the beneficiary is a party to the arrangement,
- A change solely in the interest rate payable under the life insurance contract on a policy loan,
- A change solely necessary to preserve the status of the life insurance contract under IRC § 7702,
- A change solely to the ministerial provisions of the life insurance contract (for example, a change in the address to send payment),
- A change made solely under the terms of any agreement (other than the life insurance contract) that is a part of the split dollar life insurance arrangement if the change is non-discretionary by the parties and is made pursuant to a binding commitment (whether set forth in the agreement or otherwise) in effect on or before September 17, 2003,
- A change solely in the owner of the life insurance contract as a result of a transaction to which IRC § 381(a) applies and in which substantially all of the former owner's assets are transferred to the new owner of the policy,
- A change to the policy solely if such change is required by a court or a state insurance commissioner as a result of the insolvency of the insurance company that issued the policy or
- A change solely in the insurance company that administers the policy as a result of an assumption reinsurance transaction between the issuing insurance company and the new insurance company to which the owner and the nonowner were not a party.

A conversion of an existing, pre-January 28, 2002, equity split dollar life insurance arrangement to a loan pursuant to Section IV, Paragraph 4 of Notice 2002-8, also will not be

considered a "material modification" for purposes of these final regulations. We note, however, that IRC § 1035 exchanges are not included among the "non-material modifications." The final regulations state that the Commissioner, in revenue rulings, notices and other published guidance, may provide additional guidance with respect to other modifications that are not material.

j. Planning for Post-Final Regulations Arrangements. It appears that planning for post-final regulations split dollar arrangements will have to begin by deciding whether it is in the client's interest to measure the ongoing benefit provided by the arrangement under the economic benefit regime (measuring the benefit by term cost) or under the loan regime (measuring the benefit by the foregone interest). Generally, for younger insureds and for survivorship policy arrangements, the economic benefit regime will be preferable (at least initially), while in the current, historically low interest rate environment, the loan regime will be preferable either for older insureds in single life policies or where providing an interest in policy cash values to the employee or donee without tax is important. When an economic benefit arrangement becomes uneconomic (for instance, at the first death in a survivorship arrangement), conversion to a split dollar loan or replacement with a premium financing arrangement should be considered.

Once that decision has been made, for arrangements where economic benefit treatment is desired, the next decision will be whether the arrangement should be an equity or a non-equity arrangement. If the arrangement is a donor/donee or an employer/employee non-equity arrangement, it can be documented under the collateral assignment method and the economic benefit regime will be used to measure the benefit to the donee or the employee. But since it is a non-equity arrangement, a rollout using only policy values is not possible-a rollout will require funds of the owner not derived from the policy - meaning third party arrangements will require early and, hopefully, leveraged trust funding to allow for a rollout when economic benefits are not advantageous. That will increase the gift tax "cost" of third party split dollar arrangements, compared to those done before the regulations.

On the other hand, if the arrangement is an equity arrangement, the employer, donor, or other premium provider will have to be the actual owner of the policy and the arrangement will need to be documented under the endorsement method. However, given the extremely broad definition of the phrase "access" in the final regulations for equity arrangements, it is not likely that many post-final regulations equity arrangements will be planned to be taxed under the economic benefit regime, especially those that are third party owned.

If, on the other hand, measuring the benefit from the arrangement is to be determined by interest rates, rather than term costs, or providing access to policy cash values to the employee or donee without tax is critical, then the arrangement will be treated initially under the loan regime - using a collateral assignment, equity arrangement. Even for arrangements initially treated under the economic benefit regime, at some point, a switch to the loan regime may make sense (when economic benefits are not advantageous).

If the parties expect the borrower will use the borrower's own funds to actually pay interest, then in any arrangement in which the parties desire loan treatment, the best choice is likely to be to create a loan which provides for adequate interest (based on the applicable federal rate), either paid annually (or, less likely, accrued and paid with the principal at the insured's death).

E. Use of Insurance in Buy-Sell Agreements

Life insurance often is used as a means of funding the purchase of a shareholder's stock or a partner's partnership interest pursuant to the terms of a buy-sell agreement. If the transaction is properly structured, the life insurance can be excluded from the insured's estate. In a typical buy-sell arrangement, each shareholder owns and is the beneficiary of life insurance on the life or lives of the other shareholders.

> **EXAMPLE:** A and B form a corporation and enter into a buy-sell agreement, which, in part, provides that upon the death of one of the other shareholders, the surviving shareholder may purchase the deceased shareholder's stock at fair value, which is to be determined by an appraiser. In order to ensure that each shareholder will have sufficient liquidity to purchase the other shareholder's interest in the corporation, A takes out an insurance policy on B's life, while B takes out an insurance policy on A's life.

In the preceding example, because neither A nor B has an ownership interest in the policy on their own life, the proceeds will not be includible in either of their estates, even though the policies were purchased pursuant to a reciprocal agreement (See Rev. Rul. 56-397, 1956 C.B. 599).

➔ **Planning Point:** Should you come across a situation where the insured, rather than the other shareholder, was named as owner of the insurance policy, you may be able to prevent the insurance proceeds from being included in the insured's gross estate if you can establish that the insured's retention of incidents of ownership was due to a mistake by the agent who sold the policy (See *National Metropolitan Bank v. U.S.*, 87 F. Supp. 773 (Ct. Cl. 1950), and *Watson v. Comm'r*, 36 T.C. Memo 1084 (1977)). Alternatively, if the proceeds are included in the insured's estate, the value of the decedent's interest in the entity should be reduced by the amount of the insurance proceeds (See *Mitchell Est. v. Comm'r*, 37 B.T.A. 1 (1938) and *Tompkins Est. v. Comm'r*, 13 T.C. 1054 (1949), *acq.* 1950 C.B. 5).

Buy-sell agreements also may be structured so that the corporation, rather than the shareholders, will own insurance on the lives of the shareholders. Upon a shareholder's death, the proceeds will be payable to the corporation to fund the redemption of the deceased shareholder's stock. In this situation, even if the deceased shareholder is a "controlling" shareholder, the corporation's incidents of ownership will not be attributed to the insured, because the proceeds are payable to the corporation (although the insurance will be reflected in the value of the decedent's stock interest when it is valued for estate tax purposes). The same result should obtain in the partnership context (*see Knipp Est. v. Comm'r*, 25 T.C. 153 (1955), *acq. in result* 1959-1 C.B. 4).