Chapter One

Introduction

A. The Role of Life Insurance in Estate Planning

1. In General

Most adults in the United States, particularly those who are married and have one or more children, will own one or more life insurance policies insuring their lives. Therefore, it is incumbent upon the estate planning advisor to have some knowledge of life insurance products and the role that life insurance plays in the financial well-being of a client and his or her family. In addition, the advisor should know the income and transfer tax consequences of using life insurance.

For those clients who do not already have a qualified insurance professional servicing his or her needs, the advisor should be prepared to refer the client to such a person. It is unlikely the advisor will keep current with all of the life insurance products available. In recent years, the types of products available have changed considerably. For example, before the mid-1980s, survivorship or last-to-die insurance was generally not available.

Older clients will often ask the advisor whether he or she needs additional insurance or whether he or she should retain insurance already owned. In many cases the client's estate plan will be better served if the ownership of existing life insurance policies is transferred to an irrevocable trust, or in some cases, to another individual. By transferring existing policies to an irrevocable trust, the proceeds will be removed from the insured's federal gross estate if he or she lives for more than three years after the transfer.

Life insurance plays a number of important roles in the client's financial security and estate planning. These include replacement of income, providing liquidity and business uses.

2. Replacement of Income

The most common role life insurance plays, especially for younger adults, is to provide replacement income for those who are dependent upon the income earned by the insured while he or she is alive. The client and his or her insurance professional can determine the amount needed by making various assumptions about the current and future needs of the client's dependents, rates of return on investments, and other factors. In calculating the needs of the client's dependents, the client must determine the appropriate standard of living he or she wishes to provide for the dependents after his or her death. For example, will the surviving spouse be able to continue to live in the same home, retain a vacation home, and remain unemployed (if not currently employed)? Will the children's education be provided for and will they be able to go to any college or will they have to settle for the least expensive? The higher the standard of living the client wants to provide to his or her dependents, the more insurance the client must purchase and the higher the premiums will be. Of course, paying premiums while the client is alive means the client will have less for current enjoyment or for investment for his or her own future retirement. Although the client and the insurance professional will generally agree on the desired amount of insurance before the client sees the attorney, it is common for the client to solicit the attorney's advice as to the appropriateness of the assumptions made and the accuracy of the calculations.

Once the needs of the client's dependents have been determined, the sources of funds to provide for those needs must be identified. In many cases, the client's dependents will be entitled to benefits from qualified retirement plans and social security benefits, and will enjoy the income from t he client's other investments. Any shortfall from these other sources can be eliminated with life insurance proceeds.

A limiting factor on the amount of insurance purchased will be the client's ability to pay premiums. The client's financial condition will affect the type of insurance the client can afford as well, since the client will be able to purchase substantially more term insurance than permanent insurance on a current basis. However, the premiums on term insurance increase over time, and if the client needs to retain the insurance for a long period, the increased premiums may be difficult to pay in the future. On the other hand, while permanent life insurance premiums are higher at the outset, they will generally remain constant over the life of the policy.

Permanent insurance will also provide a cash value the client can use for emergencies or retirement through policy loans or in some cases withdrawals from the cash value. It could be argued the client would achieve a better result by buying term insurance and investing the difference between the premium on term insurance and the higher premium that would have been payable on permanent insurance. However, this result will not be achieved if the client makes poor investments or consumes the balance rather than investing it. In addition, if the client's investment philosophy is very conservative, the client's return on permanent insurance may be as high as the return he or she would have achieved through his or her own investments. Therefore, in many cases a client with a long-term need for life insurance would be better off to purchase permanent insurance to the extent he or she can afford it.

Even permanent insurance can prove to be financially risky, particularly with respect to the cash value. In the late '80s and early '90s, a number of insurance companies faced financial difficulties. Although no death benefit has gone unpaid as a result of these financial difficulties, the cash values of many life insurance policies have been reduced considerably. Consequently, the advisor may be asked to opine on the financial stability of a particular insurance company. If the amount of insurance involved is high enough, which may be the case when insurance is being purchased to provide liquidity at the insured's death to pay substantial estate taxes and other debts of the estate, the advisor may use the services of companies or individuals who are experts in evaluating insurance products and insurance companies.

One way the advisor can deal with the complexity of life insurance proposals is to encourage the client to enlist more than one insurance professional to provide the proposals. Although life insurance proposals are often difficult to compare with one another, another insurance professional trying to make a sale will be more than happy to point out the problems with another professional's proposal.

3. Providing Liquidity

For those clients whose wealth is sufficient to provide for the needs of the client's dependents after his or her death, life insurance may still be necessary to provide for ready cash at the client's death. If the client's estate consists of interests in closely held businesses and real estate, it may be difficult to sell such interests or real estate at a fair market value in time to pay the federal estate tax and other debts and administration expenses due after the client's death. Although the payment of estate tax can be deferred for up to one year for reasonable cause, up to ten years for undue hardship, and up to 14 years if more than 35% of the federal gross estate consists of interests in closely held business interests,[1] the client's estate may not qualify for the deferral or the client may not want his or her beneficiaries to be saddled with the complexity and on-going estate administration that may be necessary if the deferral provisions are elected.

Because of the unlimited marital deduction which applies to descendants dying after 1981,[2] in many estate planning situations there will be no federal estate tax due until the death of the surviving spouse. Consequently, the need for liquidity will not arise until such time. Recognizing this major change in the estate tax law, insurance companies began to market a policy known as last-to-die or survivorship insurance. The death benefit under such a policy is only payable at the death of the survivor of two or more persons. In most cases, the insureds are the husband and wife. Because the death benefit is not payable until the death of the survivor, the premium on the same amount of death benefit will be less for a last-to-die policy than for a policy on one life. That is not to say that a last-to-die policy is cheaper than a single life policy. Since actuarially the survivor's death will occur at a date later than the death of the single insured, premiums will be paid for a longer period of time. In addition, if a single life policy is taken out on the life of each spouse, at the death of the first spouse the survivor will have proceeds for other purposes, including purchasing additional life insurance. In fact, many life insurance companies will allow the surviving spouse who is the beneficiary of insurance on the life of the first spouse to die to purchase a certain amount of insurance with minimal medical requirements.

The advisor will play a more important role when reviewing the recommended amount of life insurance needed to provide liquidity. Here the advisor will be able to determine with some certainty the amount of insurance needed to pay the estate taxes based on assumptions such as when the client will die and what size estate the client will have. In addition, the advisor should point out to the client alternatives to using life insurance to provide for liquidity, including the installment payment of the estate tax if the estate qual-

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[1] I.R.C. §§ 6161(a)(2), 6166(a); Treas. Reg. § 20.6161-1(a)(1) (as amended in 1975).
[2] *See* I.R.C. § 2056.

ifies, borrowing from lending institutions, or using liquid assets that may be available. In many cases, because of the favorable income tax treatment of life insurance and the ability to exclude the proceeds from the insured's estate, life insurance may prove to be the better alternative.

4. Business Uses

Life insurance also plays an important role in preserving a client's business. First, life insurance can be used to provide funds for a buy-out of a deceased owner's interest in the business. Second, life insurance proceeds can be used to help a company overcome the loss of a key employee who may have been important to the operational success of the company. In other cases, a deceased owner may have been the individual with sufficient credit standing to permit the company to borrow funds necessary for the operation of the business. Life insurance proceeds payable to the company would reduce or eliminate the need for credit. Finally, the client may want to provide life insurance as a fringe benefit to the employees of the business. Such fringe benefits include split-dollar insurance arrangements, group-term insurance, and life insurance protection through qualified retirement plans.

5. Conclusion

In conclusion, life insurance plays a vital role in financial and estate planning. The advisor must be familiar with the various life insurance products available on the market, the non-tax considerations that affect the client's decision on how much insurance to buy, what type of insurance to buy, and who should own the insurance, and the income and transfer tax consequences of purchasing and owning life insurance. If the advisor is not going to become familiar with life insurance products, he or she should develop relationships with a number of knowledgeable life insurance professionals to assist him or her in counseling clients with respect to life insurance.

B. Terminology

1. Basic Terms

The advisor must be familiar with the terms used in life insurance policies and proposals if he or she is going to properly advise the client. The <u>insured</u>, of course, is the individual whose death will obligate the insurance company (referred to sometimes as the <u>insurer</u>) to pay the <u>death benefit</u> to <u>beneficiaries</u> of the policy. Note that the death benefit may be more or less than the <u>face amount</u> of the policy, which is the stated amount of proceeds payable on the death of the insured under the terms of the policy. The death benefit will be greater than the face amount if there are paid-up additions or one-year term insurance purchased with dividends payable on the policy or if there is an accidental death benefit rider and the insured died in an accident. The death benefit may be less than the face amount of the policy if there are loans secured by the policy at the insured's death.

The <u>primary beneficiary</u> or <u>beneficiaries</u> are designated by the <u>owner</u> of the policy, who in many cases will be the insured. If the insured has transferred ownership of the policy to a trust or an individual, the trust or the individual, as the new owner, will have the right to name the beneficiary. In addition, if the insurance is purchased by someone other than the insured, the original owner, not the insured, will have the right to name the beneficiary. The primary beneficiary will be the individual or entity entitled to the policy proceeds if alive or existing at the time of the insured's death. There will usually be a <u>contingent beneficiary</u> or <u>beneficiaries</u> entitled to receive the proceeds if the primary beneficiary is not alive or in existence. For example, the individual may name his or her spouse as the primary beneficiary and a trust for the benefit of his or her children as the contingent beneficiary.

The <u>applicant</u> is the individual who signs the application for the policy, and is often the insured. The applicant will be the original owner of the policy, but may not be the current owner of the policy. The applicant can be an individual, a corporation, partnership, trust or any other entity. However, if the applicant is not the insured, the applicant must have an <u>insurable interest</u> in the insured. For example, a close relative or a business associate will generally have an insurable interest in the insured.

The owner who may not necessarily be either the insured or the original applicant, is the person who possesses economic rights with respect to the policy. In some cases, there may be more than one owner. The economic rights with respect to a life insurance policy are often referred to as <u>incidents of ownership</u>. These include the right to name the beneficiary, to surrender or cancel the policy and receive the cash value, to borrow money from the insurer using the contract as collateral, to select settlement options such as lump sum installments over a period certain, and to sell the policy to someone else.

As suggested earlier, there may be more than one owner. Two or more individuals may have equal rights with respect to each incident of ownership, or one may be entitled to a portion of the cash value or proceeds but not have any other incidents of ownership. This is the typical situation in a split-dollar life insurance arrangement where, at the insured's death, the employer or some other person is entitled to receive the premiums it has paid on the life insurance policy and the employee or some other person is entitled to receive the balance of the death benefit.

2. Riders

A life insurance policy may include one or more riders. For example, one rider provides for twice the face amount to be paid to the beneficiary of the policy if the insured dies in an accident. While seemingly a real boon to the beneficiaries of the insured, the possibility of twice the face amount being paid is not useful in estate planning since it is extremely unlikely that an insured will die in an accident. The unlikelihood that the insurance company will have to pay double the death benefit is the reason why the <u>double indemnity rider</u> is so inexpensive.

Another type of rider is a <u>disability rider</u>, which provides for the continuing payment of premiums on a life insurance policy if the insured becomes disabled. Because a disability rider is in effect a type of disability insurance, the cost of a disability rider should be compared to the cost of a disability insurance policy.

3. Dividends

An owner of a life insurance policy issued by a mutual insurance company, which is a company that is owned by its policyholders, will usually receive dividends on an annual basis based on the profitability of the life insurance company. A stock life insurance company, which is owned by stockholders rather than the company's policyholders, may also provide a similar benefit through a reduction in premiums or provide additional benefits under the policy based on the profitability of the company.

The policy owner generally has a number of options available for the dividends. First, the owner may simply receive the dividends, which will not be subject to income tax until the amount of dividends received exceeds the owner's basis in the policy, which is usually equal to the total premiums paid in the past less dividends that have been distributed to the owner or owners of the policy.[3] Second, the owner may leave dividends with the insurance company to accumulate with interest; however, the interest will be taxable to the owner currently if the owner can withdraw the interest at any time.[4] Third, the owner can use the dividends to reduce future premiums. Fourth, the owner may use the dividends to buy paid-up insurance, which is insurance that will not require any additional premiums to continue the policy in force until the insured dies or the policy is surrendered. Finally, the owner may use the dividends to purchase additional one-year term insurance. This is a popular option in split-dollar life insurance arrangements because the one-year term insurance proceeds can be used to satisfy the amount payable at death to the person, usually the insured's employer, who is entitled to receive the amount of premiums such person has paid when the policy is canceled or when the insured dies. In most financial and estate planning contexts, it is usually advisable for the owner to use the dividends to buy either paid-up permanent insurance or one-year term insurance, because doing so will increase the amount of death benefit under the policy, usually at favorable premium rates.

C. Types of Policies

1. Term Life Insurance

There are a number of types of life insurance policies available today. The following discussion will cover only those that are most important in financial and estate planning. The easiest type of life insurance to understand is term life insurance. It is pure insurance in the sense that the only benefit the policy provides is a death benefit upon the death of the insured. There is no cash value. If the term insurance is renewable, then the owner of the policy has the right to renew the policy each year regardless of the health of the insured. However, as the insured grows older, the annual premium will increase to reflect the greater likelihood the insured will die during that year. Also, the policy may no longer be renewable after the insured reaches a certain age, such as 65 or 70. In some cases, where the term policy is for a term of more than one year, the premiums may be level over the period; that is, the annual level premium is the average of the premiums that

[3] Treas. Reg. § 1.72-11(b)(1) (as amended in 1986).

[4] *Cohen v. Commissioner,* 39 T.C. 1055 (1963), *acq.,* 1964-2 C.B. 4.

would have been paid during the term on an annual renewable term policy, taking into account the time value of money. Such extended term policies are usually issued for five or ten years at the most.

The appropriate premium to charge for a term life insurance policy is determined actuarially based on how many people the same age as the insured will die during a given year. The term policy premium is calculated by determining the amount the insurance company needs to charge per $1,000 of death benefit in order to provide the death benefits due the beneficiaries of those individuals the same age as the insured who will die during that year. The insurance company will then add to this amount an additional sum for expenses, state premium taxes, commissions to the insurance sales person, and a reasonable profit. As mentioned earlier, at any given age, an individual will be able to buy more term insurance for the same premium dollar than permanent insurance, or to put it another way, a given amount of death benefit will be cheaper in a newly issued term policy than in a newly issued permanent policy. If insurance is needed for a short period of time, term insurance may be the more economical choice. On the other hand, for long-term needs, such as funding a buy-sell agreement or providing liquidity to an estate, some type of permanent insurance may be a better choice. Although the annual premium can increase in certain types of permanent policies, in a traditional whole life insurance policy the premium will remain constant over the life of the policy. Consequently, the insured can be certain of the amount payable on his or her death as long as he or she pays the same amount of premium each year until he or she dies. The same certainty would not apply in the case of term insurance. First, the premiums will increase as the insured ages, and secondly, once the insured reaches a certain age, he or she may not be able to continue the insurance coverage if he or she has developed health problems.

One type of term insurance is <u>decreasing term</u>, which is often used in connection with a mortgage or some other debt. The amount of insurance coverage declines as the amount of the debt declines. However, it is usually preferable to buy a traditional term insurance policy rather than decreasing term, since the commissions payable on decreasing term and the administrative costs are often substantially higher than on traditional term.

2. Whole Life Insurance

The most traditional type of permanent insurance is <u>whole life insurance</u>, often referred to as <u>ordinary life</u> or <u>straight life</u>. The annual premium for a whole life policy is determined by averaging the premiums that would have been payable over the life of the policy from the date the policy is issued until the insured reaches a certain age, such as 95 or 100. If the premium is paid on a monthly or quarterly basis, it will be increased to reflect the time value of money.

Because the premiums paid in the early years are substantially higher than the actuarial risk to the insurance company, the balance is credited to a <u>reserve account</u> on the insurance company's books. This reserve account reduces the amount for which the insurance company is at risk in future years, and increases each year as a result of earnings credited to the reserve account and additional amounts added to the reserve account when additional premiums are paid. The cash value of the policy, which is related to but not exactly equal to the reserve account, is available as collateral for loans and will be paid to the insured if the policy is surrendered. In some types of policies, the cash value may actually be withdrawn by the insured.

3. Endowment Contracts

Another type of permanent insurance is an endowment contract. Not often used today, an endowment contract was used in the past to provide for retirement income, because an endowment contract "endows" at a much earlier age than a traditional whole life policy. For example, a $20,000 endowment contract policy may endow when the insured reaches age 65. The insured would then have the option of withdrawing the $20,000 or using it to pay for an annuity over his remaining life or some other period. If the insured dies before reaching age 65, the $20,000 face amount would be paid to the insured's beneficiaries. Because premiums are paid for a much shorter period on an endowment contract, the premiums are substantially higher than on a traditional whole life policy.

4. Universal Life Insurance

A more recent type of permanent insurance is universal life insurance, which became popular in the 1980s. The universal life insurance policy adopts, in a fashion, the concept of buying term insurance and investing the difference between the premium on the term insurance and the premium that would have been payable on a traditional whole life insurance policy. Under a universal life policy, part of the premium is used to pay the mortality cost for the year based on the insured's age, and the balance is credited to an investment account. The investment account earns interest and will be charged in the future for mortality costs to the extent premiums are not paid. The insured/owner has the flexibility of paying higher premiums to increase the investment account, or reducing premiums, which will mean that the mortality cost will be paid from the investment account rather than by current premiums. Once the amount in the investment account is no longer sufficient to pay the mortality costs and other expenses, the policy will lapse unless the owner pays a premium equal to these amounts.

While universal life insurance was very popular in the '80s when the insurance companies could base projected cash values on the high rates of interest prevailing at the time, when these high interest rates did not last many owners were faced with increased premiums in order to maintain the policies in force. This often caused the owner to cancel the insurance policy, or to replace it with either a better performing universal life policy or a traditional whole life policy. Consequently, many advisors believe that a traditional whole life policy provides more certainty when it is important for the required amount of death benefit to be payable at the insured's death and for the premiums to remain constant. In a traditional whole life policy, the annual premium can never be increased over the stated amount in the policy. It is true that, in some cases, an agent's whole life policy proposal will show a reduction in the annual premium or even the termination of premium payments (often referred to as vanishing premiums) based on projected dividends and increases in cash value that will eventually provide sufficient annual dividends to pay the annual premiums. Unfortunately, like the projections for universal life insurance, these projections often prove to be overly optimistic and the premiums never vanish.

5. Variable Life Insurance

Another variation of permanent insurance is variable life insurance. Variable life insurance can be either variable with respect to the death benefit or the premiums payable. Under a variable life insurance policy, the premiums are deposited into an investment account chosen by the owner. The investment account may be a money market fund, a bond fund, a stock fund, or some other investment fund. The owner receives the benefit of the investment return in the fund, after deducting expenses charged by the insurance company and the insurance company's profit, and the charge for the life insurance protection. Because either the premium or the death benefit is subject to investment risk, a variable life policy has disadvantages similar to a universal life policy. However, if the purpose for purchasing the life insurance policy is to replace investments that have been placed in a charitable remainder trust, using variable insurance held in an irrevocable life insurance trust may be an appropriate way to replace the investments that would have gone to the insured's non-charitable beneficiaries at the insured's death if they had not been contributed to the charitable remainder trust.

6. Survivorship Insurance

A life insurance product that pays the death benefit only at the death of the survivor of two or more insureds is referred to as survivorship or last-to-die insurance. Usually payable on the death of the survivor of a husband or wife, it may be either term or permanent insurance. Because the unlimited marital deduction permits most couples to defer the payment of estate tax until the survivor dies, the fact that survivorship insurance is not payable until such time as the proceeds are usually needed to pay estate taxes is appealing. Although the annual premium on the same amount of life insurance coverage in a last-to-die policy will be less than the annual premium on a policy covering one life, theoretically the present value of the premiums payable under either type of policy should be the same.

D. Employer-Provided Insurance

1. Group-Term Insurance

Because many employees view life insurance as an important fringe benefit, perhaps one of the most common employee benefits is group-term insurance. Under a group-term insurance plan, the employer pays premiums for term life insurance coverage on its employees. The employer obtains an income tax deduction for the amount of the premiums it pays each year,[5] and the employees only report as income the economic value of the annual coverage in excess of $50,000 provided under all group-term insurance programs in which each employee participates.[6] The amount the employee takes into income is based

[5] I.R.C. § 162(a)(1).
[6] I.R.C. § 79(a).

on a table contained in the regulations, rather than the actual cost of the insurance to the employer.[7] However, if the plan discriminates in favor of key employees, which are either highly compensated employees or employees owning a certain interest (such as shares of stock) of the employer,[8] the key employees will report as income the economic value on all coverage provided to them calculated as the higher of the actual cost to the employer or the amount determined under the table in the regulations.[9]

2. Split-Dollar Insurance Arrangements

A split-dollar insurance arrangement involves a permanent life insurance policy in which generally two individuals or entities pay the premiums. When the policy is surrendered or at the death of the insured, one of the parties will be entitled to receive the premiums it has paid on the policy, or in some cases, the cash value of the policy if it is greater than the premiums it has paid on the policy, and the other party or its beneficiary is entitled to the balance. Split-dollar insurance is not a type of life insurance policy but rather an arrangement with respect to a life insurance policy. Although split-dollar life insurance arrangements are most commonly used in the employer/employee context, split-dollar arrangements may also be made between family members, family members and trusts for the benefit of family members, or a corporation and its shareholders.

In the employer/employee context, there are two basic types of split-dollar arrangements. Under the endorsement method, the employer owns the life insurance policy and an endorsement to the policy provides that part of the death benefit will be payable to the employee's beneficiary. Under the more typical collateral assignment method, the employee, or in some cases an irrevocable trust established for the employee's beneficiaries, owns the policy. The employer has a security interest in the policy equal to the amount it is entitled to receive out of the cash value or death benefit if the policy is surrendered or when the insured dies. Because it is often desirable to undo the split-dollar arrangement at a later date, keeping the policy ownership in the hands of the employee or an irrevocable trust through the collateral assignment method may be more advisable than placing ownership with the employer under the endorsement method.[10]

Under an employer/employee split-dollar arrangement, the employee must include in his or her gross income the value of the economic benefit received under the arrangement, less any part of the annual premium the employee pays. Before January 28, 2002, the employee's economic benefit was equal to the life insurance coverage provided him or her for the year, i.e., the death benefit payable under the policy less the amount the employer was entitled to receive. The value of the life insurance protection under a split-dollar arrangement was the lower of the value determined under the so-called PS 58 Table or the premium charged by the issuing insurance company for a standard risk one-year re-

[7] I.R.C. § 79(c).
[8] I.R.C. §§ 79(d)(6), 416(i).
[9] I.R.C. § 79(d).
[10] *See* Chapter Two, ¶ A. *infra* for a discussion of transfer-for-value issues.

newable term policy.[11] Generally, the insurance company's rate was lower than the PS 58 rates. These rates may still be used for arrangements entered into before January 28, 2002. If the split-dollar arrangement involved a last-to-die policy, then it was commonly assumed that the so-called Table 38 rates were to be used instead of the PS 58 rates. The Table 38 rates are based on the probability that both insureds will die in the same year, which is very remote, particularly at younger ages. However, when the first of the insureds dies, the appropriate rate becomes the PS 58 rate, which will be substantially higher than the Table 38 rate.

For arrangements entered into after January 28, 2002 and before September 18, 2003, as well as after September 17, 2003 until additional guidance is issued, the annual cost of life insurance protection will be the lower of the rates under Table 2001, which is set out in the appendix, or the insurer's published premium rates if those rates are available to all standard risks that apply for term insurance. However, the insurer's published premium rates will be considered to be available to all standard risks that apply for term insurance only if the insurer generally makes availability of such rates known to persons who apply for term insurance coverage from the insurer and the insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels.[12]

On September 11, 2003, the Treasury issued final regulations dealing with the tax treatment of split-dollar life insurance arrangements.[13] The final regulations were preceded by Notices 2001-10[14] and 2002-8,[15] and proposed regulations, all of which were designed to curb what the IRS felt were abusive uses of split-dollar life insurance arrangements, including equity split-dollar, reverse split-dollar, and artificially low term rates published by insurance companies solely for the purpose of split-dollar insurance arrangements.

The final regulations (as did the proposed regulations) adopt two mutually exclusive regimes for treating split-dollar life insurance arrangements: an economic benefit regime, where the owner or deemed owner is the employer, corporation, service recipient, or donor, and a split-dollar loan regime, where the owner is the employee, shareholder, service provider, or donee. A split-dollar life insurance arrangement is generally defined as any arrangement between an owner and a non-owner of a life insurance contract under which:

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[11] Rev. Rul. 64-328, 1964-2 C.B.11, as amplified by Rev. Rul. 66-110, 1966-1 C.B. 12.
[12] Notice 2002-8, 2002-1 C.B. 398.
[13] Treas. Reg. §§ 1.61-22 (dealing with the definition of split-dollar arrangements, determining which regime applies, and describing the economic benefit regime), 1.1402(a)-18 and 1.7872-15 (dealing with the split-dollar loan regime and amendments to Treas. Reg. §§ 1.61-2, 1.83-1, 1.83-3, 1.83-6, 1.301-1, and 1.3401(a)). See Joshua E. Husbands and J. Alan Jensen, Split-Dollar Life Insurance Funding: You Mean People Still Do That, *Probate and Property*, May/June 2008, Vol. 22 No. 3, pages 40-47, for a discussion of the status of split-dollar insurance arrangements after the final regulations.
[14] 2001-1 C.B. 459.
[15] 2002-1 C.B. 39859.

(1) Either party to the arrangement pays, directly or indirectly, all or any portion of the premiums on the life insurance contract, including a payment by means of a loan to the other party that is secured by the life insurance contract;

(2) At least one of the parties to the arrangement paying premiums is entitled to recover, either conditionally or unconditionally, all or any portion of those premiums and such recovery is to be made from, or secured by, the proceeds of the life insurance contract; and

(3) The arrangement is not part of a group-term life insurance plan described in I.R.C. § 79 unless the group-term plan provides permanent benefits.

The owner of a life insurance contract is the person named as the policy owner, except if two or more persons are named as policy owners of a life insurance contract and each person has all the incidents of ownership with respect to an undivided interest in the contract, each person is treated as the owner of a separate contract to the extent of such person's undivided interest. However, if, in substance, any rights, benefits, or obligations are shared to any extent among the holders of such interests, the arrangement will be treated as a split-dollar arrangement. If two or more persons are named as policy owners of a life insurance contract but each person does not have all the incidents of ownership with respect to an undivided interest in the contract, the person who is the first-named policy owner is treated as the owner of the entire contract.

An employer, service recipient or donor is treated as the owner of a life insurance contract under a split-dollar life insurance arrangement that is entered into between the employer, service recipient or donor, and an employee, service provider or donee (for example, a life insurance trust) if at all times the employee, service provider, or donee is only entitled to current life insurance protection (including paid-up additions thereto). Therefore, under a traditional collateral assignment split-dollar life insurance arrangement, where the only benefit received by the employee, service provider or donee is life insurance protection, the employer, service recipient or donor is treated as the owner (and the economic benefit regime applies).

As an employee who is a participant in a split-dollar insurance arrangement grows older, the value of the economic benefit on which the employee is taxed increases until it eventually exceeds the premium paid by the employer on the policy. At this point it is no longer financially beneficial to the employee to participate in the split-dollar arrangement since he or she would then be better advised to receive the premium amount directly from the employer as compensation income and use it to pay the premium directly, as opposed to being taxed on the higher economic value of employer-paid premiums. There have been a number of ways suggested to undo a split-dollar arrangement. For example, the employer could simply transfer its rights to the employee as additional compensation. To avoid the attendant recognition of compensation income by the employee as a result of the transfer, the employer could first borrow the amount it is entitled to receive under the arrangement and then transfer any remaining rights, which presumably would have close to a zero value, to the employee, thus terminating the arrangement. Once the split-dollar arrangement is terminated, the employee no longer has to report any economic benefit as income. If the employee has transferred the ownership of the policy to an irrevocable trust, the employer may transfer its rights directly to the trust, but the employee will still recognize compensation income if those rights have a value. The transfer of the employer's rights to the irrevocable trust may also be a transfer for value, which would cause some of the proceeds to be includible in the trust beneficiary's taxable income,[16] unless the trust is a grantor trust with respect to the insured.

A controversial issue had been the appropriate tax consequences under a so-called equity split-dollar arrangement. Under such an arrangement, the employer is entitled to receive, either when the policy is surrendered or at the employee's death, only the premiums it has paid. Consequently, once the cash value of the policy exceeds the amount of premiums the employer has paid, the employee becomes entitled to part of the cash value. Whether and when the employee had to include in income the value of his or her interest in the policy's cash value was not clear. The Internal Revenue Service ("IRS") had taken the position in a technical advice memorandum ("TAM") that the employee must report the incremental value of his or her interest in the policy's cash value as additional income each year.[17] If the employee transferred ownership of the policy to a trust or another individual, any subsequent increase in the new owner's interest in the policy's cash value was also treated as a taxable gift by the employee to the new owner.[18] However, under the final regulations dealing with split-dollar life insurance arrangements, any equity in the policy will be currently taxed to the employee under the economic benefit regime, and in the split-dollar loan regime, the employee is taxed on the imputed interest on the loan deemed to be made by the employer when it pays each premium and not on the economic benefit the employee is entitled to.

If the employer in a split-dollar arrangement is an S corporation for federal income tax purposes, i.e., a corporation that has elected to have its earnings taxed to its shareholders, the issue arises whether a split-dollar arrangement with a shareholder, whether or not the shareholder is an employee of the corporation, creates a separate class of stock. In order for a corporation to be eligible for S corporation status, it may only have one class of stock, although it may have voting and non-voting stock.[19] Under the one-class-of-stock requirement, all shareholders must be entitled to receive distributions, either in the form of dividends or liquidating distributions, based on the number of shares they own and the portion of the taxable year during which they owned their shares.[20] While the economic benefit provided to a shareholder under a split-dollar arrangement could be viewed as a disproportionate distribution of the earnings of the corporation, the IRS held in a private letter

[16] *See* Chapter Two, ¶ A. *infra*.
[17] TAM 9604001 (Sept. 8, 1995).
[18] *See* Rev. Rul. 81-198, 1981-2 C.B. 188.
[19] I.R.C. § 1361(b)(1)(D), (c)(4).
[20] Treas. Reg. § 1.1361-1(1) (as amended in 1995).

ruling ("PLR") that a split-dollar arrangement involving an S corporation did not create a second class of stock where the trustee of the trust owning the policy insuring a shareholder of the corporation was required to reimburse the corporation for the value of the economic benefit enjoyed by the trust under the arrangement.[21]

A variation of the traditional split-dollar insurance arrangement is the so-called <u>reverse split-dollar</u> insurance arrangement. Under a reverse split-dollar insurance arrangement, the employer, usually a corporation, is responsible for paying the cost of the life insurance coverage and is entitled to receive the difference between the cash value and the death benefit when the employee dies and the employee's estate or irrevocable trust to which the employee assigned his or her rights under the arrangement is entitled to the cash value. Although the employee would usually pay a greater portion of the premium than the employer if the arrangement had the same terms as a traditional split-dollar arrangement, thereby resulting in little economic benefit to the employee, under the reverse split-dollar insurance arrangements that were being marketed, the employer paid substantially more than the actual cost of the life insurance coverage, and the employee paid correspondingly less than he or she would pay under a traditional split-dollar arrangement. For example, the employer may pay the higher of the PS 58 rate or the standard risk one-year renewable term cost, rather than the lower of the two. In addition, the employer may pay an unscheduled premium or pay a premium based on a level annual premium over a period of time, resulting in a larger cash value, which under the arrangement would belong to the employee, not the employer.

In response to what it perceived as an abusive use of inappropriately high current term insurance rates in connection with reverse private split-dollar arrangements, the IRS issued Notice 2002-59[22] on August 19, 2002. The notice provides that a party participating in a split-dollar life insurance arrangement may use the premium rates in Table 2001 or the insurer's lower published premium rates only for the purpose of valuing current life insurance protection for federal tax purposes when, and to the extent, such protection is conferred as an economic benefit by one party on another party, determined without regard to consideration or premiums paid by such other party. Thus, if one party has any right to current life insurance protection, neither the premium rates in Table 2001 nor the insurer's lower published premium rates may be relied upon to value such party's current life insurance protection for the purpose of establishing the value of any policy benefits to which another party may be entitled.

For example, if a donor pays the premiums on a life insurance policy that is part of the split-dollar life insurance arrangement between the donor and a trust, and, under the arrangement, the trust has the right to current life insurance protection, the current life insurance protection has been conferred as an economic benefit by the donor on the trust, and the donor is permitted to value such current life insurance protection for federal tax purposes using either the premium rates in Table 2001 or the insurer's lower published premium rates.

[21] PLR 9735006 (May 20, 1997).
[22] 2002-2 C.B. 481.

In contrast, if a donor pays the premiums on a life insurance policy that is part of a split-dollar life insurance arrangement between the donor and a trust, and the donor (or the donor's estate) has the right to current life insurance protection under the policy, neither the premium rates in Table 2001 nor the insurer's lower published premium rates may be relied upon to value the donor's current life insurance protection for the purpose of establishing the value of the policy benefits conferred upon the trust for federal tax purposes. A similar result is obtained if the trust pays for all or a portion of its share of the policy benefits provided under the split-dollar life insurance arrangement.

Another variation of the traditional split-dollar insurance arrangement is the so-called private split-dollar insurance arrangement. Under the private split-dollar insurance arrangement, the parties to the agreement may be family members or a family member and a trust created for the benefit of other family members.[23] For example, a wife may take the role of employer and the husband the role of employee and insured. The husband's interest under the arrangement would either be initially owned by an irrevocable trust or transferred to an irrevocable trust. The trust would pay the part of the premium equal to the cost of the life insurance protection provided during the year, and the wife would pay the balance. The wife would be entitled to receive the premiums she has paid when the policy is surrendered or when the insured dies. The balance of the cash value or death benefit would be payable to the trust. The benefit of such an arrangement is that the couple has access to the cash value of the policy because of the wife's ability to withdraw or borrow the cash value. A disadvantage of such an arrangement is that the cash value, to the extent of the wife's interest, will be included in the wife's estate if she dies during the insured's lifetime, or, if she dies after the insured dies, any proceeds she received at the insured's death that have not been consumed will be included in her estate. The wife can have incidents of ownership in the policy without causing the proceeds to be included in the husband's estate, because, unlike a corporation controlled by an employee, incidents of ownership are not attributable from one spouse to another.[24]

Because private split-dollar insurance arrangements have only been approved by the IRS in private letter rulings that cannot be relied on as precedent,[25] caution should be used before recommending them to clients. Note that in most cases where traditional split-dollar insurance arrangements are called for and the policy is owned by a trust, access to the cash value is generally not needed by the employee because the employee is usually in a fairly secure financial situation. In addition, an irrevocable trust designed to hold life insurance can be structured such that the transaction can be unwound at a later date, for example, through the exercise of a special power of appointment. Nonetheless, an individual may not have an employer to participate in a traditional split-dollar insurance arrangement and may wish to keep the value of the economic benefit provided to the trust as low as possible for gift tax purposes by tying the value of the gift to the rate determined under Table

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[23] *See* PLR 9745019 (Aug. 8, 1997), PLR 9636033 (Mar. 12, 1996).

[24] Incidents of ownership held by a corporation are attributed to a controlling shareholder (a shareholder who owns more than 50% of the voting stock) if the proceeds are not payable to or for the benefit of the corporation. Treas. Reg. § 20.2042-1(c)(6) (as amended in 1979).

[25] *See supra* n. 19.

2001 or the insurer's published premium rates if those rates are available to all standard risks that apply for term insurance. In this case, a private split-dollar may be the only way to achieve this objective.[26]

3. Retirement Plans

Often employers sponsor qualified retirement plans for the benefit of their employees. The employer receives a deduction for its contribution to the plan and the employee only reports income when he or she actually receives distributions from the plan at retirement or at some other time specified in the plan.[27] In addition, there is no current income tax on the earnings from the plan's investments.[28] To prevent the use of qualified retirement plans for other than retirement benefits, there is a limitation on the amount of life insurance that can be held in the qualified retirement plan for the benefit of participants.[29]

In a defined benefit plan, the participant receives, once he or she reaches retirement age, a regular monthly payment usually based on his or her compensation during his or her working career and the number of years the employee has participated in the plan. The maximum amount of insurance that can be provided in such a plan for a participant is 100 times the monthly benefit the participant is expected to receive when he or she retires.[30] In a defined contribution plan, such as a money purchase pension plan or a profit-sharing plan, where amounts are allocated annually to each participant's account, usually based on the participant's compensation, premiums paid for life insurance on the participant's life must represent less than 50% of the value of the participant's account.[31] However, there is no limit on the amount of a participant's own voluntary contributions that can be used to pay for life insurance[32] and, in a profit-sharing plan, amounts that are currently withdrawable by the participant under the terms of the plan may be used to purchase life insurance without limitation.[33]

A participant in a qualified retirement plan must include in income the economic value of the life insurance protection provided under the plan.[34] This amount is based on

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[26] See PLR 200825011, where the IRS blessed a private split-dollar insurance arrangement between a husband and wife and an irrevocable trust for the benefit of their children. The agreement was entered into after the final regulations became effective. The trust purchased a second-to-die life insurance policy insuring the lives of the couple. Because the only economic benefit provided to the trust was life insurance protection, the husband and wife were treated as the owners of the policy and the economic benefit regime applied. According to the IRS, the life insurance proceeds payable at the death of the surviving spouse will not be included in the surviving spouse's estate, although the amount the survivor's estate receives out of the proceeds (the greater of the cash value or the premiums paid by the couple) will be included in the survivor's estate.

[27] I.R.C. §§ 404(a)(1), (3), (6); 402(a).

[28] I.R.C. § 501(a).

[29] *See* Treas. Reg. § 1.401-1(b)(i), (ii) (as amended in 1976); Rev. Rul. 54-51, 1954-1 C.B. 147.

[30] *See* Rev. Rul. 61-121, 1961-2 C.B. 65.

[31] *See* Rev. Rul. 74-307, 1974-2 C.B. 126; Rev. Rul. 54-51, 1954-1 C.B. 147.

[32] Rev. Rul. 69-408, 1969-2 C.B. 58.

[33] *See* Rev. Rul. 61-164, 1961-2 C.B. 99.

[34] I.R.C. § 72(m)(3)(B).

the excess of the death benefit provided by the life insurance policy or policies in the plan covering the participant over the cash value of the policy or policies, which are treated as any other plan investment on behalf of the participant.[35] The value of the death benefit is the lower of the rate determined under Table 2001, which is set out in the appendix, or the insurer's published premium rates if those rates are available to all standard risks that apply for term insurance.[36] A participant will not report any taxable income as a result of life insurance held in the plan if the proceeds are simply paid to the plan and used to provide benefits for all participants in the plan, not just the insured.[37] The IRS has ruled that a profit-sharing plan may purchase insurance on the life of someone other than the participant with amounts in the participant's account, but only insurance on the participant's life can be purchased with the participant's account in a money purchase pension plan.[38] The difference between a profit-sharing plan and money purchase pension plan is that the annual contribution to a money purchase pension plan (usually a percentage of each participant's annual compensation) is a fixed obligation of the employer, whereas the contribution to the profit-sharing plan is made at the discretion of the employer.

If the employee survives to retirement, the employee may receive the life insurance policy as part of the employee's benefit under the plan. In such a case, the employee will report as taxable income the value of the policy less the amount the employee has taken into income as a result of the life insurance coverage while the policy was held in the plan.[39] However, there is no current taxable income if the policy is converted to an irrevocable annuity, with no life insurance element, within 60 days after the distribution.[40] The employee reports the annuity payments as taxable income to the extent they are not considered a return of the employee's basis in the contract, which would generally be the amount reported as income because of the life insurance protection while the employer participated in the plan.[41] Although an employee can also avoid taxable income if the policy is rolled over to another qualified plan within 60 days,[42] a life insurance policy cannot be rolled into an individual retirement account (IRA).[43] If the employee dies before retiring, the death benefit payable to the employee's beneficiary will be excluded from the beneficiary's taxable income to the extent the death benefit exceeds the cash surrender value of the policy.[44]

Final regulations issued on August 9, 2005 require that the value of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection must be valued at the fair market value of the contract for purposes

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[35] *See id.*; Treas. Reg. § 1.72-16(b)(2), (3) (1963).
[36] Notice 2002-8, 2002-1 C.B. 398.
[37] *Cf.* Treas. Reg. § 1.72-16(b)(1), (6).
[38] *See* Rev. Rul. 69-523, 1969-2 C.B. 90; PLR 8426090 (Mar. 29, 1984).
[39] I.R.C. §§ 72, 402(a); Treas. Reg. § 1.402(a)-1(a)(2) (as amended in 1994).
[40] I.R.C. § 72(h).
[41] Treas. Reg. § 1.72-16(b)(4).
[42] I.R.C. § 402(c).
[43] I.R.C. § 408(a)(3).
[44] *See* I.R.C. § 72(m)(3)(C); Treas. Reg. § 1.72-16(b)(1), (c)(2)(ii).

of I.R.C. § 79, dealing with a group term insurance plan that provides benefits in addition to term insurance; I.R.C. § 83, dealing with the transfer of property in exchange for services; and I.R.C. § 402(a), dealing with the taxation of distributions from a qualified retirement plan.[45] Revenue Procedure 2005-25[46] provides safe harbors for determining the fair market value of such contracts.

E. Information Needed for Planning

1. Essential Facts

In order to properly advise a client with respect to life insurance, the advisor will need to obtain the following information concerning each policy insuring the client's life:

a. The insurance company;
b. The policy number;
c. The type of insurance;
d. The face amount of the insurance and the amount of death benefit, if different;
e. The owner and any successive owners of the policy;
f. The beneficiary and any contingent beneficiaries;
g. Any outstanding loans and the repayment terms and interest rate;
h. The amount of premium and when paid;
i. The dividend option selected if dividends are payable on the policy;
j. Information on any riders; and
k. The identity of the applicant.

2. Obtaining Information; Beneficiary Designations

The above information can usually be obtained from the policy itself, and in particular, from the application form for the insurance, a copy of which is usually attached to the policy. However, this information should be verified directly with the insurance company because the application could be incorrect or the information could have since changed. For example, the ownership of the policy could have been transferred after the policy was first issued, the beneficiary could have been changed, the death benefit payable under the policy could be different from the face amount stated in the policy, the amount of any policy loan would not be reflected in the policy or the application, and, with respect to policies providing for flexible premium payments, more or less than the stated premium could have been paid since the policy was first issued. Also, because it is likely in many cases that as a result of estate planning, the beneficiary designations or even ownership of the policy will need to be changed, beneficiary and ownership change forms should be requested from the insurance company. While many insurance companies will accept standard forms for these purposes, it is usually more efficient to use the particular insurance

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[45] Treasury Decision 9223.
[46] 2005-17 I.R.B. 962.

company's own forms. In addition, if the ownership of the policy is to be transferred, an IRS Form 712, Life Insurance Statement, should be requested from the company, which will provide the current value of the policy, taking into account any outstanding policy loans. A Form 712 will also show the premiums paid to date on the policy, therefore the owner's tax basis can often be determined. However, if the policy was not purchased by the current owner, the basis of the policy in the hands of the current owner may be different than the amount of premiums that have been paid.