OOPS! THE FIFTY MOST COMMON LIFE INSURANCE PLANNING MISTAKES

SOUTHERN ARIZONA ESTATE PLANNING COUNCIL
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OOPS! THE FIFTY MOST COMMON LIFE INSURANCE PLANNING MISTAKES

TABLE OF CONTENTS

Page

PERSONAL (ESTATE PLANNING) INSURANCE TRANSACTIONS....................................1

1. Creating Problems in the policy application...1

   A) Failure to properly plan for a successor owner of the policy, where the policy owner is an individual other than the insured. 1

   B) Naming an individual as the beneficiary of a policy, with no successor individual or trust beneficiary named...2

   C) Naming a minor child (or any other incapacitated person) as the beneficiary of a policy. 2

   D) Naming multiple individuals (such as the insured's children) as the owners of a life insurance policy. 3

   E) Not naming an insurance trust which owns a policy as the revocable beneficiary. 4

2. The three-corner life insurance policy – a different owner, insured, and beneficiary – the Goodman problem...4

3. Creating phantom income by surrendering a policy (or letting a policy lapse) which was subject to an outstanding loan. 5

4. Exchanging a policy under Section 1035, which is subject to a loan, for a new policy, not subject to a loan in the same amount. 6

5. Loans against or withdrawals from a modified endowment contract (a "MEC"), or using such a policy as collateral for a third party loan.........................7

6. Borrowing against a policy in excess of the owner's income tax basis and then transferring the policy subject to the loan as a gift to a new owner................8

7. Surrendering a policy for its cash value without checking the life settlement market..9

8. Calculating the amount and character of the gain on a policy sale in the settlement market. 10

9. A transfer of a new life insurance policy to an irrevocable insurance trust or other third party owner after its acquisition by the insured – the Section 2035 three year transfer rule. 11

10. Be careful in determining adequate and full consideration for the sale of a policy to an ILIT or a spouse (prior to a gift to an ILIT) to avoid the three year rule of Section 2035. 12

11. Transferring a policy from the insured to a third-party owner (such as an ILIT) without obtaining the policy's gift tax value from the carrier, in advance. 14

12. Transferring a policy during the insured's lifetime without considering the transfer for value rule and its exceptions. 16

13. Post-Final Regulation split-dollar arrangements that don't state adequate AFR interest, which are treated as term loans, especially those involving gift term loans. 17

14. Related party premium financing arrangements which could violate provisions of the Final Split-Dollar Regulations. 18

15. Large premium financing arrangements using a variable policy as collateral, potentially violating Federal Reserve Regulation U. 20

16. Not restricting a collateral assignment of a policy taken back by the insured (or one of the insureds) who advances money to pay policy premiums under a private premium financing or split-dollar arrangement. 21

17. Terminating a private pre-Final Regulation split-dollar arrangement without considering the risk that any policy equity on termination would be a transfer for transfer tax purposes. 21

18. Entering into a post-Final Regulation private split-dollar arrangement or a premium financing arrangement for a single life policy without checking the other as an alternative, or, in either case, without having an exit strategy. 22

19. Not considering using a private split-dollar arrangement to fund a survivorship policy to use the low survivorship economic benefit rates (while both insureds are alive). 24

20. Not checking the availability of the insurer's alternative term rate (in lieu of the Table 2001 rate) for private post-Final Regulation split-dollar arrangements for a single life policy. 25

21. Changing a pre-Final Regulation private split-dollar arrangement without considering whether it could be considered a "material modification" of the arrangement. 26

22. Not planning for the disposition of the split-dollar receivable or premium financing note in the estate of the insured in a private premium funding arrangement. 28

23. Creating an "old style" equity, collateral assignment private split-dollar arrangement after the Final Split-Dollar Regulations without recognizing the effect of those Regulations. 29

24. Planning around Code Section 677(a)(3) if an ILIT is to be a non-grantor trust. 29

25. Making sure premium gifts to ILIT with Crummey powers qualify for gift tax annual exclusion. 31

26. Avoiding naming the insured as trustee of ILIT. 32

27. Failing to restrict the insured's power to remove and replace the ILIT trustee by requiring any appointed successor trustee not be the insured or a related or subordinate party to the insured. 33

28. Avoiding transfer for value if the policy is sold to ILIT or insured's spouse (prior to gift to ILIT) to avoid three year rule of Section 2035. 34

29. For ILITs with Crummey withdraw powers, drafting the ILIT so that the Crummey power is triggered by both direct and indirect premium gifts to the ILIT. 35

BUSINESS INSURANCE (INCLUDING EMPLOYEE BENEFIT) TRANSACTIONS WITH ESTATE PLANNING IMPLICATIONS 37

30. Re-arranging the ownership interests in multiple shareholder cross-owned life insurance policies after the death of a shareholder – violating the transfer for value rule. 37

31. Partnership (or LLC) insurance coverage on a partner or member which doesn't take into account whether the insurance is payable to the entity or not. 38

32. A "controlling" shareholder split-dollar arrangement with a third party owner, not documented as such. 38

BUSINESS INSURANCE (INCLUDING EMPLOYEE BENEFIT) TRANSACTIONS...........39

33. The two-party entity-related life insurance problem – the entity as an owner of the policy and an individual as the beneficiary (not using split-dollar or loan arrangements). 39

34. The undocumented life insurance employee benefit transaction – a split-dollar arrangement, a loan, a bonus arrangement, or a non-qualified deferred compensation arrangement – with no plan document. 40

35. Non-contributory, non-employee shareholder split-dollar arrangements in multiple shareholder S Corporations which treat the economic benefit amounts or the interest imputed as dividends to the shareholders.........................41

36. Termination of a compensatory pre-Final Regulation split-dollar arrangement which doesn't consider and plan for the potential income and gift tax consequences of "policy equity" under Notices 2002-8 and 2007-34. 42

37. Entering into a post-Final Regulation compensatory split-dollar arrangement or a premium financing arrangement for a single life policy insuring an employee without checking the other as an alternative, or, in either case, without having an exit strategy. 44

38. Creating an "old style" equity collateral assignment compensatory split-dollar arrangement after the Final Split-Dollar Regulations.................................45

39. Not amending compensatory equity split-dollar arrangements to comply with the requirements of Section 409A and Notice 2007-34................................46

40. Not considering a compensatory split-dollar arrangement to fund a survivorship policy insuring the lives of an employee and his or her spouse to use the low survivorship economic benefit rates (while both insureds are alive)...46

41. Not checking the availability of the insurer's alternative term rate (in lieu of the Table 2001 rate) for post-Final Regulation compensatory split-dollar arrangements for a single life policy insuring an employee.......................48

42. "Funding" a non-qualified deferred compensation plan for both ERISA and tax purposes by "tracking" the policy terms into the agreement. 48

43. Acquiring employer-owned life insurance on the life of an employee without complying with the requirements of Section 101(j) in advance. 49

44. Changing a pre-Final Split-Dollar Regulation compensatory split-dollar arrangement without considering whether it was a "material modification" of the arrangement. 50

45. Avoiding premium reimbursement economic benefit split dollar because of employer income tax consequences. 51

46. Being careful in modifying non-equity split dollar arrangement to avoid potential taxes to premium payer. 52

47. Avoiding incidents of ownership to the insured partner for split-dollar agreement between a partnership and an ILIT. 54

48. Not considering the relative advantages and disadvantages before choosing between loan regime and economic benefit regime split dollar. 56

49. In economic benefit regime split dollar, avoid giving the non-owner employee current access to cash value. 57

50. In order to avoid income taxation of the death proceeds to the non-owner's beneficiary, be sure that the employee non-owner pays the term premium or includes it in his income for a non-equity split dollar arrangement. 58

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OOPS! 50 COMMON LIFE INSURANCE PLANNING MISTAKES

Personal (Estate Planning) Insurance Transactions.

1. Creating Problems in the policy application.

A) Failure to properly plan for a successor owner of the policy, where the policy owner is an individual other than the insured.

If the owner of a policy is an individual other than the insured and there is no designated individual or entity as the successor owner, at the policy owner's death (before the insured), ownership of the policy passes under the default terms of the policy – usually to the owner's probate estate. Therefore, some level of probate proceedings (depending on the value of the policy and the owner's state of residence) would be required to transfer ownership of the policy to the successor owner under the owner's Will (or the intestacy laws of his or her state of domicile). In addition, the owner's legatee may not be someone the insured would want to own the policy on his or her life.

If under the policy owner's Will or applicable intestacy laws, the policy were to go to the insured, assuming he or she wished to give it away to keep the proceeds out of his or her estate for estate tax purposes, the transfer would be subject to the Section 2035 three-year rule, meaning the death proceeds would be includible in his or her estate, if he or she died within three years of the transfer. If the owner of the policy became a trust for the benefit of the insured, he or she could not safely be the trustee, since that would give the insured fiduciary incidents of ownership in the policy.[1] Potentially, a power of appointment granted to the insured

[1] Treas. Reg. §20.2042-1(c)(4); see Rev. Rul. 72-261, 1972-2 C.B. 276, revoked by Rev. Rul. 84-179, 1984-2 C.B. 195.

over the trust could create a risk of inclusion of the policy proceeds in the insured's estate under Section 2042, as well.

Finally, if the insured (not the owner's estate) is the default owner of the policy and if no alternate successor owner has been designated, then upon the insured's death prior to the death of the owner, there may be a risk that the insured would be treated as having a reversion in the policy, causing the proceeds to be included in his or her estate for estate tax purposes.[2]

B) Naming an individual as the beneficiary of a policy, with no successor individual or trust beneficiary named.

Similarly, where an individual is named the beneficiary of the policy, with no successor individual, trust or other entity as the contingent beneficiary, and the named beneficiary predeceases the insured, the policy death proceeds will be payable in accordance with the default terms of the policy, usually to the estate of the insured. This problem can be solved by providing for a successor beneficiary in the policy application or by naming one after the primary beneficiary's death.

If this is the only asset of the insured, the omission of a successor beneficiary will necessitate opening a probate estate for the policy proceeds, and in any event, will expose the proceeds to claims of creditors and the delay and expense of probate.

C) Naming a minor child (or any other incapacitated person) as the beneficiary of a policy.

If a minor is designated directly as a beneficiary of a policy, then any proceeds payable to that minor upon the insured's death would be required to be held in a court

[2] I.R.C. §2042.

supervised guardianship or custodianship. Not only is this cumbersome and expensive, but guardianships and custodianships must terminate when the beneficiary reaches age 18 or, at best, age 21.

Accordingly, the insured's estate plan should contain provisions to create trusts for the minor, and the beneficiary designation should name the appropriate entity created (or to be created) under the insured's estate plan.

D) Naming multiple individuals (such as the insured's children) as the owners of a life insurance policy.

With multiple individual owners, there is a risk that a gift of the policy to them, as a group, or direct payment of premiums by the insured to the insurer, won't qualify for the gift tax annual exclusion,[3] and, in any event, problems will arise if one owner dies, divorces, goes bankrupt, or becomes incompetent before the insured's death or one owner merely decides not to contribute his or her share of the premium.

As an alternative, consider the creation of a partnership or LLC to own the policy; all of those issues can be dealt with in the partnership or LLC operating agreement.

Note, however, the possibility of creating valuation discounts for interests in a policy which are gifted to multiple owners, based on the inability of any one owner to unilaterally exercise incidents of ownership in the policy even if the gift doesn't qualify for the annual exclusion.

[3] See Skouras v. Commissioner, 14 T.C. 523 (1950).

E) Not naming an insurance trust which owns a policy as the revocable beneficiary.

The trustee of an ILIT owes a fiduciary duty to the beneficiaries to assure that the trust is both the owner and the beneficiary of its policy; if it weren't, could the Goodman case issue, discussed below, treat payment of the death proceeds as a gift by the trust beneficiaries?

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

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

In a typical situation, a husband might be the insured, his wife the owner, and their children the policy beneficiaries. Under the holding of the Goodman case[4], at the insured's death, in this situation, the wife would be considered to have made a gift of the entire policy death proceeds to the children – obviously an unanticipated and undesirable result. If the beneficiary were a trust in which the wife had an interest, the gift would be the actuarial value of the remainder, assuming the wife's retained interest was a "qualified interest" under Section 2702 of the Code; otherwise it would be a gift of the entire proceeds.[5] If the beneficiary were a skip person from the wife's point of view, or a trust for skip persons, the wife would also have made a generation-skipping transfer at the insured's death.

[4] Goodman v. Commissioner, 156 F.2d 218 (2nd Cir. 1946).

[5] If she had a power of appointment over the trust, her gift would be incomplete, but a portion of the trust would be includible in her estate for estate tax purposes, under I.R.C. § 2038.

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

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

Any amount received in a single sum under a life insurance contract on its complete surrender, redemption, lapse, or maturity is includible in the gross income of the policy owner, as ordinary income[6] to the extent that that amount exceeds his or her "investment in the contract,"[7] a basis-like concept. Investment in the contract is the aggregate amount of premiums or other consideration paid for the contract, less any amount received under the contract, to the extent that amount was excludable from gross income (such as dividends received on a participating policy, so long as they don't exceed basis).[8]

Accordingly, investment in the contract will be aggregate premiums paid by the taxpayer, reduced by any dividends, unrepaid loans, accumulated interest on loans, and any other amounts received under the contract, such as withdrawals, which were not previously includible in gross income.[9] If dividends are received in cash or are used to reduce premiums, they will reduce the investment in the contract; presumably, dividends used to purchase term riders will also reduce investment in the contract, but dividends used to purchase paid-up additions will not (since they will be retained inside the policy and its cash value). Any part of the premiums attributable to other benefits, such as a disability income benefit, also reduces investment in the contract.

[6] For the reasons discussed below, and subject to possible capital gain treatment, as also discussed below.

[7] I.R.C. §72(e)(5)(a) and (3); Treas. Reg. §1.72-11(d)(1).

[8] I.R.C. §72(c)(1), 72(e)(6).

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

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

Accordingly, any policy loan will be a part of the consideration received by the taxpayer on a policy surrender or lapse, generating ordinary income[10]–without generating any cash in the case of a lapse, or potentially not enough cash to pay the tax, in the case of a surrender.

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

Under Code Section 1035 and Regulation Section 1.1035-1, a life insurance policy can be exchanged for another policy without recognition of gain or loss, if the policies exchanged "relate to the same insured." If a policy with a loan on it is exchanged for another policy, the amount of the loan on the first policy which is discharged in the transaction will be treated as "boot," money or other property received in the exchange generating taxable income in an otherwise non-taxable exchange without generating any cash to pay the tax.[11]

[10] See the discussion regarding the capital gain treatment of a policy sale under Rev. Rul. 2009-13, above, and the possible application of Section 1234A to a policy lapse or surrender, discussed below.

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

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

[11] Treas. Reg. §1.1035-1, referring to Treas. Reg. §1.1031(b)-1(c) for the taxation of "boot" received in an otherwise tax-free exchange.

To avoid recognition of the gain in such a situation, the new policy has to be issued with a loan equal to the loan on the policy exchanged;[12] alternatively, of course, the loan on the first policy could be repaid before the exchange.

5. Loans against or withdrawals from a modified endowment contract (a "MEC"), or using such a policy as collateral for a third party loan.

A modified endowment policy is any insurance policy issued after June 21, 1988, under which the cumulative premium payments in any of the first seven years exceeds the sum of net level premiums which would have been paid to provide a paid-up policy after the payment of seven level annual premiums (the so-called seven pay test).[13]

Distributions from modified endowment contracts are subject to the same rules as distributions from deferred annuity contracts – income rather than return of premiums comes out first as a result of any withdrawal or distribution.[14] In addition, loans against the cash value of a modified endowment contract are treated as distributions for this purpose.

Finally, there is a 10% penalty tax on any withdrawal from or loan against a MEC if the "taxpayer" – not necessarily the insured – is under 59-1/2. It is unclear as to who the taxpayer is in the case of a trust owned policy; if it is a grantor trust, presumably the taxpayer is the grantor (there isn't any direct authority for that, but it is the practice of carriers when issuing 1099s).

The pledge of a Modified Endowment Contract as collateral for a third party loan (or even – apparently – the agreement to pledge a MEC for such a loan) is treated as a loan

[12] PLRs 860433 and 8816015.

[13] I.R.C. §7702A. Once a policy becomes a MEC, no modification or exchange to another policy can change that result.

[14] I.R.C. §72(e)(10).

against or withdrawal from the Modified Endowment Contract, in order to avoid what would otherwise be an end-run around the policy loan or withdrawal provisions of Section 7702A, by merely using the policy as collateral for that third party loan.[15]

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

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

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

Accordingly, many commentators feel that collateral assignment split-dollar should not be treated as a loan against or withdrawal from a Modified Endowment Contract (although there is no authority for either position). In any event, using the unsecured documentation method (where the policy is not assigned as collateral for the advances) should avoid this issue.

However, if the loan exceeds the insured's income tax basis in the policy–the transfer will be treated as a sale, with the loan proceeds treated as the amount realized.[16] That

[15] Whether or not entering into a collateral assignment split-dollar arrangement with a Modified Endowment Contract and pledging it as collateral for the split-dollar advances would be treated as using the policy as collateral for a third party loan is not clear, but it appears that collateral assignment split-dollar is a different economic transaction, since no cash is received by the "borrower" at the time of the transaction.

[16] Rev. Rul. 69-187, 1969-1 C.B. 45.

will have two adverse income tax effects – there will be gain to report on the transfer, and, perhaps more importantly, the transfer will be subject to the transfer for value rules (discussed below) at the insured's death (since the normal exception for gift transfers from those rules – the carryover basis exception – will not be applicable, unless, as noted below, the transfer is to a grantor trust), or the transferee is otherwise exempt from the transfer for value rule, as a "proper party" (as also discussed below).

As an alternative, in a universal-type policy, the insured could withdraw from the policy, tax-free, up to investment in the contract,[17] to reduce the value of the policy prior to the gift, with no such concerns.

Finally, if the gift were to a grantor trust, any gain on the transfer would go unrecognized for income tax purposes,[18] and, because of that, the carryover basis exception to the transfer for value rule would apply.[19]

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

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

However, the advent of the life settlement market[20] has meant that, at least for older insureds (probably age 70 and above), with relatively large policies, where the insured's health has declined since he or she took out the policy, a life settlement company may be willing

[17] I.R.C. §72(e)(5).

[18] Rev. Rul. 85-13, 1985-1 C.B. 184.

[19] I.R.C. § 101(a)(2)(B). In addition, the transfer would be treated as an exempt transfer to the insured under the transfer for value rule. See Rev. Rul. 2007-13, 2007-1 C.B. 684.

[20] Which grew out of the viatical settlement market for terminally or chronically ill insureds.

to pay more than the policy's cash surrender value to acquire the policy during the insured's lifetime.[21]

Accordingly, advisors need to be careful that their older, less healthy clients don't inadvertently surrender a policy which is no longer needed without checking the availability of a life settlement, assuming the insured is comfortable with a third party owning a policy on his or her life,[22] the risk of a death shortly after the sale, and the fact that the sold policy will "count" against his or her ability to acquire additional insurance – this is sometimes referred to as a sale of future insurability.[23]

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

A life insurance policy is a capital asset (since it is not expressly excluded from the Section 1221 definition of a capital asset). As noted above, if a policy is cancelled or surrendered to the insurance carrier in exchange for cash surrender value, any gain on the policy is ordinary income, despite the fact that the policy is a capital asset, because the transaction does not qualify as a "sale or exchange" of the policy.[24]

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

[22] Arguably, not an irrational concern.

[23] Since the purchasers of a life settlement policy would pay income taxes on death proceeds in excess of basis under the transfer for value rules of I.R.C. § 101(a)(2), new I.R.C. 6050Y requires the purchaser and the insurance carrier to file various information returns of the life settlement arrangement.

[24] But note the argument that Section 1234A (which eliminates the sale or exchange requirement for cancellation of a right relating to a capital asset to get capital gain treatment) applies to a policy surrender, (which is a cancellation of a right with respect to capital gain property) and would arguably eliminate the requirement for a sale or exchange to support capital gain treatment.

Rev. Rul. 2009-13, above, without citing any authority, said it did not apply; see also TAM 200452033, to the same effect. Note again, the settlement reached in Hunt v. Cir., described above.

However, if the policy is sold in the life settlement market (and perhaps in other sale transactions), since it is a capital asset and since the sale would qualify as a sale or exchange, any gain on the sale, in excess of basis, should be capital. Note, however, that based on the substitution of income theory of cases such as CIR v. P.G. Lake, Inc.,[25] gain above basis up to the policy's cash surrender value at the time of the sale is ordinary, since it is, in effect, a payment in lieu of interest earned on policy cash values.[26] Accordingly, under Rev. Rul. 2009-13, above, gain on a sale of a policy in the life settlement market over basis up to cash value is ordinary income and any gain over cash value is capital.

In Rev. Rul. 2009-13, above, the IRS also – controversially – held that in a policy sale in the life settlement market, basis (as opposed to investment in the contract, which is applicable in the case of policy surrenders or lapses, not sales, as discussed above) was reduced by the cost of insurance protection provided to the insured (without any guidance on how to measure it). However, this ruling was retroactively reversed by Congress in the Tax Cuts and Jobs Act of 2017.[27]

9. A transfer of a new life insurance policy to an irrevocable insurance trust or other third party owner after its acquisition by the insured – the Section 2035 three year transfer rule.

Under the present version of Section 2035 (the "three-year transfer" rule), if the insured has transferred as a gift any interest in a policy to a third party owner (such as a trust) within three years of his or her death, then even if he or she no longer holds any incident of

[25] 356 U.S. 260 (1958).

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

[27] I.R.C. § 1016(a)(1)(B).

ownership in the policy, the policy proceeds will be included in the insured's estate for estate tax purposes.[28] Even momentary ownership of a policy by the insured transferred by gift within three years of his or her death will require inclusion of the full policy proceeds in his or her estate for estate tax purposes.

The only safe way to avoid this rule is to be sure that the insured never owned incidents of ownership in the policy on his or her life – even for an instant, – by having the desired third party owner be the initial applicant and owner of the policy (even if done with the insured's gifted funds).

10. Be careful in determining adequate and full consideration for the sale of a policy to an ILIT or a spouse (prior to a gift to an ILIT) to avoid the three year rule of Section 2035.

If the insured transfers an insurance policy to an ILIT, the three year rule for including the death proceeds in the insured's gross estate will apply should the insured die within three years of the transfer.[29] However, an exception to Section 2035 applies if the policy is sold pursuant to a bona fide sale for adequate and full consideration.[30]

The issue is what is "adequate and full consideration." If the sales price is as little as $1.00 under adequate and full consideration, the entire death proceeds reduced by the inadequate consideration paid would be included in the insured's gross estate should the insured die within three years of the sale/gift. Practitioners should be aware of two possible problem areas.

[28] I.R.C. §2035.

[29] I.R.C. § 2035.

[30] I.R.C. § 2035(b)(1).

1. Valuation of policies is not always clear. The value of an existing cash value policy with future premium payments is the interpolated terminal reserve plus the proportionate part of gross premiums paid before the transfer applicable to the time after the transfer (the "unused premium").[31] Interpolated terminal reserve fits well with whole life policies but not well with universal life policies which debuted after the regulations were issued. Furthermore, "reserve" is not defined and for universal life policies, insurance carriers use state law reserves, federal income tax reserves, cash value or accumulation reserves with widely varying results. A few carriers list two or three of these reserve valuations on their Forms 712 and leave it up to the taxpayer to choose the correct value. AG 38 reserves and deficiency reserves may affect valuation for no-lapse guarantee policy valuation. However, interpolated terminal reserve may not be used "because of the unusual nature of the contract " such as a shortened life expectancy at the time of the sale.[32] If there is uncertainty, the insured may want to purchase a policy appraisal to back up the sales price.

2. There has been some concern that, for Section 2035 sales purposes, the value of the policy is its face value and not its interpolated terminal reserve. Many practitioners reject this possibility but the issue has not been definitely decided. TAM 8806004 ruled that the adequate and full consideration under Section 2035 is the amount of insurance coverage that would be excluded from the gross estate because of the sale – the full face value of the policy. The IRS may not still maintain this position since it has issued two private rulings after the TAM applying adequate and full consideration under Section 2035 to a sale of policies for interpolated terminal reserve without mention of the value of death proceeds.[33] In an

[31] Treas. Reg. § 25.2512-6(a) and ex. 4. Also see Treas. Reg. § 20.2031-8(a)(2) and (3) ex. 3.

[32] Treas. Reg. § 25-2512-6(a). Estate of Pritchard v. Commissioner, 4 T.C. 204 (1944). PLR 9413045.

[33] PLR 9413045. PLR 199905010.

analogous area under Section 2036 where the remainder interest is sold for adequate and full consideration while retaining the income interest, a vast majority of the courts have held that adequate and full consideration was the value of the remainder interest and not the entire value of the property including the income interest.[34]

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

Under the Section 2512 Regulations,[35] the gift tax value of a policy transferred during the insured's lifetime is determined by its "replacement" cost, the cost of a "comparable policy". However, the Regulations recognize that for a policy that has been in force for some time (an undefined term) on which future premiums are due, obtaining the cost of a comparable policy would be difficult; accordingly, the Regulations provide that, in this situation, the cost of a comparable policy may be (not must be)[36] approximated by the so-called interpolated terminal reserve formula – the policy's interpolated terminated reserve plus any prepaid premiums.[37]

While technically only traditional whole life policies allow for the calculation of an interpolated terminal reserve (because only they have stated cash values which increase at stated rates and fixed premiums), the ITR formula is used by carriers in reporting the gift tax values of policies transferred during the insured's lifetime, on a Form 712, for universal and

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

[35] Reg. Sec. 25.2512-6.

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

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

variable policies (which don't have fixed premiums or stated cash values which increase at stated rates).

Historically, carriers reported a policy's ITR value as its gift tax value on a Form 712, when requested to do so. More recently, some carriers have begun to report a series of possible values for a policy transferred during the insured's lifetime, including the policy's cash or accumulation value, its cash surrender value, its interpolated terminal reserve value and its PERC value (a calculation required for transfers of policies in some income tax situations by the 2005 regulations issued under Section 83).[38] Most carriers have determined that a policy's "fair market value" is a legal issue to be determined by counsel for the policy owner and its only role is to provide the range of values for counsel.

The warning here is that the fair market value of a policy for gift tax purposes may be significantly higher than its cash surrender value – for example, a no-lapse guarantee universal life policy may literally have a zero cash surrender value but a very large ITR value[39] – and the only way to know what the policy's potential gift tax value is to request a Form 712 from the issuing carrier, before the policy is transferred.[40]

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

[39] As is true with many level term policies.

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

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

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

There is, however, an exception to that general rule for transfers of the policy for value during the insured's lifetime. If a policy is transferred for value during the insured's lifetime, unless one of the exceptions to the transfer for value rule (described below) applies, the only portion of the death proceeds which will be excludable from the beneficiary's gross income are equal to the amount paid by the transferee for the policy plus any future premiums paid by the transferee. The "value" for a transfer which might subject it to the transfer for value rule need not be a cash payment – the mutuality of a contractual agreement to transfer the policy has been held to be enough to support the application for the transfer for value rule.[41]

Fortunately, there are a number of helpful exceptions to the transfer for value rule applicable in an estate planning context.[42] Those exceptions include transfers to one of the four "proper party" transferees:

1. A transfer to the insured (including, for this purpose, a transfer to a trust which is a wholly grantor trust from the point of the insured);[43]
2. A transfer to a partner of the insured;
3. A transfer to a partnership in which the insured is a partner (including for this purpose an LLC taxed as a partnership); and

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

[42] I.R.C. §101(a)(2).

[43] See Rev. Rul. 2007-13, above.

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

In addition, a transfer in which the transferee's basis is determined, in whole or in part, by the transferor's basis (including, for this purpose a transfer to the insured's spouse, or former spouse, if incident to a divorce), is also exempt from the rule.[44]

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

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

Under the Final Split-Dollar Regulations, other than donor/donee or employer/employee non-equity split-dollar arrangements, collateral assignment arrangements (where the policy is not owned by the premium provider) must be treated under the loan regime, governed by Section 7872, rather than the economic benefit regime, governed by Section 61.[45]

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

[44] I.R.C. §1041(b)(2).

[45] Reg Sec. 1.61-22(b)(3).

For a demand loan, the interest rate is based on the short term AFR, which changes every month, and the interest is treated by the lender as received on an annual basis. For a hybrid loan, including for this purpose, a loan payable at the death of an individual, the interest rate is determined based on the term of the loan (the insured's life expectancy, under the IRS Tables), but the interest is treated as received by the lender on an annual basis.[46] Importantly, however, gift term loans are treated as hybrid loans only for income tax purposes; accordingly, while for both income and gift tax purposes, the AFR is based on the term of the loan, for gift tax purposes, all of the interest during the expected term of the loan, discounted back to present value, is treated as received in the year the loan is entered into (bunching the discounted value of all of that interest in the first year of the loan for transfer tax purposes).

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

14. Related party premium financing arrangements which could violate provisions of the Final Split-Dollar Regulations.

Under the Final Split-Dollar Regulations, a premium financing transaction (a loan with interest paid or accrued at the AFR) will meet the very broad definition of a "split-dollar arrangement," because it is a transaction in which one party advances money to a second party to acquire a life insurance policy, and the loan is either repayable out of the policy cash value or its death proceeds (or both) or is secured by the policy.[47]

[46] Loans payable at the death of an insured are only treated as hybrid loans under the Split-Dollar Regulations, not for other I.R.C. § 7872 purposes.

[47] Reg. Sec. 1.61-22(b).

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

In the first place, if the arrangement is "non-recourse" (an undefined term in the Regulations), unless each of the parties to the premium financing transaction attaches to his, her, or its income tax return in each year a loan is made under the arrangement, a statement that a "reasonable person" would expect the loan to be repaid, the loan is treated as if it provided for contingent interest, meaning that merely paying or accruing the AFR will not avoid the application of Section 7872 to a portion of the loan.[48]

Secondly, if the lender were to ever forgive any interest due on the loan, that forgiveness would be treated as income or a gift (depending on the relationship of the parties), plus, unless the statement described above is filed, there would be a penalty equal to three percentage points over the interest rate provided for underpayments of Federal tax.

Next, if the lender is "to pay" the borrower the interest due under the loan, then, despite the borrower's actual payment of interest to the lender, the loan is treated as if it were a Section 7872 loan.[49] There is no formal definition of the phrase "to pay", so that any time there is an arrangement (explicit or implicit) that the lender will provide the borrower with funds to pay the interest, that provision would apply. As an example, in a donor/donee premium financing

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

[49] It's unclear what the effect of this provision is – do we ignore the actual payment of interest and treat this as a I.R.C. § 7872 transaction, or is the payment recognized and then I.R.C. § 7872 applied as well?

arrangement that required the payment of interest on an annual basis, the donor's annual gift of the amount of the interest to the donee would presumably qualify as a "to pay" transaction.[50]

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

15. Large premium financing arrangements using a variable policy as collateral, potentially violating Federal Reserve Regulation U.

A variable life policy is, by definition, a security for Federal securities law purposes (since the funds underlying the policy are securities). Accordingly, a premium financing transaction involving a minimum of $200,000 of outstanding credit in any one quarter or $500,000 in total outstanding loans to finance a variable policy will be a margin loan, subject to Regulation U, if (but apparently only if) the policy is used as collateral for the loan.[51]

The practical effect of the margin loan rules applying to such a transaction would be to limit the amount that could be loaned to the margin rules of 50% of the value of security acquired with the loan (presumably based upon the policy's cash surrender value). Accordingly, premium financing with a variable policy will not generally be economically effective if the policy must be pledged as collateral.[52]

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

[51] Staff Opinion T-917.191 (1985).

[52] In private premium financing transactions, not securing the loan with the policy (an unsecured arrangement) would appear to avoid the issue. Query as to taking a security interest only in the death benefit (not the cash value) of a variable policy.

16. Not restricting a collateral assignment of a policy taken back by the insured (or one of the insureds) who advances money to pay policy premiums under a private premium financing or split-dollar arrangement.

An insured (or one of the insureds in a survivorship policy) may advance money to a third party owner (like a trust) to pay premiums on a policy on his or her life, under a private split-dollar or private premium financing arrangement. Usually, he or she will take back the policy as security for those advances, under a collateral assignment document.

If the standard American Bankers form is used, the insured will have extremely broad rights in the policy under that assignment, which will constitute incidents of ownership in the policy for Section 2042 purposes.[53]

Use of either a "restricted" assignment form (in which the lender's only right is to be repaid its advances at the end of the term of the loan) or not taking back the policy as security (an "unsecured arrangement") will avoid the issue.

17. Terminating a private pre-Final Regulation split-dollar arrangement without considering the risk that any policy equity on termination would be a transfer for transfer tax purposes.

A private pre-Final Regulation split-dollar arrangement which hasn't been "materially modified" (as discussed below) after the effective date of the Regulations, is governed by Notice 2002-8.[54]

Under Notice 2002-8, so long as the arrangement is in effect and the parties are reporting or paying the economic benefit costs, there will be no other transfer tax consequences

[53] Presumably, giving up these rights would be subject to the I.R.C. § 2035 three year rule.

[54] 2002-1 C.B. 398.

of the arrangement, even if policy values owned by the policy owner exceed the donor's advances.

However, under that Notice, by negative inference, on termination of the arrangement during the insured's life, the IRS will take the position that any such policy equity was a gift by the donor to the owner, subject to the Notice's so-called "no inference" provision. Under that provision, the IRS will not be able to assert those policy values were transferred for transfer tax purposes based on the Notice or the Proposed or Final Split-Dollar Regulations.

It, however, isn't clear that the IRS wouldn't attempt to do so under prior law;[55] accordingly, any such termination has to take that possibility into account.[56]

18. Entering into a post-Final Regulation private split-dollar arrangement or a premium financing arrangement for a single life policy without checking the other as an alternative, or, in either case, without having an exit strategy.

Whether premium financing (a loan with interest, either paid or accrued at the AFR) or a split-dollar arrangement using the economic benefit regime makes the most sense in a given post-Final Regulation private premium funding transaction depends upon whether the policy is a single life or a survivorship policy, and, if it is a single life policy, both the age of the insured and the relative level of interest rates.

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

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

In general, for survivorship policies, private, non-equity split-dollar arrangements using the economic benefit regime will continue to make sense, because the extremely low economic benefit for survivorship policies (at least while both insureds are alive).[57]

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

In either case, entering into such an arrangement without an effective exit strategy to unwind the arrangement during the insured's lifetime is problematic. Over time, economic benefits continue to increase as the insured ages; in a survivorship policy, at the first death, the attractive term rates are no longer available; and loan arrangements get increasingly expensive as more premiums are advanced and more interest is due on those advances (especially if interest is accrued). In any such case, the longer the arrangement continues, the smaller the death benefit which will remain payable to the policy beneficiary, unless the policy death benefit can be planned to increase to track the advances or loans (perhaps including accrued interest).[58]

Exit strategy planning contemplates creating a side fund to be owned by the policy owner, which can, over time, be used to repay the premium advances under the split-dollar arrangement or the premium loans under the premium financing transaction. If the owner

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

[58] Of course, that extra death benefit requires additional underwriting capability and an additional premium.

is an irrevocable trust, creating the side fund needs to be done on a transfer tax leveraged basis, perhaps including additional policy loans to the trust (with interest paid or accrued at the AFR), having the trust become the residuary beneficiary of a grantor retained annuity trust (if the insurance trust does not have generation skipping implications) or the purchaser in an installment sale.[59] In addition, as noted above, consideration should be given to arranging for the policy death benefit to increase, to keep the proceeds payable to the owner constant (for an additional premium).

19. Not considering using a private split-dollar arrangement to fund a survivorship policy to use the low survivorship economic benefit rates (while both insureds are alive).

The issuance of the Final Split-Dollar Regulations in late 2003, effective for transactions entered into or "materially modified" after the effective date of the Regulations, as noted in several places above, has eliminated many – but not all – uses of split-dollar. While some commentators have taken the position that the Final Regulations "killed" split-dollar going forward, one place where an economic benefit regime split-dollar arrangement still makes sense is when the policy acquired with the split-dollar advances is a survivorship policy. There, while both insureds are alive, the measure of the economic benefit is derived from Table 2001, to measure the actuarial risk of both insureds dying in the same year (a very small risk).[60]

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

[60] Notice 2002-8, 2002-1 C.B. 398. The Notice states that survivorship rates should be "appropriate adjustments" to Table 2001 single life rates but does not describe the adjustments. However, the commonly used adjustment is to multiply the Table 2001 rate of one insured by the Table 2001 rate of the other insured with further multiplication by 1.025 as an adjustment for interest.

That special measure of the economic benefit provided to the policy beneficiary for survivorship policies makes them the most attractive kind of policy with which to consider creating new private, non-equity split-dollar arrangements. Those arrangements would need to be donor/donee "non-equity" arrangements, where the insured/premium provider was entitled to the greater of the premiums advanced or the policy cash values (determined without regard to surrender charges).

Accordingly, although it is true that split-dollar arrangements may not make as much sense as they did prior to the issuance of the Final Regulations, they will often make sense from a tax point of view in funding survivorship policies (while both insureds are alive); after the first death, the economic benefit reverts to the traditional economic benefit measure for any single life policy – the lower of the Table 2001 rates or the insurance carrier's qualifying alternative term rates.[61]

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

At least until the IRS publishes what the Final Regulations call "uniform term rates" for determining the measure of the economic benefit in private, non-equity post-Final Regulation split-dollar arrangements, the economic benefit can be measured by the lower of the Table 2001 rates or the insurance company's "qualifying" alternative term rates.[62] For post-January 28, 2002 arrangements, under Notice 2002-8,[63] qualifying term rates must be published,

[61] Note that even with low term rates, there is a gift being made (unless the economic benefit is contributed by the trust) – in AFR interest accrued premium financing, there is no gift.

[62] Otherwise, there is nothing in the Final Regulations dealing with (nor restricting) the use of alternative term rates that otherwise qualify under Notice 2002-8, 2002-1 C.B. 398.

[63] 2002-1 C.B. 398.

generally available rates for one year term insurance, which must be made known to proposed insureds who are sold insurance through the carrier's normal distribution channels and, importantly, must be "regularly sold by the carrier" (an undefined term).

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

21. Changing a pre-Final Regulation private split-dollar arrangement without considering whether it could be considered a "material modification" of the arrangement.

As noted above, a private pre-Final Regulation split-dollar arrangement which hasn't been "materially modified" after the effective date of the Regulations, is governed by Notice 2002-8.[64] Conversely, a private pre-Final Regulation arrangement which has been "materially modified" after the effective date of the Final Regulations will no longer be governed by Notice 2002-8, but by the generally less favorable rules of the Final Regulations.

The Final Regulations do not contain a helpful definition of the phrase "materially modified" – they contain a so-called "angel list", a non-exclusive list of non-material modifications.[65] In addition, the IRS has indicated that this is an area in which they will not issue private letter rulings.[66]

[64] 2002-1 C.B. 398.

[65] Reg. Sec. 1.61-22(j)(2).

[66] See Rev. Proc. 2015-3 §3.01(8), 2015-1 I.R.B. 129.

Accordingly, any change to a private pre-Final Regulation split-dollar agreement, the terms of the economic "deal" between the parties, or even a change to the underlying policy needs to be approached as a potential material modification to the arrangement, subjecting the arrangement to the rules of the Final Split-Dollar Regulations from the date of the change. Since most pre-Final Regulation private arrangements were equity, collateral assignment arrangements (where the premium provider was only entitled to recover his or her premium advances), applying the rules of the Final Regulations to that arrangement would require that it be treated under the loan regime (measuring tax consequences of the arrangement by the foregone interest under Section 7872, as described above) rather than the economic benefit regime (measuring the benefit by the term costs, under Section 61).[67] In addition, this "switch" would likely be treated as a termination of the arrangement under Notice 2002-8, treating any policy equity as having been transferred, subject to its no inference provision.

Accordingly, where it is important for a non-tax reason to change the arrangement or the underlying policy and it is important to be able to continue to be able to use term cost to measure the benefit of the arrangement, the agreement would need to be amended to convert it into a non-equity arrangement (where the premium provider would be entitled to the greater of his or her advances or policy cash values), which would then qualify for one of the very narrow exceptions to the general rule of the Final Regulations that collateral assignment arrangements must use the loan regime to measure the benefit.[68]

[67] Reg. Sec. 1.61-22(b)(3).

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

22. Not planning for the disposition of the split-dollar receivable or premium financing note in the estate of the insured in a private premium funding arrangement.

In a private premium funding arrangement, the insured (or one of the insureds – or both of the insureds – in a survivorship policy arrangement) is either advancing premiums to a third party owner (such as an ILIT) under a split-dollar arrangement or is loaning money to the third-party owner under a premium financing arrangement, with interest either paid or accrued at the applicable federal rate. As noted above, a private premium funding arrangement is used to reduce the gift (and potential GST) consequences of funding an irrevocable life insurance trust – reducing the gift required from the full policy premium to the economic benefit of the arrangement (with split-dollar) or to any interest required to be gifted to the trust (in a premium financing arrangement).

The down-side of reducing or eliminating the gift otherwise created by having to fund policy premiums is that an increasing part of the death benefit of the policy will be returned to the insured or his or her successor in interest (either his or her revocable trust or his or her probate estate). That concern is heightened in both a post-Final Regulation private split-dollar arrangement (since the premium provider must get back the greater of premium advanced or the then policy cash value), and in an interest accrued premium financing transaction. The concern is that an increasing portion of the death benefit will be returned to the donor's successor in interest and an ever decreasing portion will be left in the irrevocable life insurance trust, unless the policy can be structured so that the death benefit grows either as cash value grows (in a split-dollar arrangement) or can grow to track premiums advanced (and perhaps accrued interest).

In any event, disposition of the receivable or the note in the insured's estate plan by specific bequest should be considered. The receivable or the note might be bequeathed to a surviving spouse, a charity, or even back to the trust which owns the policy.[69]

23. Creating an "old style" equity, collateral assignment private split-dollar arrangement after the Final Split-Dollar Regulations without recognizing the effect of those Regulations.

As noted above, any equity collateral assignment split-dollar arrangement entered into (or materially modified) after the Final Regulations will be required to use the loan regime, governed by Section 7872, rather than the economic benefit regime, governed by Section 61. Accordingly, the measure of the benefit will be determined by the interest imputed rather than term costs.

Private (donor/donee) collateral assignment arrangements entered into after the Final Regulations can use the economic benefit regime only if they are non-equity – that is, the premium provider must be entitled to receive the greater of the premiums advanced or the policy cash values (determined without regard to surrender charges).[70]

24. Planning around Code Section 677(a)(3) if an ILIT is to be a non-grantor trust.

Although it is quite often advantageous to have an ILIT be a grantor trust, such as to avoid transfer for value rules and depletion of trust assets by trust paying income taxes, sometimes the grantor does not want to be taxed on the trust income. Such a situation is where a

[69] In the latter case, it would be extinguished by operation of law, with no tax consequences, under I.R.C. § 102, but might also be treated as a transfer of the policy itself, rather than the receivable, under the Final Regulations.

[70] Reg. Sec. 1.61-22(b)(3)(ii)(B).

trust has significant income producing assets in addition to the life insurance policy. In such a case, the trust should be drafted to avoid the grantor trust triggers of Code Sections 671-678.

Code Section 677(a)(3) provides that an ILIT is a grantor trust to the extent trust income is applied or may be applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse as long as the policy is not irrevocably payable to a charity and the application of the income does not depend upon the approval of an adverse party.

If the ILIT is silent about payment of premiums with trust income, state law will probably authorize the trustee to make such payments resulting in a grantor trust. What if the ILIT prohibits the use of income to pay premiums and instead they are paid with principal or contributions to the trust? One old case implied that, even if the trust prohibited the use of income to pay premiums, the breach of trust by the trustee who uses trust income to pay premiums would not prevent grantor trust status treatment.[71] Also, PLR 8839008 involved an ILIT which prohibited applying "trust income" to payment of premiums, but the IRS found a grantor trust since the IRS construed the document as referring to accounting income and not taxable income.

Possible ways to ensure that an ILIT will be a non-grantor trust are for the ILIT to be drafted so that either income is automatically distributed to the beneficiaries upon receipt, or that income is segregated in a separate accrued income account which cannot, under the terms of the trust, be used to pay premiums. To avoid the rationale of PLR 8839008, the prohibition should expressly apply to taxable income. Perhaps the best way to ensure that the insured won't be treated as a grantor under Code Section 677(a)(3) is to require that any discretionary use of trust income to pay premiums on a policy on the life of the grantor or the grantor's spouse be

[71] Rand v. Commissioner, 40 B.T.A. 233 (1939), aff'd, 116 F.2d 326 (8th Cir. 1941).

consented to by an "adverse party" – a trust beneficiary whose interest would be affected by such a use of trust income – and then not actually use trust income to pay premiums.

25. Making sure premium gifts to ILIT with Crummey powers qualify for gift tax annual exclusion.

An ILIT with Crummey withdraw powers can qualify premium gifts for the gift tax annual exclusion. However, to qualify, the ILIT must have adequate assets to satisfy the withdraw power if exercised. This can be a problem if the only asset in the ILIT is the life insurance policy that has a value less than the withdraw power (including term and group term policies and non-equity private split dollar arrangements) at any time before the withdraw power lapses.

A solution is to funnel the premium payment through the trust. The trustee would give notice to the beneficiaries, hold the cash until the Crummey power lapses and then pay the premium. The donor should not pay the premium directly to the insurance carrier.

For a group term policy, the employer pays the premium directly to the carrier and not through the ILIT. In this situation, the settlor should make a front end gift to the ILIT to create a side fund in the ILIT sufficient to cover future Crummey withdrawal powers.[72]

The IRS has ruled that the annual exclusion applies if the power holder can withdraw the term policy without any indication of a side fund.[73] However, a policy withdraw power without a side fund might not be sufficient if the group term policy value does not equal or exceed the Crummey withdraw power at all times before lapse of the power. Although the

[72] PLRs 811123, 8103074 and 80006109.

[73] PLR 8021058.

group term policy may have a value equal to the unused premium, the full premium value on the payment date will decline each day during the power lapse period.[74]

26. Avoiding naming the insured as trustee of ILIT.

Although it may be possible to name the insured as trustee in certain narrow circumstances, the safer course of action is not to do so in order to be sure there are no incidents of ownership possessed by the trustee are attributable to the insured under Code Section 2042(2).

With regard to the insured serving as trustee, the IRS position is reflected in Revenue Ruling 84-179[75] which provides that an insured-trustee possesses incidents of ownership if any of the following exists:

1. The trustee powers are exercisable for the insured's personal benefit.

2. The insured transferred the policy or other consideration for purchasing or maintaining the policy to the trust.

3. The devolution of the trustee powers on the insured was part of a prearranged plan involving the participation of the insured.

Thus it is possible for the insured to be trustee if the insured is not the grantor or beneficiary such as an ILIT created by the will of the insured's spouse naming the insured as trustee for the benefit of adult children. But be careful that insured does not donate future premium payments to the trust.

Again, the safest course is to avoid having the insured serve as trustee in all circumstances.

[74] See Rev. Rul. 76-490, 1976-2 C.B. 300.

[75] 1984-2 C.B. 195.

27. Failing to restrict the insured's power to remove and replace the ILIT trustee by requiring any appointed successor trustee not be the insured or a related or subordinate party to the insured.

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

In Revenue Ruling 95-58,[76] with regard to Code Sections 2036 and 2038, the IRS ruled that the grantor's power to remove and replace a trustee did not give the trustee's discretionary powers to the grantor of the trust if the successor trustee cannot be the grantor or any person who is related or subordinate to the grantor within the meaning of Code Section 672(c). In PLR 9607008 and PLR 200314009, the IRS extended the rationale of Revenue Ruling 95-58 to powers of removal possessed by a beneficiary under Code Section 2041 and to powers of removal possessed by the insured under Code Section 2042(2).[77]

There is some question whether the related and subordinate party restriction is correct since it is an income tax concept and not an estate tax provision. The Estate of Wall v. Commissioner,[78] did not require a Section 672(c) restriction on appointment of a successor trustee. However, that issue was not brought before the court by the IRS since at that time it was arguing that the power to remove and replace always resulted in gross estate inclusion. Obviously, it is easier to include the related or subordinate party restriction in order not to fight

[76] 1995-02 C.B. 191.

[77] PLR 9607008 (I.R.C. § 2041). PLR 200314009 (I.R.C. § 2042).

[78] 101 T.C. 300 (1993), cited in Revenue Ruling 95-58.

with the IRS. However, a court might not agree with the IRS if the language is inadvertently omitted.

28. Avoiding transfer for value if the policy is sold to ILIT or insured's spouse (prior to gift to ILIT) to avoid three year rule of Section 2035.

If the insured owns a policy on the insured's life which is no longer needed, a gift of the policy to an ILIT of his incidents in ownership in the policy will result in the inclusion of the death proceeds in the insured's gross estate should the insured die within three years of the gift.[79] An exception to this rule is where the life insurance policy is transferred in a bona fide sale for adequate and full consideration in money or money's worth.[80] To fall within this exception, the insured could sell the policy to the insured's spouse who would contribute the policy to the spouse's ILIT. For the spouse's estate tax purposes, the spouse should not be a beneficiary of the ILIT. The gift by the spouse of the policy to the spouse's ILIT would not be subject to Section 2035 should the spouse die within three years of the transfer since Section 2035 only applies to transfers of incidents of ownership by the insured.

As an alternative (if the insured has no spouse or the spouse has to be a beneficiary of the ILIT), the insured could sell the policy directly to the insured's ILIT for adequate and full consideration. If the spouse or the ILIT did not have the funds to purchase the policy, the insured could gift the funds to them but, to weaken any IRS argument of step transaction, the gift and the sale should be separated by at least one year.

Caution: Make sure that the sale of the policy to the spouse or ILIT qualifies for an exception to the transfer for value rule of Code Section 101(a)(2). Otherwise the death

[79] I.R.C. § 2035.

[80] I.R.C. § 2035(b)(1).

proceeds in excess of policy basis would be ordinary income to the beneficiary. A sale to the insured's spouse automatically qualifies as an exception. Under Code Section 1041, sales between spouses are treated as gifts and "the basis of the transferee in the property shall be the adjusted basis of the transferor."[81] Since the spouse has the same basis in the policy as the insured, this qualifies for an exception to the transfer for value rule.[82]

If the sale is directly from the insured to the ILIT, the exemption from transfer for value is not automatic but must be planned. If the insured sells the policy to the insured's grantor trust, this is treated as a sale by the insured to himself and as a non-taxable event. Thus the insured's basis in the policy is transferred to the grantor trust falling within the common basis exception to transfer for value under Section 101(a)(2)(A).[83] If the ILIT is not a grantor trust, the sale must be to a transferee who is exempt from the transfer for value rule such as when the ILIT is a partner of the insured.[84] However, a sale to a non-grantor trust, even though within the transfer for value exception, would be a taxable event and could result in a gain to the insured seller.

29. For ILITs with Crummey withdraw powers, drafting the ILIT so that the Crummey power is triggered by both direct and indirect premium gifts to the ILIT.

If the Crummey power is drafted to apply to gifts to a ILIT, the IRS could argue that premium payments directly to the life insurance carrier, while constituting a taxable gift to

[81] I.R.C. § 1041(b)(2).

[82] I.R.C. § 101(a)(2)(A).

[83] Rev. Rul. 2007-13, (situation 2), 2007-11 I.R.B. 684.

[84] I.R.C. § 101(a)(2)(B).

the ILIT, do not trigger the Crummey power since the premium was not given to the ILIT with the trustee paying the premium to the carrier.

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

At least for ILITs containing group term policies with the employer paying the premium directly to the insurance company, the IRS has approved Crummey powers which expressly applied to indirect gifts of premiums to the ILIT.[85]

In Turner v. Commissioner,[86] the insured paid life insurance premiums for cash value policies directly to the life insurance company. The IRS claimed that the Crummey withdraw right was illusory since this was an indirect gift without notice to the beneficiaries. The Tax Court held the Crummey withdraw power effectively made indirect premium gifts a present interest gift since the ILIT expressly provided that the power applied to "each direct or indirect transfer to the trust."

The takeaway is that premiums, if at all possible, should be funneled through the ILIT. Furthermore, the ILIT should be drafted to apply the Crummey withdraw power to "direct and indirect gifts" in case the premium is paid directly to the insurance carrier by someone other than the trustee (such as for group term policies owned by the ILIT).

[85] PLR 81-3074 ("contributions directly or indirectly transferred"). PLR 8138102 ("premiums…which are paid, by the settlor or any other person, rather than being paid to the trustee"). PLR 8138170 ("contributions…including…any premiums…that are paid by the taxpayer or any other person directly to the insurance company").

[86] T.C. Memo 2011-29.

Business Insurance (Including Employee Benefit) Transactions with Estate Planning Implications

30. Re-arranging the ownership interests in multiple shareholder cross-owned life insurance policies after the death of a shareholder – violating the transfer for value rule.

With cross-owned life insurance policies funding a cross-purchase shareholders agreement involving three or more shareholders, at the death of the first shareholder to die, the remaining shareholders will want to repurchase the policies on their co-shareholders lives, now owned by the estate of the deceased shareholder, in order to keep the arrangement fully funded.

Those purchases will be transfers for purposes of the transfer for value rule, and they will not be exempt from that rule, since transfers among co-shareholders are not specifically exempted by the rule.[87]

The only solution to this problem is to be sure that the shareholders are also partners (or members of a limited liability company taxed as a partnership) in a state law valid partnership (or limited liability company), since transfers among partners (or members in an LLC taxed as a partnership) are exempt from the transfer for value rule, even where the partnership or LLC has nothing to do with the policy.[88]

[87] I.R.C. §101(a)(2).

[88] Id. See also, PLRs 9042023 and 200747002.

31. Partnership (or LLC) insurance coverage on a partner or member which doesn't take into account whether the insurance is payable to the entity or not.

Some practitioners utilize key-person insurance coverage owned by and payable to a family limited partnership or LLC taxable as a partnership, as an alternative to having a client create and fund an irrevocable insurance trust, because of the extra flexibility the contractual nature of the partnership agreement (or LLC agreement) provides. In those cases, the insured's estate will include the value of the entity interest, potentially increased by a proportionate part of the proceeds.[89]

However, where the insured is a general partner in the partnership (or a managing member in the LLC), it must be clear under the organizational document of the entity that the insured may not exercise incidents of ownership on a policy on his or her life owned by but not payable to the entity; all such incidents of ownership must be exercisable only by partners or managers other than the insured, to avoid the risk of including the policy proceeds in the insured's estate for estate tax purposes under Section 2042.

32. A "controlling" shareholder split-dollar arrangement with a third party owner, not documented as such.

Where any shareholder-employee of a corporation enters into a split-dollar arrangement with his or her corporation, if the policy proceeds are intended not to be includible in his or her estate for estate tax purposes, the policy must be owned by and payable to a third party owner (such as an irrevocable insurance trust).

[89] See Knipp v. CIR., 25 T.C. 153 (1955) and Rev. Rul. 83-147, 1983-2 C.B. 158. See PLRs 200947006 and 200948001, extending the rule in Knipp and the Ruling to partnerships which only owned policies and were not engaged in a trade or business.

In addition, for a controlling shareholder,[90] the corporation may not have any incidents of ownership in the policy under the split-dollar agreement or the collateral assignment document filed in connection therewith (since corporate incidents of ownership in policies on controlling shareholders' lives are attributable to the controlling shareholder for estate tax purposes, to the extent the policy proceeds are not payable to or for the benefit of the corporation).[91]

The use of either a "restricted" collateral assignment split-dollar arrangement (in which corporate rights are limited to being repaid for advances) or an "undocumented" (or "unsecured") split-dollar arrangement (in which the policy is not used as collateral) must be used, in order to divorce the corporation from corporate incidents of ownership in the policy, to prevent them from being attributed to a controlling shareholder.[92]

Business Insurance (Including Employee Benefit) Transactions

33. The two-party entity-related life insurance problem – the entity as an owner of the policy and an individual as the beneficiary (not using split-dollar or loan arrangements).

Assuming the policy is not structured under a split-dollar or a loan arrangement, if an entity owns a policy on the life of an individual (whether an employee, a shareholder, or an independent contractor such as director), the entity must be the beneficiary of the policy, or there will be inadvertent, adverse income tax consequences to the insured or the beneficiary.

[90] A controlling shareholder is, generally, one who owns more than 50% of the voting control of the corporation, without most forms of attribution. See Treas. Reg. §20-2042-1(c)(6).

[91] Note this rule only applies in a corporate context.

[92] See PLRs 95110496, 9651030, 9651017 and 9710027.

Where the entity owns the policy and is not the policy beneficiary, and assuming no split-dollar or loan arrangement is in effect, the most likely result is that the full premiums paid by the entity will be treated as taxable income to the insured each year;[93] the entity should get an offsetting compensation deduction, if the arrangement is employment-related (and assuming total compensation is reasonable).

The other alternative is that the full policy proceeds will be taxable income to the beneficiary; again, there should be an offsetting deduction for the entity in an employment-related arrangement (on the same assumption).

34. The undocumented life insurance employee benefit transaction – a split-dollar arrangement, a loan, a bonus arrangement, or a non-qualified deferred compensation arrangement – with no plan document.

Where an employer is paying some or all of the premiums on a policy, if there is no plan documentation, the income tax consequences of the arrangement both to the insured and the employer are at best unclear; the Internal Revenue Service's position will likely be to consider the arrangement as a bonus arrangement, treating the entire premium as taxable income to the insured (and deductible by the employer), where the death proceeds are not paid to the employer.[94]

In any situation where an employer is paying all or part of the premiums on a policy for the benefit of an employee or shareholder and is not the policy beneficiary, documentation of the arrangement is required to obtain the intended income tax consequences of the arrangement to the parties.

[93] See Doran v. CIR, 246 F.2d 934 (9th Cir. 1957).

[94] See e.g., Goos v. CIR, T.C.M. 1991-146.

In addition, for employment arrangements, a written plan document is required to comply with the ERISA rules for both employee welfare benefit plans and employee pension plans (even those that are exempt from most other ERISA requirements).[95]

35. Non-contributory, non-employee shareholder split-dollar arrangements in multiple shareholder S Corporations which treat the economic benefit amounts or the interest imputed as dividends to the shareholders.

Under prior law, where the insured did not contribute to the premium of a split-dollar arrangement (sometimes called employer pay-all split-dollar), the insured was taxed on the "economic benefit" of the arrangement. Under Revenue Ruling 79-50,[96] a corporation and an insured who is merely a shareholder, and not an employee, can enter into a split-dollar arrangement, with the same tax results to the insured shareholder as those received by the insured employee in employment related split-dollar (taxation of the economic benefit amount, minus any contribution to the arrangement by the insured). Under Revenue Ruling 79-50, in non-contributory, shareholder-corporate split-dollar arrangements, the economic benefit amount is taxed to the shareholder as a dividend (to the extent of E&P).

The Final Split-Dollar Regulations include in their definition of split-dollar arrangements corporate/shareholder arrangements, and therefore continue these rules for post-final regulation arrangements.[97]

If the corporation party to a corporate-shareholder split-dollar arrangement is an S Corporation, with more than one shareholder, the dividend resulting from the split-dollar

[95] See e.g., parts 4 and 5 of Subtitle B of Title I of the Employee Retirement Income Security Act of 1974; DOL Reg. §2560.503-1.

[96] 1979-1 C.B. 138.

[97] Although collateral assignment arrangements may not use the economic benefit regime, under a special exception, discussed below.

arrangement to the insured shareholder would create a second class of stock, which would terminate the corporation's S election.[98]

The easy way to avoid this risk is to be sure that in any S Corporation-shareholder split-dollar arrangement, the insured shareholder contributes the full economic benefit cost of the arrangement every year; that way, there should be no dividend to report to the insured shareholder under the arrangement, and no risk of having created a second class of stock.[99] If the split-dollar arrangement is an equity split-dollar arrangement, however, having the shareholder contribute an amount equal to the economic benefit would not appear to offset the dividend and would therefore not eliminate the second class of stock risk, if the equity were taxable.

The same issue is raised by a loan regime split-dollar arrangement, taxable under Regulation Section 1.7872-15, where the interest would be imputed as a dividend. To avoid this issue in a loan transaction, interest should be paid or accrued at the AFR.

36. Termination of a compensatory pre-Final Regulation split-dollar arrangement which doesn't consider and plan for the potential income and gift tax consequences of "policy equity" under Notices 2002-8 and 2007-34.

In an employment related split-dollar arrangement, where the employer's interest in the policy is limited to its cumulative premiums, if policy cash values at some point exceed cumulative employer premiums, that excess (sometimes called policy "equity") will belong to the policy owner (either the insured or his or her irrevocable insurance trust). In those situations, it has always been unclear whether that policy equity will be income to the insured employee, and if so, when it would be considered income to him or her.

[98] I.R.C. §1361; Treas. Reg. §1.1361-1.

[99] See PLRs 9331009 and 9413023. For post-final regulation arrangements, that contribution would be income to the corporation; Reg. Sec. 1.61-22(f)(2)(ii).

In one technical advice memorandum,[100] the IRS took the position that the equity was taxable to the insured employee, under the theory of Section 83 (taxing transfers of property in connection with the rendition of services), as it accrued. In addition, that ruling held that if the policy were owned by an irrevocable insurance trust, the equity that would be income to the employee would also be considered a gift to the trust by the insured employee (and presumably a generation-skipping transfer by the insured employee, if the trust had generation-skipping implications).

Under Notice 2002-8,[101] for pre-final regulation arrangements, policy equity is specifically held to be income only on termination of the arrangement during the insured's lifetime (with two safe harbors for pre-January 28, 2002 arrangements which were converted or terminated by 1/1/04), subject to what has become known as its "no inference" provision.[102] In a compensatory context, under Notice 2007-34,[103] Section 409A will also apply to that policy equity at that time, to the extent it is not grandfathered from the application of Section 409A,[104] without any "no inference" protection.

To manage this risk, pre-Final Regulation equity split-dollar policy illustrations ought to assume that, as a worst case scenario, the equity is income taxable and subject to transfer tax (if the policy is owned by a third party – such as an insurance trust). The creation of policy equity needs to be carefully monitored in such arrangements, and an exit strategy to

[100] TAM 9604001.

[101] 2002-1 C.B. 398.

[102] Under which the IRS cannot infer anything about the taxation of equity based on pre-Notice law – that is, anything in Notice 2002-8 or the Proposed or Final Split-Dollar Regulations.

[103] 2007-17 I.R.B. 996.

[104] Either because the arrangement itself was grandfathered (which would be unusual) or to the extent the policy cash value was attributable to premiums paid before 1/1/05.

unwind (roll-out) the arrangement during the insured's lifetime should be considered either before equity develops or at least when it is still at a manageable level; the only safe alternative is to keep the arrangement in effect until the insured's death, with ever-increasing economic benefits.[105]

37. Entering into a post-Final Regulation compensatory split-dollar arrangement or a premium financing arrangement for a single life policy insuring an employee without checking the other as an alternative, or, in either case, without having an exit strategy.

Whether premium financing (a loan with interest, either paid or accrued at the AFR) or a split-dollar arrangement using the economic benefit regime makes the most sense in a given post-final regulation transaction depends upon whether the policy is a single life or a survivorship policy, and, if it is a single life policy, both the age of the insured and the relative level of interest rates.

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

With a single life policy (or a survivorship policy after the first death), private premium financing, with interest paid or accrued at the AFR, may make more sense if the insured is older, if interest rates are relatively low, and if the insurance carrier does not have alternative term rates which qualify to be used in lieu of the Table 2001 rates.

[105] Reliance on the "no inference" language of the Notice to avoid taxation of the equity may – or may not– prove to be helpful, and note that Notice 2007-34, above, has no similar provision for purposes of applying I.R.C. § 409A to the arrangement.

In either case, entering into such an arrangement without an effective exit strategy, where the policy is owned by a third party – such as an insurance trust – to unwind the arrangement during the insured's lifetime is problematic. Over time, economic benefits continue to increase as the insured ages, and loan arrangements get increasingly expensive as more premiums are advanced and more interest is due on those advances. In either case, the longer the arrangement continues, the smaller the death benefit which will remain payable to the policy beneficiary.

Exit strategy planning contemplates creating a side fund to be owned by the policy owner, which can, over time, be used to repay the premium advances under the split-dollar arrangement or the premium loans under the premium financing transaction. If the owner is an irrevocable trust, creating the side fund needs to be done on a transfer tax leveraged basis, perhaps including additional policy loans (with AFR interest) to the trust, having the trust become the residuary beneficiary of a grantor retained annuity trust (if the insurance trust does not have generation skipping implications) or the purchaser in an installment sale.

38. Creating an "old style" equity collateral assignment compensatory split-dollar arrangement after the Final Split-Dollar Regulations.

As noted above, any equity collateral assignment split-dollar arrangement entered into (or materially modified) after the Final Regulations will be required to use the loan regime, governed by Section 7872, rather than the economic benefit regime, governed by Section 61. Accordingly, the measure of the benefit will be determined by the interest imputed rather than term costs.

Compensatory (employer-employee) collateral assignment arrangements entered into after the Final Regulations can use the economic benefit regime only if they are non-equity –

that is, the premium provider must get back the greater of the premiums advanced or the policy cash values (determined without regard to surrender charges).

39. Not amending compensatory equity split-dollar arrangements to comply with the requirements of Section 409A and Notice 2007-34.

As noted above, equity split-dollar arrangements are, to the extent not grandfathered, subject to Section 409A on termination, under Notice 2007-34.[106] In order to comply with the requirements of Section 409A, these agreements had to be amended, no later than 12/31/08. Those amendments must conform the provisions of the agreement which give the employee access to the equity to the limited number of determinable events allowed by Section 409A. As an example, a common provision which gives the employee the power to terminate the agreement does not comply with the distribution provisions allowed by Section 409A; it would need to be eliminated or only exercisable at a fixed time.

Notice 2007-34 also provides that amendments to such an agreement to comply with Section 409A will not, assuming that the Notice's requirements are met, be treated as material modifications of the agreement under the Final Split-Dollar Regulations; note, however, that some of those required modifications may raise economic issues for the parties.

40. Not considering a compensatory split-dollar arrangement to fund a survivorship policy insuring the lives of an employee and his or her spouse to use the low survivorship economic benefit rates (while both insureds are alive).

The issuance of the Final split-dollar Regulations in late 2003, effective for transactions entered into or "materially modified" after the effective date of the regulations, as

[106] FN 103 above.

noted in several places above, has eliminated many – but not all – uses of employment-related split-dollar. While some commentators have taken the position that the Final Regulations "killed" split-dollar going forward, one place where an economic benefit regime split-dollar arrangement still makes sense is when the policy acquired with the split-dollar advances is a survivorship policy. There, while both insureds are alive, the measure of the economic benefit is derived from Table 2001, to measure the actuarial risk of both insureds dying in the same year (a very small risk). See FN 60.

Accordingly, that special measure of the economic benefit provided to the policy beneficiary for survivorship policies makes them the most attractive kind of policy to consider creating new split-dollar arrangements for. Again, as noted above, those arrangements would need to be employer/employee "non-equity" arrangements, where the premium provider was entitled to the greater of the premiums advanced or the policy cash values (determined without regard to surrender charges).

Although split-dollar arrangements may not make as much sense as they did prior to the issuance of the Final Regulations, the one place where they will likely make sense from a tax point of view will be in funding survivorship policies (while both insureds are alive); after the first death, the economic benefit reverts to the traditional economic benefit measure for any single life policy – the lower of the Table 2001 rates or the insurance carrier's qualifying alternative term rates.

41. Not checking the availability of the insurer's alternative term rate (in lieu of the Table 2001 rate) for post-Final Regulation compensatory split-dollar arrangements for a single life policy insuring an employee.

At least until the IRS publishes what the Final Regulations call "uniform term rates" for determining the measure of the economic benefit in post-final regulation split-dollar arrangements, the economic benefit can be measured by the lower of the Table 2001 rates or the insurance company's "qualifying" alternative term rates.[107] For post-January 28, 2002 arrangements, qualifying term rates must be published, generally available rates for one year term insurance, which must be made known to proposed insureds who are sold insurance through the carrier's normal distribution channels and must be "regularly sold by the carrier" (an undefined term).

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

42. "Funding" a non-qualified deferred compensation plan for both ERISA and tax purposes by "tracking" the policy terms into the agreement.

In a non-qualified deferred compensation arrangement, where a life insurance policy, owned by and payable to the corporation, is used to informally fund the corporation's obligations under the arrangement, there must be adequate "distancing" between that policy and

[107] FN 101 above.

the employee-participant's rights under the arrangement.[108] Specifically, the terms of the policy may not be reflected in the agreement; incorporating the terms of the policy into the agreement would likely to be held to "fund" the arrangement both for income tax and ERISA purposes – taxing the employee-participant on the policy values currently and causing the arrangement to fail to qualify for the "top hat" exemption from the application of ERISA.[109]

Where certain terms of the policy are integral to the terms of the plan – such as a crediting rate for deferrals based on policy value growth – it must be clear that the terms of the policy are only being used as an "index" of the employee-participant's rights under the plan, and that he or she has no direct interest in the policy itself. That "distancing" must be true not only in the plan document, but in all employee communications.

43. Acquiring employer-owned life insurance on the life of an employee without complying with the requirements of Section 101(j) in advance.

Section 101(j) was adopted as what was then called the Corporate Owned Life Insurance Best Practices Act, to assure that employers which acquired policies on the lives of their employees had gotten their consent, in advance, to the acquisition.

Section 101(j) however applies to any policy acquired by any employer (regardless of form) on the life of an employee, and provides that, unless its eligibility, notice, and consent provisions are complied with in advance of the acquisition of the policy,[110] the policy death proceeds in excess of premiums paid will not be excludible from the income of the employer. In addition, it imposes recordkeeping and annual reporting requirements on

[108] See Goldsmith v. U.S., 586 F.2d 810 (Ct. Cl. 1978).

[109] See DOL Advisory Opinion 81-11A.

[110] Once the policy is issued, there is no way to "fix" the lack of prior notice and consent – unless the policy is surrendered and a new policy is acquired with prior notice and consent, or, perhaps, if the policy is "substantially changed", as discussed below, with prior notice and consent.

employers. Finally, it applies to any policy acquired after the effective date of the Section, August 17, 2006, or any policy "substantially changed" after that date (not including a policy exchange where the death benefit is not increased).[111]

44. Changing a pre-Final Split-Dollar Regulation compensatory split-dollar arrangement without considering whether it was a "material modification" of the arrangement.

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

The Final Regulations do not contain a helpful definition of the phrase "materially modified" – they contain a so-called "angel list", a non-exclusive list of non-material modifications. In addition, the IRS has indicated that this is an area in which they will not issue private letter rulings.

Accordingly, any change to a compensatory pre-Final Regulation split-dollar agreement, the terms of the economic "deal" between the parties, or even a change to the underlying policy needs to be approached as a potential material modification to the arrangement subjecting the arrangement to the rules of the Final Split-Dollar Regulations, from the date of the change. Since most pre-Final Regulation compensatory arrangements were equity, collateral assignment arrangements (where the premium provider was only entitled to recover his or her

[111] As noted above, there is no such definitional protection for policy exchanges under the Final Split-Dollar Regulation's "material modification" provision.

premium advances), applying the rules of the Final Regulations to that arrangement would require that it be treated under the loan regime (measuring tax consequences of the arrangement by the foregone interest under Section 7872) rather than the economic benefit regime (measuring the benefit by the term costs, under Section 61).

Where it is important for a non-tax reason to change the arrangement or the underlying policy and it is important to be able to continue to be able to use term cost to measure the benefit of the arrangement, the agreement would need to be amended to convert it into a non-equity arrangement (where the premium provider was entitled to the greater of his or her advances or policy cash values), which would then qualify for one of the very narrow exceptions to the general rule of the Final Regulations that collateral assignment arrangements must use the loan regime to measure the benefit.[112]

45. Avoiding premium reimbursement economic benefit split dollar because of employer income tax consequences.

Reimbursement of term premium by non-owner employee will be taxable to the owner employer. Any term or other economic benefit paid by the non-owner, directly or indirectly, to the owner of the life insurance contract is included in the owner's gross income.[113] This regulation came as a surprise and is a change from the premium reimbursement rules for grandfathered split dollar arrangements. The Preamble to the regulation justifies the income inclusion of the term premium reimbursement on the grounds the owner is "renting" out part of the insurance benefit to the non-owner for consideration.

[112] That exception is only available for donor/donee or employer/employee arrangements.

[113] Treas. Reg. § 1.61-22(f)(2)(ii).

Presumably there is no "indirect" reimbursement or income to the owner employer if the non-owner employee does not pay the term premium but it is included in the employee's W-2 as compensation. If the non-owner is the insured owner's grantor ILIT in a non-equity arrangement, the grantor trust rules of Revenue Ruling 85-13[114] will apply to disregard this income. In any event, most split dollar arrangements entered into after 2003 will not use term premium reimbursement.

46. Being careful in modifying non-equity split dollar arrangement to avoid potential taxes to premium payer.

As noted earlier, in a non-equity endorsement split dollar, the premium payer is "treated" as the policy owner for tax purposes, even though the other party actually owns the policy for contractual purposes. This allows the arrangement to fall under the economic benefit regime. What if the premium payer later transfers all or part of the payer's non-equity interest to the other party so that the non-equity split dollar arrangement ends. There is no actual transfer of the policy by the premium payer since the other party was already the contractual owner of the policy.

Reg. Section 1.61-22(c)(1)(ii)(B) provides that, if the non-equity exception applies and if the arrangement is "modified" so as not to qualify for the non-equity exception (e.g., part of the cash value is transferred to the employee, service provider or donee) and immediately after the modification the employer, service recipient or donor is no longer the owner under the split dollar arrangement, the premium payer "is treated as having made a transfer of the entire life insurance contract to the employee, service provider or donee" with the excess of the policy fair market value over premiums paid and consideration received for the

[114] 1985-1 C.B. 184.

modification being income, dividend or gift to the employee, service provider or donee owner of the policy.[115]

What is a "modification" which triggers the transfer? The term is not defined by the regulation. Clearly a transfer of part of the cash value to the former non-owner would be a modification since the policy would no longer qualify as non-equity and the cash value is now split between the two parties. Presumably a sale or gift of the premium payer's entire interest in the policy to the employee, service provider or donee would also be a modification since it has changed the economic benefit of the arrangement. However, there is another school of thought that a gift or sale of the premium payer's entire interest in the policy is not a modification but a termination of the arrangement avoiding the split dollar regulation. Is a termination also a modification? It might be the ultimate modification but there are no authorities on point.

This is an important distinction when an intergenerational discount split dollar policy is involved. Under the typical discount split dollar arrangement, an ILIT for the benefit of a grandchild owns a policy on the life of the child. Pursuant to a non-equity private split dollar arrangement, the grandparent assumes an obligation to pay premiums in excess of the ILIT term premium payment for the pure death coverage with no right to terminate the arrangement or to access the cash value. Since the cash value is tied up until the death of the child, the goal is to take a severe discount for the cash value sale or gift. If the sale or gift is not a modification, then arguably the value of the gift or sale of the premium payer's interest is deeply discounted because of the restrictions of the split dollar arrangement. On the other hand, if the sale or gift is

[115] Treas. Reg. § 1.61-22(g)(1).

a modification (including a termination), then the value of the premium payer's interest is the fair market value of the policy under the split dollar regulation and not the discounted value.[116]

47. Avoiding incidents of ownership to the insured partner for split-dollar agreement between a partnership and an ILIT.

If a partnership owns a policy on the life of an insured general partner, the IRS position is that partnership incidents of ownership over death proceeds not payable to or for the benefit of the partnership are attributable to the insured.[117] This is based on the aggregate theory that partnership assets are controlled by the partners. There is no controlling partner regulation as there is for a controlling shareholder of a corporation. Rev. Rul. 83-147 involved a one-third partner.[118] Two Tax Court opinions imply that it does not follow the aggregate theory but the entity theory which would not have an attribution of incidents of ownership.[119] But the IRS does not agree.[120]

The partnership attribution rules probably apply to economic benefit regime and loan regime split-dollar arrangements unless there is careful planning. Note that the final split-dollar regulations reserve comment on application of the two regimes to split-dollar arrangements.[121] However, it is wise to assume that the split-dollar rules apply to partnership arrangements.

[116] Two recent Tax Court cases involving intergenerational economic benefit regime found problems under I.R.C. §§ 2036, 2038 and 2703. Estate of Cahill, T.C. Memo 2018-84. Estate of Morrisette, T.C. Docket #4415-14, June 21, 2018 Order.

[117] Rev. Rul. 83-147, 1983-2 C.B. 158

[118] I.R.S. Gen. Couns. Memo. 39,034 (9-21-1983).

[119] Estate of Knipp v. Commissioner, 25 T.C. 153 (1955), acq. in result, 1959-1 C.B. 4. Watson v. Commissioner, T.C. Memo. 1977-268, 36 T.C.M. (CCH) 1084.

[120] See Gen. Couns. Memo 39,034.

[121] Treas. Reg. § 1.61-22(c)(1)(iv).

1. Economic benefit regime. If the partnership owns the policy and endorses the pure death benefit to an ILIT, if is likely that the incidents of ownership of the partnership over the proceeds paid to the ILIT will be attributed to the deceased insured partner. One way to avoid attribution is to provide in the partnership agreement that a general partner is prohibited from exercising incidents of ownership over a policy owned by the partnership on the life of such partner.[122] If the insured is a limited partner, there is no attribution of incidents of ownership if the partnership agreement gives no management or control to limited partners.[123]

2. Loan Regime. A loan by the insured's partnership of premiums to the ILIT by itself should give no incidents of ownership to the partner. The partnership is a creditor and not an owner.[124] Thus an unsecured loan by the partnership is safe. However, care should be taken if the ILIT gives a collateral assignment of the policy as security for the loan. In a typical collateral assignment, the creditor has broad powers to surrender or withdraw from a policy or to take policy loan if there is a default. Such broad powers might be construed to be incidents of ownership.

To be safe, if a collateral assignment is deemed important, it should be specially drafted as a restricted access or "bare bones" collateral assignment which gives all incidents of ownership to the trustee and restricts the partnership rights solely to payment from cash value at a lifetime termination of the arrangement or from proceeds at termination of the arrangement at the death of the insured partner. The IRS has approved a bare bones collateral assignment for a

[122] See PLR 200017051.

[123] PLR 200111038.

[124] See PLR 9809032 where the insured loaned money to his ILIT.

partnership.[125] The IRS has approved many bare bones collateral assignments for corporate split dollar arrangements.[126]

48. Not considering the relative advantages and disadvantages before choosing between loan regime and economic benefit regime split dollar.

Before a policy is purchased for a split dollar arrangement, the parties should carefully consider the differences between the loan regime and the economic benefit regime and which regime best fits their situation: (a) The loan regime where the premium payer (donor, employer, corporation or partnership) loans the premium money to the policy owner (ILIT, employee, shareholder or partner) or (b) the economic benefit regime where the premium payer owns the policy and endorses all or part of the pure death benefit to the ILIT, employee, shareholder or partner.

Here are some of the major differences between the two regimes which might impact one way or the other as to which should be used:

1. Who should own the equity cash value in excess of aggregate premiums? Under the loan regime, the cash value equity over premium loans is owned by the non-premium paying owner without any income taxes as the equity accrues. This allows the non-premium paying owner to accrue more ownership in the policy cash value without having taxable income.

This may not be an advantage for policies with little cash value such as no lapse guarantee or lightly funded universal life policies. Under the economic benefit regime, all of the cash value must be owned by the premium payer (to avoid taxing cash value to the non-owner) which might be desirable if the premium payer owner wants a return on his premium payment

[125] PLR 9204041.

[126] PLR 9511046. PLR 9651030. PLR 9709027. PLR 9808024. PLR 9848011. PLR 200728015. See PLR 9318009.

investment or if such owner wants to use the extra cash value for business purposes such as funding a non- qualified deferred compensation agreement with the insured.

2. Which regime results in less cost to the non-premium payer? The cost of the loan regime is the AFR interest paid by or taxed to the owner of the policy. The economic benefit regime cost is the term premium on the endorsed insurance coverage. Traditionally, the AFR was higher than the term premium except for older insureds. However, in these days of low interest rates, the AFR may be lower than the term premium even at a relatively young age of the insured. The relative AFR and term premium should be checked before making this decision.

3. Who should control the policy? Under, the loan regime the non-premium payer owns the policy. Under the economic benefit regime, the premium payer owns the policy. This may be important when a variable life insurance policy is involved in determining who should control the investments.

49. In economic benefit regime split dollar, avoid giving the non-owner employee current access to cash value.

Most economic benefit regime split dollar arrangements limit the non-owner's rights in the policy to current insurance protection. The owner has all of the cash value and other rights in the policy. In such cases, the only economic benefit to the non-owner employee for income and gift tax purposes is the term cost of current insurance protection.

However, if the non-owner also has "current access" to policy cash value, such accessible cash value is an additional economic benefit to the non-owner. An example is where the owner's rights in the policy are limited to the lesser of the aggregate premiums paid or the policy cash value. The excess cash value over premiums would be taxable to the employee non-owner if he has current access.

If the non-owner employee has the future right to cash value in excess of premium payments, can current taxation be delayed if the employee is given no current right to access the cash value? It might still be taxable. Reg. Section 1.61-22(d)(4)(ii)(B) states that an non-owner has taxable current access to policy cash value not only if he has current access directly or indirectly to the cash value but also if (a) the cash value is inaccessible to the owner OR (b) the cash value is inaccessible to the owner's general creditors. Note that these three are disjunctive. Thus the non-owner would be taxed if either the owner or the owner's creditors cannot access the cash value.

In addition to the tax consequences, the non-owner executive would probably not like an arrangement where the employer or the employer's creditors could access the policy equity before termination of the arrangement. Even if the employer owner (and not the employee non-owner) is given current access to the cash value which otherwise will be paid to the executive at termination of the arrangement, some state laws protect cash value from the creditors of the policy owner. In those states, it may be necessary for the split dollar contract to expressly allow the creditors of the owner to reach the equity in the policy until the split dollar arrangement terminates.

50. In order to avoid income taxation of the death proceeds to the non-owner's beneficiary, be sure that the employee non-owner pays the term premium or includes it in his income for a non-equity split dollar arrangement.

The split dollar regulations state that death proceeds payable to a beneficiary (other than the policy owner) by reason of the death of the insured in an economic benefit regime split dollar are generally excluded from the beneficiary's gross income under Code Section 101(a).[127]

However, the regulation goes on to state "to the extent such amount is not allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account" in his W-2. The Preamble to the split dollar regulations provides that, when the non-owner neither pays the term premium nor includes it in his income, the proceeds are treated as if they were paid to the owner tax-free under Code Section 101(a) but then distributed by the owner to the beneficiary outside of Code Section 101(a).

Clearly, if the split dollar arrangement does not require the insured-employee to pay the term premium or to include it in his income, the death proceeds would be taxable to the beneficiary. But even if the split dollar arrangement does require payment or inclusion, the language of the regulation could be construed to require income inclusion for the beneficiary if the non-owner routinely does not pay the term premium or have it included in his income. It is important scrupulously for the non-owner employee to pay the premium or include it in his income to prevent such an argument by the IRS. This is a potential serious penalty for lack of follow through after the split dollar arrangement is executed.

[127] Treas. Reg. § 1.61-22(f)(3)(i).