SOPHISTICATED LIFE INSURANCE TECHNIQUES

ABA SECTION OF TAXATION
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MARY ANN MANCINI, ESQ.
BRYAN CAVE LLP
WASHINGTON, DC

LAWRENCE BRODY, ESQ.
BRYAN CAVE LLP
ST. LOUIS, MISSOURI

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A. General.

1. Alternatives.

(a) Loans to pay premiums on a life insurance policy (premium financing) can, in general, take two forms – loans that bear interest, at the Applicable Federal Rate (the "AFR") and those that don't.

(i) Loans that bear interest at the AFR will generally not be governed by Section 7872; those that don't will be.

(b) Loans that bear interest at the AFR can also take two forms – loans that provide for payment of interest on a current (annual) basis and those that accrue interest at the AFR and pay it with principal at the end of the term of the loan.

(i) Each has different tax and economic consequences, as discussed below.

(c) Loans that don't bear interest at the AFR can take three forms – demand loans, term loans, and so-called "hybrid" loans, each of which also has different economic and tax consequences, as also discussed below.

(i) These loans, known as interest-free loans – technically, below-market rate loans are governed by Section 7872, which has the effect of imputing interest at the AFR, for both income and gift (and, where appropriate, GST) tax purposes.

(ii) For interest-free <u>demand</u> loans, the interest is imputed for tax purposes on an annual basis, at the short-term AFR (which changes monthly, but can be averaged annually).

(iii) For interest-free <u>term</u> loans, the interest is imputed at the short-term, mid-term, or long-term AFR (depending on the term of the loan) and is fixed for the term of the loan, <u>but</u> all of the interest over the expected term of the loan, discounted back to present value, is imputed in the year of the loan.

(a) Making them impractical, in nearly every situation.

(iv) Interest-free hybrid loans have characteristics of both demand and term loans.

(a) Gift term loans are one form of hybrid loans.

(1) They are treated, for purposes of imputing interest for income tax, but not for gift tax purposes, as demand loans, but the AFR is fixed, and is determined based on the stated term of the loan.

(2) Because that exception doesn't apply for gift purposes, gift term loans are treated as term loans for gift purposes, again, making them impractical.

(b) Under the still proposed Section 7872 regulations, applicable to interest-free loans in general (having nothing to do with split-dollar arrangements) and to pre-final split-dollar regulation arrangements, only compensation term loans that end with employment are treated as hybrid loans – loans based on life expectancy are, under those proposed regulations, treated as term loans.

(c) However, under the final split-dollar Section 7872 regulations (which, as noted below will apply to premium financing arrangements entered into or materially modified after the effective date of the final regulations), both compensation term loans that terminate with employment and term loans where the term is determined by life expectancy are treated as hybrid loans.

(1) Both of these kinds of loans should be treated as described above for income tax purposes.

(2) But note that they appear to be treated for gift tax purposes as gift term loans – again, making them impractical.

(v) As discussed below, as a practical matter, these rules will mean, in most cases, that only demand interest-free loans, term compensation loans, or loans that are due at the insured's death will make sense for income tax purposes.

(a) Note again the issue of whether hybrid loans will be treated as term loans for gift tax purposes.

(vi) As also discussed below, interest-bearing term loans (with interest paid or accrued at the AFR) could also make sense, to lock in today's rate for the term of the loan.

(a) Note, however, the impact of the provisions of the final split-dollar regulations, discussed below, if the lender and the borrower are related and the lender is "to pay" the interest amount to the borrower, if the interest is to be forgiven, or if the arrangement is non-recourse.

(d) Under the final split-dollar regulations, any post-September 17, 2003 premium financing arrangement (or any prior arrangement "materially modified" thereafter), will meet the broad definition of a "split-dollar loan," meaning it will be governed by the complex Section 7872 rules, unless it provides for the payment or accrual of interest at the AFR.

(i) Under one of the unusual rules of the regulations, <u>even if</u> the loan provides for adequate interest, it will be treated as an interest-free loan, subject to Section 7872, if the lender is "to pay" the interest, directly or indirectly.

(a) The phrase "to pay" isn't defined, except by examples.

(b) It is a facts and circumstances test.

(c) A bonus plan by an employer to pay the interest or a gift plan by a donor to pay the interest would be subject to this provision; it isn't clear how formal the "plan" would need to be to be nor how "connected" the payment by the lender and the payment of the interest would need to be for the arrangement to be subject to this provision, however.

(d) Does this provision double-tax the interest for tax purposes – once as a direct gift or compensation and once under Section 7872 – or do we literally ignore the actual payment and receipt of interest for tax purposes?

(ii) In addition, if the lender forgives any interest due on the loan, the forgiveness will be taxable (as income or a gift, depending on the relationship of the parties) and a deferral charge (based on the underpayment rate plus 3%) will apply.

(iii) These two rules may lead some clients and advisors to consider recasting a proposed related party loan arrangement as one governed by Section 7872, rather than one that provides for the payment of adequate interest.

(a) Which may have been the intent of these provisions.

(iv) Under another unusual rule of the regulations applicable to <u>both</u> Section 7872 loans <u>and</u> those that provide for adequate interest, if a split-dollar loan is "non-recourse" (an undefined term, which might include a loan to a trust with no assets other than the policy), unless the parties attach statements to their tax returns reflecting the arrangement each year a loan is made, the loan would be treated as providing for contingent interest under Section 7872.

(a) That would complicate the calculation of the imputed interest and increase the risk that interest adequate to avoid the application of Section 7872 is being paid or accrued.

(1) If the contingent interest rules apply, the loan is “imputed,” by calculating the present value of the payments at the AFR and comparing that to the face of the loan – any difference is an imputed transfer when the loan is made.

(b) Clients should be advised to routinely attach these statements to their returns for related party premium financing (as well as loan regime split-dollar) arrangements.

(v) Finally, the regulations provide a required ordering rule for repayments of split-dollar loans, which will prevent the parties from choosing which loans to pay first (perhaps because they have the highest interest).

(a) The rules require repayments go first to accrued interest, in the order it was accrued, then to loan principal, in the order the loans were made.

(vi) Note that in most cases, these rules will only impact related party financing arrangements.

(a) Third party lenders won’t forgive the interest on the loan or provide the borrower with the interest payments, and their loans would normally clearly be recourse (except in the non-recourse, short-term premium financing technique discussed below).

(b) See Temp. Reg. Sec. 1.7872-5T(b)(1), making Section 7872 inapplicable to transactions in the normal course of a lender’s business.

2. Financing Variable Policies – The Possible Application of Federal Reserve Regulation U.

(a) In many cases, if the policy being financed is a variable policy, the loan may be considered a loan to purchase margin stock that is secured, directly or indirectly, by margin stock (the underlying securities in the separate accounts), and will require compliance with Regulation U of the Board of Governors of the Federal Reserve System (the "Board").

(i) According to the Board's Staff, the policy itself isn't margin stock, only the underlying funds.

(ii) If 75% or more of the investments in the policy at the time of the loan are pure bond or money market funds (which are not considered "margin stock"), the loan would not be subject to the loan-to-value limitations of Reg U, but might require the preparation of a purpose statement.

(a) What about a later change in the underlying policy investments, from non-margin to margin securities?

(b) Under 12 C.F.R. Section 221.3(a)(2)(iii), that would appear not to create a margin arrangement, but if the change could be shown to have been contemplated at the outset, as a way to circumvent the rule, it likely would be found to have created a margin arrangement.

(b) Board staff has concluded that a loan to acquire a variable policy by a lender, other than the insurer, is indirectly secured by margin stock, if the policy is pledged as collateral. A loan by the insurer against the policy would not be, since while that loan is outstanding, the separate accounts do not participate in the performance of the underlying investments. FRRS 5-919.111 (1987), reconsidered and confirmed by FRRS 5-917.191 (1988).

(i) Such a loan, to purchase and secured by a variable policy, is "purpose credit" – a loan for the "purpose" (whether immediate, incidental, or ultimate) of purchasing or carrying margin stock under Regulation U. 12 C.F.R. §221.2 and FRRS 5-878.1 (1987)

(ii) A loan used to purchase or carry a variable policy but not secured by the policy would not be considered to be directly or indirectly secured by the policy (unless the policy accounted for a significant portion of the assets of the borrower in violation of the safe harbor rule). If the lender, in good faith, has not relied on the margin stock as collateral in extending the credit, the arrangement is not a margin loan. 12 C.F.R. Section 221.2.

(a) However, a so-called “negative pledge” of the policy – a provision of the loan agreement preventing the owner from pledging or accessing the policy – would likely be enough to treat the policy as having been indirectly pledged for the loan. 12 C.F.R. Section 221.2. Similarly, other covenants that limit the borrower’s actions with respect to the policy (such as requiring prepayments of the loan in certain circumstances, or limiting other debt) might likewise be enough to treat the loan as being indirectly secured by the policy.

(b) For related-party loan transactions, not taking a security interest in the policy (useful for other reasons, as discussed below), would apparently avoid this issue (unless it violated the safe harbor or contained covenants limiting the borrower’s access to the policy).

  (1) What about a loan to a trust which owns nothing but a variable policy – even without a pledge of the policy, is the loan indirectly secured by the margin stock, as a practical matter? Can it be said the lender isn’t, in good faith, relying on the margin stock as collateral? Would it matter if the trust owned other assets, in addition to the policy, or if the loan were guaranteed by the beneficiaries?

  (2) Under the safe harbor rule, if the policy is not more than 25% of the value of the trust, the loan is not a margin loan. 12 C.F.R. Section 221.2. See FRRS 5-917.23. Under

the safe harbor, there is an irrebuttable presumption it isn't a margin loan if the margin securities account for less than 25% of the borrower's assets; above 25%, there is no presumption either way – it is a facts and circumstances test. Would a guarantee of 25% of the loan satisfy this requirement?

(c) What about using only the death benefit as collateral for the loan – would that avoid the issue, since the policy itself isn't margin stock?

(1) As noted above, only the underlying funds are considered margin stock.

(d) What about using an equity indexed universal life policy as an alternative to a variable policy?

(1) They are not treated as securities for securities law purposes.

(2) But see SEC Rule 151A(2008), prospectively treating equity indexed annuities as securities, where it was likely the annuity amounts would exceed the amounts guaranteed under the contract, and also the SEC's position on total return equity swaps.

(c) In order to be considered a "lender" for this purpose, the lender would have to extend credit of $200,000 or more for such purpose in any calendar quarter or have $500,000 or more in margin credit outstanding. 12 C.F.R. Section 221.2 and Section 221.3(b).

(d) Under Regulation U, the amount of any such loan treated as a margin loan will be limited to 50% of the value (at the date of the transaction) of the margin stock securing the loan. 12 C.F.R. §221.3.

(i) For a variable policy acquired with such a loan, it isn't clear whether the value takes into account surrender charges.

(a) In any event, in the early years of the transaction, only a fraction of the premiums could be loaned under this limit.

(ii) Once the loan is made, there is apparently no further requirement under Regulation U to monitor the value of the policy for compliance with the 50% requirement (unless the underlying investments are sold, in which case there may need to be replacement collateral, under 12 FRRS 221.3(f). 12 C.F.R. Section 221.3(a)(2).

(iii) However, each time a loan is made, under a so-called "true-up" provision, the total loan and the then value of the property must meet this test again. 12 C.F.R. Section 221.3(d)(2).

(e) The lender, if not a broker or bank, may have to register with the Federal Reserve, if the loan meets the threshold dollar amount test (unless the loan is outside the "ordinary course of business", which is an extremely narrow exception).

(i) A loan by an employer to allow an employee or his or her trust to acquire a variable policy would likely be considered in the "ordinary course" of the employer's business and require registration. FRRS 5-925.2 (1992).

(ii) A loan by an individual to his or her trust to acquire a variable policy could be considered in the "ordinary course of business" for the management or the preservation of property, although there is no direct authority for that.

(a) Informally, the Staff has confirmed that conclusion.

(iii) A non-bank lender must register with the Board and file annual reports if the lender extends $200,000 of more of credit in a calendar quarter or has $500,000 or more in margin credit outstanding; the lender and the borrower must also keep a purpose statement in their own files (i.e., not filed with the Board, but maintained in the credit file and available to be reviewed by the Board upon request) to disclose the purpose of the credit. 12 C.F.R. Sections 221.2 and 221.3(b).

(f) Accordingly, premium financing will less likely be used with variable policies, especially where third party financing is involved, since there, the policy will always be pledged as collateral.

(i) But the same issue would arise in private financing, where the policy is used as collateral, or may be viewed as indirectly used as collateral if the dollar amount and ordinary course of business tests are met.

(ii) In an employment context, the same issue would arise if the dollar amount test is met and the policy is taken as collateral.

(g) Would the same analysis apply to employment-related or donor/donee split-dollar arrangements used to acquire a variable policy?

(i) On the one hand, such an arrangement has the same economic effect as a premium loan.

(ii) On the other hand, either form of split-dollar is a benefit transaction – either as compensation or a gift to the policy owner (if it is non-contributory).

(a) In another context, the Staff of the Board concluded that employment-related split-dollar arrangements were not an extension of credit by a bank to an executive for purposes of Reg. O, since the executive wasn't personally liable to the bank – it was looking only the policy for repayment of it, advance; FRRS 3-1044 (1994) where the executive reported the bank's advances as taxable income.

(b) In that same context, it similarly concluded that such an arrangement wasn't an extension of credit. FRRS 3-1081.3 (1981).

3. Economics.

(a) As in any other financing transaction, premium financing works best for clients who don't need to finance the premiums, but choose to do so.

(i) That is, where it is being used for transfer tax minimization purposes.

(a) By reducing the value of the transfer for transfer tax purposes from the full premium to the interest gifted or imputed.

(b) Or by eliminating the gift, if the interest is accrued and paid with the principal at death.

(ii) Or to manage the lender's cash flow.

(iii) Or to acquire a policy with no cash outlay, in a non-recourse arrangement, as discussed below.

4. Exit strategies.

(a) Like split-dollar arrangements, premium financing arrangements should be planned at the outset with an exit strategy for terminating the arrangement during the insured's lifetime.

(i) Since each year's premium is treated as a separate loan, the loans and interest will cumulate over the insured's lifetime.

(ii) This is especially an issue for loans with interest accrued, rather than paid.

(b) Since these are, by definition, "equity arrangements," policy values in excess of amounts due the lender could eventually be used to do a rollout, without tax consequences.

(i) Unlike post-final regulation split-dollar arrangements taxed under the economic benefit regime, discussed below, which, for the reasons discussed below, will always be done as "non-equity" arrangements.

(c) For trust-owned policies using premium financing, leveraged gifts to the trust (of discounted entities) or non-gift transfers of growth assets or entities (installment sales, zeroed-out GRATs [if the trust isn't a GST trust], zeroed-out CLTs, etc.) should be considered, to create a side fund which could be used, either alone or with policy values, to exit the arrangement during the insured's life.

(i) In most of those cases, grantor trust status for the trust would normally be advantageous (and is required for an effective installment sale).

(a) Subject to the concerns raised below, if the loan is outstanding when grantor trust status terminates.

(ii) As discussed below, an additional, up front loan from the grantor, with interest paid or accrued at the AFR, would create an immediate side fund, which could be used to pay interest or exit the transaction (if the trust could earn more than the AFR charged on this loan).

(a) This might be particularly attractive in an era of low interest rates, to lock in the rate for the term of the loan.

(d) In any event, consideration should be given to designing the policy so that the death benefit increases to keep the trust's death benefit level.

(i) At the cost of extra premiums.

(e) Creating a side fund would allow termination of the loan during the insured's lifetime.

(i) Avoiding the potential tax issue raised by termination of the trust's grantor trust status at the grantor's death while the loan is outstanding (discussed below).

(ii) Ending either the gifting needed to service the loan in current interest payment transactions or the erosion of the death benefit in interest accrual transactions.

(iii) Ending an increasingly expensive arrangement which reduces the death benefit left in the trust.

(iv) Avoiding issues under the "to pay" provision of the regulations, discussed above.

(v) But, it could increase the potential tax issue on termination of the trust's grantor status at the grantor's death, because the trust will have more assets treated as sold by the grantor to the trust in exchange for the outstanding loan (as discussed in detail below).

5. Will related-party premium financing loans be respected (that is, will they be treated as a bona fide debt obligation) for tax purposes.

(a) If not, the loan may be recharacterized as equity or might be disregarded for tax purposes.

(b) See, e.g., Sutter v. CIR, T.C. Memo 1998-250, based on extreme facts, which held the loan used to acquire the policy should be disregarded for income tax purposes.

(i) Accordingly, the borrower was taxed on the amounts loaned.

(c) Most usual premium financing arrangements, even between related parties, should be considered bona debt obligations for income tax purposes.

(i) As discussed above, under Reg. Sec. 1.7872-15(a)(2) of the Final Split-Dollar Regulations, a split-dollar loan (including a premium financing arrangement) will be treated as a loan for federal tax purposes if it would be treated as a loan under general tax law principles or if a reasonable person would expect it to be repaid.

(a) The Explanation provides that would be true, even in the early years of a premium financing loan to an otherwise unfunded trust, where the policy cash value was less than the loan.

(ii) Under general principles of federal tax law, the courts have looked to the intent of the parties to establish an enforceable obligation, the enforceability of the obligation under state law, and the likelihood that the loan will be repaid.

(iii) Similarly, in determining whether a purported loan is debt or disguised equity, the courts have looked to whether the loan was an unconditional promise to pay a fixed amount, with stated interest and fixed maturity, whether it was subordinated or secured, whether the borrower was thinly capitalized, the existence of a note, the availability of the lender's remedies in the event of a default, and any control the lender has of the loan proceeds.

(iv) Finally, in a series of gift tax cases and rulings, intra-family loans have been respected for gift tax purposes, unless the notes were intended not to be enforced or to be forgiven.

(a) Compare Rev. Rul. 77-299, 1977-2.C.B.343 and Deal v. CIR 29 T.C. 730 (1958) with Haygood v. CIR, 42 T.C. 936 (1964).

(v) Given the Regulation provision and these authorities, absent unusual facts, private premium financing transactions should be respected as loans for tax purposes.

B. Premium financing formats.

1. Premium financing takes a number of formats.

(a) The legal and tax issues depend on the identity of the lender, the relationship between the lender and the borrower, and the terms of the loan.

(b) Each format has different tax and economic consequences, as discussed below.

2. Private premium financing.

(a) These are interest-bearing loans to an irrevocable life insurance trust (an "ILIT") to pay premiums, by the insured(s), interest at the AFR, paid annually or accrued, principal repaid at death.

(b) This is an alternative to private split-dollar, with a different measure of the gift.

(i) The gift would be the amount needed to be gifted each year to pay the interest to the insured (if the trust has no other assets), rather than economic benefit amounts.

(a) If the trust has been previously funded, it could pay the interest without gifts from the insured.

(b) If the trust has no other funding, once the policy has sufficient cash value, the trustee could withdraw from or borrow against the policy to pay the interest, also avoiding ongoing gifts by the insured.

(1) Any such transaction would have to have real world economic consequences, to be respected for tax purposes; the trust would want to avoid borrowing or withdrawing the amount of the interest at the same time it is to be paid to the insured(s).

(2) If the policy were a MEC, the loan or withdrawal could have tax consequences to the trust (or the grantor, if the trust were a grantor trust).

(ii) As noted above, under the final regulations, under a facts and circumstances test, if the interest is to be paid by the insured, the arrangement will be treated as a split-dollar loan subject to Section 7872.

(a) To avoid this rule, there needs to be a disconnect between the insured's gifts to the trust and its payment of interest to the insured.

(1) Which is a matter of degree, with no bright line test available.

(iii) And with no tax on any policy equity which develops.

(c) The insured(s) will have no interest in policy values in excess of the loan amount.

(i) The trust will own cash values that exceed the loan, but there will be no "equity" issue for gift tax purposes, as there would be in a private split-dollar arrangement, described below.

(ii) This will limit the amount includible in the insured's estate to the premiums advanced (plus interest received over the term of the loan), and leave all excess policy values in the trust, with no tax consequences.

(d) There will be no income tax consequences from the loan transaction to either party, if the trust is a grantor trust, from the lender's point of view, under the income tax non-recognition rule for transactions between grantors and their grantor trusts, of Rev. Rul. 85-13, 1985-1 C.B. 184.

(i) There are a number of ways the trust can be drafted as an intentional grantor trust, treating the grantor as the owner of the trust for income tax purposes, without causing estate tax inclusion of the trust in the grantor's estate, including giving the grantor the power to borrow without security, under Section 675(2).

(ii) Any unpaid but accrued interest for the year of the grantor's death paid thereafter would be taxable to his or her estate as IRD, since the trust would not then be a grantor trust.

(e) At the grantor's death (or earlier termination of the trust's grantor status), the trust would no longer be a grantor trust, and, subject to an important exception, which would appear to apply here, under Reg. Sec. 1.1001-2(c)(Ex. 5), the grantor will be treated as having sold any assets then owned by the trust (the policy and any other funding assets) to the trust in exchange for the loan.

(i) Gain would be recognized to the extent the loan exceeds the grantor's basis in the policy and any other funding assets (since the grantor has been relieved of the liability on the loan).

(ii) Note that this same rule applies to any liability of the trust which is outstanding when grantor trust status terminates, whether to the insured or a third party lender.

(iii) Also note that this rule applies to <u>all</u> of the assets of the trust (including the policy and any side-fund).

(iv) Here, grantor status avoids taxation of the interest paid or accrued to the grantor on an on-going basis, so it may make sense to create trusts used in these transactions as grantor trusts, despite that risk.

(v) It had generally been presumed the gain would be capital, since insurance is not excluded under Section 1221 from being a capital asset and the deemed sale should provide the required sale or exchange.

(a) Note, however, that under the substitution of income doctrine, gain over basis up to cash value was presumed to be ordinary. See, e.g., CIR v. P.G. Lake, Inc., 356 U.S. 260 (1958).

(b) See TAM 200452033 taking that position on both issues and Rev. Rul. 2009-13, 2009-21 I.R.B., so holding on both issues.

(vi) The exception is for a loan which was used by the borrower to acquire assets, if the loan was not taken into account in determining the acquirer's basis in the assets – arguably, such as this "disregarded" loan. Reg. Sec. 1.1001-2(a)(3).

(a) See, however, TAM 200011005, apparently limiting this exception to loans made by the grantor, not the trust, to acquire the asset.

(1) In the TAM, the trust borrowed to make required annuity payments to the grantor, not in connection with acquiring its asset.

(b) In any event, so long as the trust is a grantor trust, the trust's loan should be treated as made by the grantor for all income tax purposes, including for purposes of this exemption.

(vii) In addition, since the trust was a grantor trust when the loan was taken out, the trust's basis in the policy should be the grantor's basis, offsetting any gain on the policy. This concept would only be helpful for any other assets in the trust, if the grantor's basis in them were substantial.

(a) Note, however, the IRS' position that policy basis is reduced, not only by any non-taxable dividends received, but also by the "value" of the insurance protection provided.

(b) See PLR 9443020, reaching that conclusion, with no analysis, and also stating that the value of the insurance protection provided could be approximated by the difference between total premiums paid and policy cash value, absent any direct evidence of that value.

(1) Most commentators disagree with both conclusions of this PLR; no other personal use asset seems to be subject to this depreciation–like analysis.

(2) In any event, it would seem some measure of term costs would be a better measure of the value of that protection, since the difference between premiums paid and cash value is also attributable to commissions and expenses.

(c) See also CCA 200501004, restating the IRS position.

(d) But see, both Gallun v. CIR, 327 F.2d 809 (7th Cir. 1964), not requiring any such reduction in basis on a policy sale, and Rev. Rul. 70-38, 1970-C.B. 11.

(e) This is sometimes described as the difference between the aggregate premium theory and the policy investment theory of policy basis (that investment in a policy is both an investment in the cash value and a purchase of a death benefit).

(f) Finally, in Rev. Rul. 2009-13 the IRS adopted the policy investment theory, holding that basis is reduced by the "cost of insurance”, for the death benefit protection it provided the policy owner.

(1) The ruling did not discuss how to determine those costs.

(2) In universal policies, those costs are disclosed; in whole life policies, they would have to be provided by the carrier.

(viii) In any event, this is a deemed transfer only for income tax, not transfer tax, purposes.

(ix) The uncertainty of this result may require a re-evaluation of whether the trust should be created as a grantor trust or not.

(a) As noted above, where the grantor is the lender, this risk will likely be worth running, to avoid current tax on the interest paid or accrued to the grantor.

(1) Or, where grantor trust status is otherwise required because of other planning being done with the trust, as described above.

(b) In other cases – third party financing in a trust not used for other planning, for instance – non-grantor status for the trust may make more sense, to avoid this issue for the grantor.

(1) Note that, given Section 677(a)(3), it will be difficult to avoid grantor trust status for an insurance trust, as to fiduciary accounting income, unless income can only be used to pay premiums in the discretion of an adverse party trustee (such as a trust beneficiary), or with the consent of such a party.

(x) However, the practicalities are such that most trusts involved in these transactions are created as intentional grantor trusts, despite this theoretical risk.

(f) There is an estate tax issue for the insured(s) raised by this arrangement under Section 2042(2), if the policy is used as security for the loans.

(i) The assignment to the insured must be “restricted”, as in controlling shareholder or private split-dollar (see PLRs 9511046 and 9745019), or the arrangement would have to be “unsecured” – which as noted above, apparently avoid application of Regulation U to loans to finance a variable policy.

(ii) The loan itself (ignoring the security issue, described above) will not create an incident of ownership, under Section 2042(2).

(a) See PLR 9809032, holding that an insured’s loans to the trust to pay premiums did not, in and of themselves, create an incident of ownership.

(iii) In any event, the value of the note would be includable in the insured’s estate, under Section 2031.

(a) Including all accrued interest.

(g) If the policy is a survivorship policy and only one of the insureds lends premium amounts to the ILIT, if he or she dies first, the note will be includible in his or her estate, and consideration must be given to its disposition at death.

(i) It could go to the surviving spouse/insured.

(a) Since the original lender was an insured, any security interest for the loan would have had to have been restricted from inception.

(1) If it weren’t, adding the restrictions then would begin a three year rule under Section 2035.

(ii) Or it could go to the ILIT, where it would be cancelled by operation of law, (since the ILIT would own its own note), without tax consequences, under Section 108, since it was acquired by bequest.

(a) This would use up unified credit and could generate an estate tax at the first spouse's death.

(h) Economically, this is a loan at the lowest applicable term loan AFR, probably without security, always renewable (in the discretion of the insured(s)).

(i) If the interest is being paid currently, the death benefit will only be eroded by the principal of the loans at the insured's death.

(ii) As discussed below, if the interest is accrued until death, however, if the policy death benefit doesn't increase, there will be less death benefit left in the trust.

(a) And the note includable in the insured's estate will be larger than if interest were paid currently.

(1) That is one of the trade-offs for no current gifts to the trust to allow it to pay the interest currently.

(b) And, as noted below, although there is a theoretical issue as to whether the accrued interest paid to the insured's successor at death will be IRD, the better argument is that only the interest accrued for the year of death would be.

(i) In an era of low interest rates, depending on the insured's cash flow, lending more than is currently needed to pay premiums may make sense, to lock in low rates for a long term.

(i) The ILIT can arbitrage the loan proceeds not needed to pay current premiums.

(a) Creating an immediate side fund.

(b) With any income earned on the invested funds taxed to the grantor/insured under the grantor trust rules, without any resulting gift.

(ii) Or, the ILIT can put the loan proceeds into the policy, to increase its tax efficiency.

(a) Subject to concerns about creating a MEC.

(1) Which would be a particular issue here, since the pledge of the policy might trigger a tax on any gain in the policy, under Section 72(e).

(i) Another reason to consider using an unsecured arrangement.

(j) As noted above, although the loan could be structured as an interest-free loan (with the unstated interest treated as a gift), that raises the additional issues discussed in detail above.

(i) The loan could be a no-interest demand loan, with the unstated interest treated as a gift each year under Section 7872.

(a) That would mean that the interest rate would have to fluctuate monthly during the term of the loan, (although there is an annual rate convention that allows it to fluctuate annually), preventing the ability to lock in current rates for the term of the loan (if that were advantageous).

(ii) Alternatively, it could be a term loan based on life expectancy (one of the hybrids, discussed above), with interest at the AFR determined by the expected term, treated as transferred annually.

(a) Note again the gift tax issue for these loans, as discussed above.

(iii) Again, the arrangement would have to be unsecured, or any security interest would have to be "restricted," to avoid an incident of ownership issue for the insured.

(iv) And again, there will be no income tax consequences to either party, in a grantor trust context.

(k) As also discussed above, the loan from the insured could also provide for interest to be accrued and paid at death with the loan principal, avoiding the application of Section 7872 if the accrual is at the AFR.

(i) There would be no gifts at all to the trust during the insured’s life, even if the trust weren’t otherwise funded (since none would be needed to pay the interest currently).

(ii) The accrued interest at death should not be IRD, since under the OID rules of Sections 1271 through 1275, the interest would be currently taxable to the insured, even though, as discussed above, in a grantor trust situation, it would not be treated as income, based on Rev. Rul. 85-13.

(a) Again, interest accrued in the year of death would be IRD to the insured’s estate, because when it was paid, the trust wouldn’t be a grantor trust and it wouldn’t have been previously treated as OID.

(iii) Economically, more of the death benefit will be included in the grantor/insured’s gross estate over time and less will be left in the trust at his or her death (unless the policy death benefit increases at least as fast the interest accrues).

(a) Accordingly, this would likely make the most sense for a short-term arrangement, which would be replaced or paid off during the life expectancy of the insured.

(b) Note the development of so-called Option C choices in some universal life policies, designed to track the loan plus accrued interest.

(c) This will effect underwriting the policy, to be sure enough coverage is available to provide enough death benefit to repay the loan.

(d) Note the possible use of this note to make a charitable bequest at the grantor’s death, to avoid estate inclusion.

(iv) Because of the ever-increasing cost of this arrangement, an exit strategy would be crucial.

3. The same transaction with the insured's spouse as the lender.

(a) There should be no incident of ownership issue under Section 2042(2) here, assuming the policy owned by the ILIT isn't on the spouse's life or a survivorship policy in which he or she is one of the insureds.

(i) A traditional collateral assignment could be used to secure the spouse's advances; that would allow the spouse access to the policy cash values during the insured's lifetime.

(a) A restricted assignment would need to be used, if the spouse is an insured under the policy, or if the note and assignment were to be left to the insured if the spouse died first.

(b) If the loan were an interest-free loan governed by Section 7872, there would be no income tax consequences to the spouse, since Section 7872 treats spouses as one person, and the grantor trust should, for income tax purposes, be treated as the insured spouse. Section 7872(f).

(i) However, if the loan were interest-bearing, apparently Section 1041 (which protects transfers of property between spouses for income tax purposes) wouldn't apply to prevent taxation of the interest paid by the insured's grantor trust to his or her spouse. See, Gibbs v. CIR, T.C. Memo 1997-196.

(a) The trust could, however, be created as a grantor trust from the non-insured spouse's point of view.

(c) If the spouse died before the insured, the note and assignment couldn't safely go back to the insured (if the assignment weren't restricted) – although it could be changed to a restricted assignment then, that would presumably start the Section 2035 three year rule.

(i) The recipient of the note and assignment at the spouse's death would need to be planned for.

(a) Again, the ILIT could be a good choice.

(ii) The note would be includible in the spouse's estate for estate tax purposes.

(iii) Assuming premiums continue to be due, another premium provider or another arrangement to pay premiums will have to be considered.

(d) Note again the Section 1001 issue, discussed above, if the loan is outstanding when grantor trust status terminates; the issue exists whether the loan is by the grantor or by another party (here, the spouse).

(i) Since the grantor is not the lender, there may be less incentive to create the trust as a grantor trust (unless the loan is an interest-free loan governed by Section 7872, or unless the trust needs to be a grantor trust for other estate planning techniques).

4. The same transaction with the insured's employer or controlled entity (such as an FLP) as the lender.

(a) Again, with the insured gifting the interest amount to the trust each year to pay the lender the interest due (unless the trust were otherwise funded).

(i) In an employment context, if the employer had a plan to bonus the interest to the insured, then, as discussed above and below, under the final split-dollar regulations, the loan would be treated as an interest-free loan, subject to Section 7872, despite payment of the interest by the ILIT.

(b) This would create interest income to the entity (or its owners, if it is a pass-through entity).

(c) So long as the interest charged is at the AFR, the transaction would be treated as a loan by the entity directly to the trust, and not as a loan to the insured and a re-loan by the insured to the ILIT, as would be the case if this were a below market interest loan governed by Section 7872, since here the insured derives no taxable benefit from the transaction.

(d) The loan would be a part of the value of the controlled entity, which might or might not effect the value of the insured's interest in the entity at death.

(i) And the insured's access to the loan principal would be indirect and might have tax consequences (if the entity weren't a pass-through).

(e) The transaction could be an interest-free loan from the insured's employer to the ILIT, treated as a loan to the insured and a re-loan to the ILIT.

(i) As noted above, the loan would either have to be a demand loan, a compensation loan, or a term loan based on the insured's life expectancy, subject to the gift issue for hybrid loans (described above).

(ii) The insured would have compensation income and be treated as making a gift of the interest to the ILIT, and, unless the ILIT were a grantor trust, would have interest income from the trust.

(f) If the employer were a public reporting company and the insured were a covered executive or a director, Section 402 of the Sarbanes-Oxley Act of 2002 would prohibit such loans.

(g) Note the Section 1001 issue, discussed above, if the loan is outstanding when grantor trust status terminates, even though the loan isn't to the grantor.

(i) Again, since the grantor is not the lender, there may be less incentive to create the trust as a grantor trust.

5. Interest-bearing loans to an ILIT to pay premiums, by the insured(s), interest at the AFR, payable annually, principal paid at death, financed by a third party lender at variable, usually short-term, market rates.

(a) The same tax and economic issues as loans to the trust by the insured exist here, plus the economic issues of the insured's loan from the third party – such as the cash flow required (since there will be a difference between the interest charged on the two loans and the third party loan may have a shorter maturity), the effect on the insured's borrowing capacity, etc.

(i) Presumably, the fact that there is a difference between the interest rates should not raise any gift tax issues for the loan to the trust (because use of the AFR rate should provide a safe harbor).

(ii) Compared to a third party loan directly to the trust, this allows a reduction in the gifts needed to be made to the trust and reduces the insured's estate.

(b) This will create an estate tax deduction under Section 2053 to offset the inclusion of the note from the trust in the insured's estate for estate tax purposes.

(c) In addition, there is an issue of the insured only having a restricted security interest (or none at all), which the third party lender would not want as collateral.

(i) Meaning the third party lender would effectively be relying on the insured's credit (and any other collateral for the loan – but not the policy).

(ii) If the trust were to pledge the policy as security for the insured's loan, there is an incident of ownership risk.

(a) Since the trust is using its policy as security for a loan to the insured by the third party lender.

(1) See, <u>e.g.</u>, <u>Pritchard v. U.S.</u>, 397 F.2d 60 (10th Cir. 1968), holding there was a retained incident of ownership, where the loan was arranged as a part of the policy acquisition.

(b) And a risk of a breach of fiduciary duty to the beneficiaries by the trustee.

(1) Unless the trust were to be adequately compensated for "loaning" (and risking losing) its asset.

(d) Note again the Section 1001 issue; since the insured is the lender to the trust, the trust would likely be created as a grantor trust, despite that risk.

6. Short-term, non-recourse, interest-accrued loans from a third party lender, to pay the initial policy premiums.

(a) These arrangements are discussed in more detail below, as sales of insurability —investor initiated life insurance or loans to life settlement transactions.

(i) They combine third party premium financing (of a limited kind) and a potential life settlement of the policy at the end of the term of the loan (as one alternative).

(a) Life settlements are described in detail below.

(b) From the insured's point of view, there appear to be a limited number of risks or disadvantages so long as the insured understands the transaction, which is not always the case; see, e.g., the allegations in King vs. Meltzer, - F. Supp 2d – (C.D. Cal. 2007).

(i) They are sometimes sold as two years of "free insurance."

(a) Perhaps better described as a premium-free two year call on a policy.

(ii) What the insured gives up is his or her insurability – the ability to buy more insurance.

(c) From a tax point of view, if the insured/owner defaults on the loan, he or she will be treated as if he or she sold the policy for the then outstanding loan balance, under Reg. Sec. 1.1001-2(a), creating gain measured by the difference between that balance (likely including the accrued interest) and basis in the policy (note again the basis issue, discussed above).

(a) There is an argument that accrued interest isn't included in the amount realized, under a tax benefit theory – since there was no tax deduction for the interest, it should not be included in the sale price.

(1) See Ltr. Rul. 9251023.

(b) Some of these transactions provide an additional loan amount as an inducement to the insured.

(1) Which would not become part of the owner's basis in the policy.

(d) Gain on a sale of the policy over basis (as discussed above) will be ordinary income up to the cash value and a capital transaction thereafter.

(i) Although the policy is a capital asset and there is a sale, the argument is that the payment for the cash value increases are interest substitutes.

(ii) See TAM 200452033, taking the position that even though a policy is a capital asset, the definition of a capital asset "excludes … accretion to the value of a capital asset properly attributable to ordinary income," based on the "substitute for ordinary income" doctrine of cases like C.I.R. v. P.G. Lake, Inc., above, and holding that gain up to cash value was ordinary.

(a) Would a variable policy sale yield a different result, since there increases in cash values are market, not interest, driven?

(iii) See Rev. Rul. 2009-13, holding that gain above basis (as reduced by the "cost of insurance" is ordinary up to cash value and capital thereafter, under the substitution of income theory, citing P.G. Lake, above.

(e) If this were treated as something other than a true loan for tax purposes, based on the parties' intent, the premiums advanced might be treated as part of the purchase price for the policy, or even as ordinary income.

(i) See Sutter v. Cir., TCM 1998-250, based on unusually bad facts – where it was clear neither party intended the "loan" to be repaid; the court held the "loans" were income to the borrower.

(ii) In these transactions, the lender clearly intends to have the loan repaid or to foreclose on the policy.

(a) Although in many of these transactions, it is usually economically impossible for the trust to ever repay the loan and the owner will have to walk away from the transaction.

(iii) See also Reg. Sec. 1.7872-15(a)(2), providing that a split-dollar loan which a "reasonable person" would expect to be repaid is treated as a loan for federal tax purposes, even if it wouldn't be under general tax principles.

(a) Again, will these loans be repaid?

(f) In these transactions, the policy owner is a non-grantor trust, to try to avoid these tax results for the insured.

(i) It isn't clear that such a trust would be respected for income tax purposes, however.

(a) Under Section 677(a)(3), an insurance trust would almost always be a grantor trust, as to fiduciary accounting income, since, normally income is, or can be, used to pay premiums; whether that status can be intentionally avoided where a trust owns insurance on the grantor's life isn't clear.

(1) Perhaps the only way to assure non-grantor status for an insurance trust as to fiduciary accounting income is to avoid Section 677(a)(3) by requiring trust income be used to pay premiums with the consent of an "adverse party" – a trust beneficiary.

(b) See LAFA 20062701F, taking the position that a trust, designed as a non-grantor trust, was a grantor trust under that provision, even when it didn't own any insurance.

(1) Admittedly, a stretch, but indicative of the Service's argument in this area when it wants to find a trust a grantor trust.

(g) Note the insurable interest issue for the lender, discussed below.

(i) On December 19, 2005, the General Counsel of the New York Department of Insurance issued an Opinion raising both the insurable interest issue and the rebate issue for these transactions under New York law.

(a) See also the Utah and Louisiana Insurance Commissioners' Bulletins on these transactions, reaching similar conclusions.

(ii) New York Life has filed a series of lawsuits seeking to invalidate a number of its policies as having been sold – without its knowledge – to trusts that did not have the requisite insurable interest under New York law.

(a) Apparently, these policies were sold before the applications were changed to ask about intended life settlements or third party owners.

(b) It is hard to tell from the petition, but these policies were apparently sold to trusts for the benefit of a family member and the premium provider.

(c) Some of these lawsuits have since been withdrawn, where the insurer's offer of rescission was accepted.

(h) Could the insured have any liability to the lender if the policy wasn't valid or the insured's estate was entitled to the proceeds under state law, because there was no insurable interest?

(i) Do the loan documents cover this; whose risk is it (or should it be)?

(i) See also, <u>LifeProduct Clearing LLC v. Angel,</u> 07 Civ. 475 (2008), known as the <u>Lobel</u> case, in which the New York District Court judge denied a motion for judgment on the pleadings, in a case filed against the insured's estate by the purchaser of an interest in a trust created to own a policy arguably purchased with the intent to sell an interest in the trust to an investor.

(i) Based on the language of the order, the judge left no doubt he would find no insurable interest here.

(j) As discussed below, the industry is opposed to these transactions, many insurers will not support them, and state insurance regulators are acting to stop them.

(i) But as also noted below, new variations are being developed to respond to these concerns.

II. Split-Dollar Arrangements.

A. General.

1. Categories of split-dollar arrangements.

(a) In an employment context, traditionally.

(b) In other contexts, traditionally.

(i) Private.

(ii) Shareholder.

(iii) Third party.

(iv) Others.

(c) Specifically defined under the final regulations, for the first time.

(i) Discussed below.

2. The basic, traditional tax consequences.

(a) Rev. Rul. 64-328 (now revoked).

(i) The "economic benefit" concept.

(b) Rev. Rul. 66-110 (also now revoked).

(i) Refinement of that concept, allowing the use of alternative term rates.

(ii) The "other benefit" concept, and what it meant for the taxation of policy "equity" (defined below).

(c) Rev. Rul. 78-420 (also now revoked) and Rev. Rul. 81-198.

(i) Extension of the income tax rules for transfer tax purposes in third party arrangements.

(ii) The leverage concept for the transfer taxes.

(d) The revoked rulings were “replaced,” for pre-final regulation arrangements by Notice 2002-8, described below.

(e) And, as discussed below, the final regulations govern post-final regulation arrangement (as also defined below).

3. Split-Dollar methods.

(a) Endorsement.

(i) Employer, premium provider owned.

(b) Collateral assignment.

(i) Employee or third party owner.

(c) Co-ownership.

(d) For pre-final regulation arrangements, there traditionally was <u>no difference in basic tax consequences</u>, regardless of the documentation method used or ownership of the policy.

(i) Based on the “similar benefit” concept.

(e) As discussed below, for post-final regulation arrangements, the tax result generally depends on policy ownership.

4. The tax leverage of split-dollar.

(a) Reducing the transfer tax cost of moving premium dollars to purchase an insurance policy.

(b) Traditionally, to the economic benefit of providing the death benefit to the owner, measured by a term cost.

(i) Which increases each year and at some point becomes uneconomic.

5. Exit strategies.

(a) Like premium financing, split-dollar is a short-term solution, requiring an exit strategy, so that it doesn’t go on after it is no longer tax-leveraged.

(i) At the first death in a survivorship policy arrangement, for example.

(b) Those exit strategies are the same-leveraged gifts, sales or loans to the trust which owns the policy to create a side-fund, which can be used to repay the premium advances.

(c) Unlike premium financing arrangements, as discussed in detail below, post-final regulation split-dollar arrangements will be designed as non-equity arrangements.

(i) Meaning that the policy cash values can't be accessed to unwind the arrangement during the insured's life.

(d) As in premium financing arrangements, designing policies with an increasing death benefit would be helpful here as well, to track the premium advances.

(i) Of course, at a cost.

(e) And it might be helpful to design the policy with low or no cash values (to reduce the amount repayable to the premium advancer, in a non-equity arrangement).

B. Measure of the economic benefit in split-dollar arrangements.

1. The economic benefit is premium insensitive, both as to the level of the premium and whether a premium was paid in a given year.

(a) It is based on the death benefit provided to the policy beneficiary under the arrangement.

2. Traditionally, the economic benefit was measured by the lower of the carrier's qualifying term rates or the IRS table rates, under Rev. Rul. 66-110.

3. Validity of alternative term rates.

(a) Prior law, especially Rev. Rul. 66-110, requiring the rate be a generally available, published, one-year term rate.

(i) Especially multiple year policies.

(b) The implicit criticism of those rates in Notice 2001-10.

(c) Pre-1/28/02 arrangements under Notice 2002-8.

(i) Grandfathering from the new limitations.

(d) Post-1/28/02 arrangements under Notice 2002-8.

(i) New limitations are imposed beginning in 2004, designed to assure the rates used reflect term policies actually sold.

(e) The proposed and final regulations.

(i) Their general silence on the subject.

(ii) But what they probably suggest for the future about updated Tables – what are called "uniform term factors" (which may be exclusive).

(iii) Unless and until we get exclusive Tables, post-January 28, 2002 qualifying alternative term rates continue to be available, even for post-final regulation arrangements.

(f) The 2005 IRS audit guidelines for split-dollar arrangements.

(i) They suggest that post-final regulation arrangements can continue to use qualifying alternative term rates, as some have.

(a) And apparently slightly change the additional limitations imposed by Notice 2002-8.

(g) There is a risk that the carrier will terminate its support of its alternative term rates, as some have.

(i) With little, or (even worse) no notice.

(ii) Leaving the insured with no choice, other than to revert to the higher Table 2001 rates.

(h) How do advisors decide if the carrier's rate qualifies under the Notice?

(i) Some carrier's take the position their rates qualify and others that theirs don't.

(ii) Some carrier won't give any assurances, but require that decision to be made by the client or his or her advisors, based on the facts supplied by the carrier.

(i) See the grid attached describing these rules.

(j) Also see the comparison table attached, showing the differences between one carrier's alternative term rates and the Table 2001 rates.

(i) Note the magnitude of those differences, especially at older ages.

(ii) Underscoring the importance of the availability of those rates in single life arrangements.

4. Table rates.

(a) PS 58 rates through 2001

(i) Based on 1946 male, smoker rates.

(b) Table 2001 beginning in 2002

(i) Lower at every age than the PS 58 rates.

(c) Future (lower) tables.

(i) Hinted at by both sets of proposed regulations and the final regulations.

(a) Described as "uniform term factors " (whatever those are)."

5. Survivorship policies.

(a) Historically, the US 38 rates, derived from the PS 58 rates, but only while both insureds are alive.

(i) Alternative survivorship term rates.

(a) There is no authority for those rates.

(b) Currently, survivorship rates derived from the Table 2001 single life rates, as suggested by Notice 2002-8, but only while both insureds are alive.

(i) They will be much lower than even the best alternative term rate and are even lower than the US 38 rates.

(ii) Making survivorship split-dollar especially attractive, after the issuance of Table 2001, while both insureds are alive.

(iii) See both the summary table of survivorship rates, at selected ages and the entire table of survivorship rates, attached.

(c) Importantly, once one insured dies, the rates revert to the normal single life rates, described above.

(i) Suggesting a possible switch to a loan at that point.

(a) Note the possible transfer issue raised by such a switch, under the final regulations, discussed below.

(ii) Better planning would be to have funded for an exit strategy at that point.

(a) Perhaps including individual policies on each insured, owned by the same trust.

(b) Some older survivorship policies provide for an increase in cash value at that point, which could be used as an exit strategy.

6. These rates are used for both income and transfer tax (gift and GST) purposes where the policy is owned by a third party.

(a) For reverse split-dollar arrangements, it has never been clear how to measure the benefit provided under the arrangement.

(i) See Notice 2002-59.

C. The taxation of policy equity in pre-Final Regulation arrangements.

1. Defined.

(a) An arrangement where there are policy cash values in excess of cumulative premiums due back to the premium provider and the premium provider is only to get back its premiums, so that those excess cash values belong to the policy owner.

2. Taxation under prior law.

(a) Taxation under TAM 9604001.

(i) Under Section 83.

(a) Currently.

(ii) Also for transfer tax purposes.

(a) Where the policy is owned by a third party.

(b) Taxation under other authority.

(i) Especially Rev. Rul. 66-110.

(a) Currently.

(ii) Also for transfer tax purposes.

(c) Some of the arguments for non-taxation.

(i) Rev. Rul. 64-328.

(ii) The "loan" theory of collateral assignment arrangements.

3. Taxation under the Notices.

(a) Taxation under the choice given by the interim guidance of Notice 2001-10.

(i) Section 83.

(a) Taxation of the economic benefit (unless contributed) and of the equity, presumably only at rollout (termination of the arrangement during the insured's lifetime).

(ii) Section 7872.

(a) Taxation of the forgone interest, but no tax on the equity (ever).

(b) As discussed below in more detail, Notice 2002-8 revoked Notice 2001-10, but continued to provide the same two choices for the treatment of pre-final regulations split-dollar arrangements as provided for in Notice 2001-10.

(i) Section 83.

(a) Taxation of the economic benefit currently (unless contributed).

(b) Taxation of the equity, but clearly only at rollout.

(ii) Section 7872.

(a) Tax only on the interest element.

(1) The interest rate and timing of taxation are both determined by whether the loan is (or, as in hybrid loans, is considered) a term loan or a demand loan.

(b) No tax on the equity – ever.

4. Importantly, Notice 2002-8 continues to govern the tax treatment of pre-final regulation arrangements, even after the adoption of the regulations (as described below).

(a) So long as they are not “materially modified” thereafter.

(i) Whatever that means.

5. Taxation under the further guidance of Notice 2002-8 for pre-final regulation arrangements taxed under Section 83.

(a) Safe harbor grandfathering.

(i) Pre-1/28/02 arrangements that were terminated during the insured’s lifetime by repaying the premium provider (“rolled out”) by 1/1/04.

(ii) Conversion to a Section 7872 loan beginning on January 1, 2004, by reporting the transaction as such on the parties’ tax returns.

(a) Treating all prior advances as the first “loan,” even though they had generated an economic benefit in prior years.

(b) Those arrangements not rolled out or converted by then.

(i) Taxation of the equity only at rollout.

(ii) So-called no inference “grandfathering” – the IRS won’t infer anything about taxation of equity at rollout from the Notices or the regulations.

(a) This has been called wait and see (if someone else gets audited) split-dollar.

(b) Note the potential effect of Section 409A on this issue in compensation arrangements, discussed below.

(iii) No taxation of the equity if the arrangement continues for life – split-dollar for life.

(a) On-going economic benefits.

(b) Unless the policy owner pays them out of its assets (including the policy).

(1) Economic substance issues.

(2) Taxation under traditional pre-final regulation rules.

(c) Post 1/28/02, pre-final regulation arrangements.

(i) Same results.

(d) What are "arrangements entered into" and what (if anything) would be a substantial modification which would lose date grandfathering?

(i) There is no definition of the former and no reference at all to the latter.

(ii) Both are defined in the final regulations.

(e) Same result for transfer tax purposes.

6. Taxation under Notice 2002-8 for pre-final regulation arrangements taxed under Section 7872

(a) Including pre-January 28, 2002 arrangements converted to loan arrangements by January 1, 2004.

(b) Again, no tax on the equity.

(i) Ever.

(c) The measure and the timing of the income are determined by the nature of the loan, as described above.

(i) Term loans.

(ii) Demand loans.

(iii) Hybrid treatment for gift and compensation term loans.

(a) But gift term loans are treated as term loans for gift tax purposes.

(b) And, loans repayable at death are term, not hybrid, loans, for pre-final regulation arrangements, under the pre-final regulation proposed Section 7872 regulations.

(d) In many cases, a term loan where interest is paid or accrued at the AFR may make more sense.

(i) Since the interest rate is fixed for the term of each loan when the advances are made, but there is no bunching of the interest as in a term, below-market rate loan.

D. Taxation of policy equity under the final regulations.

1. With one exception, these rules apply to arrangements entered into after adoption of the final regulations – that is, they are, with that one exception, prospective.

2. The one exception is for pre-final regulation arrangements, which are “materially modified” after the final regulations were adopted – September 18, 2003 (with an exception for arrangements converted under a safe harbor under Notice 2002-8 thereafter).

(a) There is no helpful definition of the term material modification in the Regulations.

(i) They provide a non-exclusive list of non-material changes – the so-called “angel list.”

(ii) That list does not include Section 1035 exchanges.

(a) Despite the fact that the proposed regulations asked for comments on whether such an exchange would be a material modification.

(b) See the Technical Explanation to the COLI Best Practices provisions of the Pension Protection Act of 2006, which explains the phrase “material change” to a policy as not including administrative changes, changes from general to separate account products, or changes as a result of an option or right granted under the contract.

(i) See also Ltr. Rul. 200627021, dealing with a "material change" to a policy for purposes of Section 264(f) grandfathering.

(c) Without further guidance, which isn't anticipated, clients should assume that <u>any change</u> to the economics of the arrangement or even to the policy is "material."

(i) The effect of converting the arrangement to one governed by the regulations will then have to be analyzed – in some cases it will change the tax result and in others (particularly non-equity arrangements) it won't.

(d) This is now an area in which the IRS won't rule.

(i) See Rev. Proc. 2008-3, 2008-1 IRB. 110, Section 3.01(2).

3. Notice 2002-8 will apply to all pre-final regulation arrangements.

(a) Again, assuming no post-September 18, 2003 material modification to the arrangement or the policy (other than a safe harbor conversion).

4. Split-dollar arrangements are <u>broadly</u> defined.

(a) Any arrangement where one party advances premiums, some or all of which will be repaid from or are secured by the policy.

(i) Including some compensatory arrangements that aren't covered by that definition, because repayment isn't secured by or to be repaid from the policy.

(ii) Including premium financing arrangements.

(b) They specifically include (but aren't limited to) employer-employee, corporate-shareholder, and donor-donee arrangements.

(c) But not "true" undivided interest joint ownership arrangements (whatever those are).

(d) The regulations “reserve” the application of this definition to partnerships.

5. With one important exception, described below, which regime will apply to post-final regulation equity arrangements will depend <u>exclusively</u> on policy ownership.

(a) A major change in the concept of split-dollar

(b) And one which has real world consequences.

6. Section 61 (not, as under Notice 2002-8, Section 83) will govern <u>endorsement method arrangements</u>, entered into or materially modified after the regulations are adopted.

(a) Meaning that with one exception, described below, if the benefit is to be measured by term costs, the arrangement <u>must</u> be documented on an endorsement basis, with the premium provider as the actual policy owner.

(b) The economic benefit will be taxed (unless contributed).

(i) If contributed, it will be taxed to the policy owner and will not provide basis to the contributor.

(a) Another major change to the prior rules.

(c) Any current or future interest in the equity will be taxed (as income or a gift, depending on the relationship of the parties) on a <u>current</u> basis.

(i) To the extent the non-owner has “access” (as defined) to the cash value.

(d) Access is broadly defined.

(i) The equity will be taxed on a current basis, under a constructive receipt theory, if the non-owner has access to the equity (now or in the future), or (surprisingly) the owner or the owner’s creditors don’t have access to the equity.

(a) The owner wouldn’t have access to the equity if its rights were restricted by the agreement (for instance, in a controlling shareholder situation).

(b) The owner's creditors wouldn't have access to the equity if state creditor protection laws prohibited it.

(c) The Explanation to the regulations also provides that the non-owner has access to the equity if he or she can assign his or her rights in the cash value of the policy.

(ii) For this purpose, surrender changes are ignored, no losses for declines in cash value are allowed, and cash values are measured at the end of each calendar year (or, on an elective basis, the anniversary date).

(e) Special valuation rules are provided for transfers of the policy (or an interest in the policy) to the non-owner.

(i) Ignoring surrender charges (and any other device to understate cash values) for income tax purposes.

(a) Note how broadly this "device" language could be interpreted.

(ii) Using the gift tax regulation valuation rule for gift tax purposes.

(a) A precursor to the 2005 policy valuation regulations, discussed below.

(f) Any amount received under the contract by the non-owner is treated as first having been paid to the owner and then transferred to the non-owner (for income or gift tax purposes).

(g) The death benefit will only be excludable by the non-owner's beneficiary to the extent the non-owner paid for or was taxed on the economic benefit.

(i) Which seems an unusual exception to the general exclusionary rule of Section 101, since it doesn't appear in the Code or the Section 101 Regulations.

7. Again, with one important exception noted below, Section 7872 will govern post-final regulation <u>collateral assignment arrangements</u>.

(a) That will mean if the benefit is to be measured by interest rates, the arrangement <u>will have to be</u> documented on a collateral assignment basis, with the non-premium provider as the owner.

(b) Taxation is based on the interest-free nature of the arrangement, depending on whether it is a term loan, a demand loan, or a hybrid loan.

(c) There will be no tax on the equity, either currently or on termination of the arrangement (either during life or at death).

(d) Under a special rule for hybrid loans, term loans with a maturity based on life expectancy, those conditioned on the performance of substantial services, and gift term loans will be treated as a term loan for determining the AFR, but as a demand loan for determining when the interest is taxed.

   (i) Gift term loans are, however, treated as term loans for gift tax purposes (making them undesirable); it isn't clear if gift hybrid loans will be treated as term loans for gift tax purposes.

   (ii) Note that loans based on life expectancy were treated as term loans prior to the final split-dollar regulations.

(e) If the arrangement is non-recourse (as most would be), the parties will have to attach statements to their returns <u>every year</u> a loan is made under the arrangement representing that a reasonable person would expect that the loan will be paid, to prevent the contingent interest rules of Section 7872.

   (i) Contingent interest treatment means all contingent payments are ignored for purposes of determining whether the loan is a below market loan, even if interest is currently paid or accrued at the AFR.

   (ii) Would failing to file such a notice for one year trigger this issue?

(f) If the loan provides for repayment of less than all of the loan principal, it is treated as two loans, and the part not subject to repayment is currently taxable.

(i) If the lender forgives any principal and/or interest or takes back the policy in which the cash value is equal to or less than cumulative premiums plus accrued interest, the difference will be taxable to the borrower (even if the non-recourse statement has been filed).

8. There is one major exception to the general rule that policy ownership is the sole determinant of the tax result.

(a) That exception is for <u>non-equity</u> donor-donee or employer-employee (or service provider – service recipient) arrangements, which <u>must be</u> treated under the economic benefit regime, regardless of which party owns the policy.

(i) The donor or employer is deemed to be the policy owner, resulting in economic benefit treatment.

(b) Meaning that these arrangements allow economic benefit treatment even for collateral assignment method arrangement.

(c) A similar rule applies to employer-employee or donor-donee arrangements when the employee or donee isn't the owner or treated as the owner.

(d) No other non-equity collateral assignment arrangements – such as corporate/shareholder or trust-to-trust arrangements – quality for this treatment.

(i) Apparently, Treasury was concerned about entity-to-entity arrangements (such as trust-to-trust or corporate-to-partnership) using the economic benefit regime.

(e) If the arrangement is modified so that it is no longer non-equity, the deemed owner rule no longer applies and the policy is treated as transferred to the real owner.

9. With very few, very minor exceptions, the final regulations are identical to a combination of both sets of proposed regulations.

10. Again, these rules are effective for arrangements entered into (a newly defined term in the regulations) after September 17, 2003 or prior arrangements "materially modified" thereafter.

(a) The final regulations provide a non-exclusive list of (mostly non-helpful) non-material modifications.

(i) Again, not including policy exchanges.

E. Planning going forward.

1. What can and should be done about existing pre-final regulation arrangements that did not qualify for or did not take advantage of the safe harbors of the Notice before January 1, 2004?

(a) In practice, most arrangements that were eligible for the safe harbors probably didn't take advantage of them.

(i) Either because the opportunity was missed, or there wasn't enough equity to make termination necessary or even a practical possibility (especially where repaying the premium provider would have meant another source of future premiums would have been required).

(b) The conversion to an interest-free loan safe harbor may have been used more often, where future premiums were due.

(i) Note that it only required the parties to treat the arrangement as a loan on their tax returns beginning in 2004.

(c) Some arrangements will be kept in split-dollar for life, taking advantage of the last safe harbor.

(i) With ongoing economic benefit costs, unless the policy owner can pay them.

(a) Including alternative term costs, if available.

(d) Many arrangements will be planned to rollout after January 1, 2004.

(i) If there is no equity at that point, there will be no tax consequences.

(a) But a plan to pay any future premiums due in cash will need to be in place.

(b) Meaning either a no-equity split-dollar arrangement or some form of premium financing.

(ii) If there is equity then, the owner will have to rely on the no inference provision of the Notice – "wait and see (if someone else gets audited) split-dollar."

(a) And a plan to pay future premiums will likewise need to be in place, unless the equity remaining in the policy can pay those premiums.

(b) Again, split-dollar or premium financing.

(c) As discussed below, note the issue of the loss of the no-inference protection for the non-grandfathered portion of compensatory arrangements under Section 409A and Notice 2007-34.

2. Split-dollar exit strategies for pre-final regulation arrangements (especially third party owned arrangements).

(a) Using policy values to repay the premium provider.

(i) Practical issues.

(a) Obviously, only when there is sufficient equity to do so, and (on a projected basis) to leave enough in the policy to carry itself.

(ii) Possible tax issues.

(a) Taxation of the equity at that time.

(1) Only when premiums are <u>fully</u> repaid.

(b) Taxation of policy withdrawals or loans before rollout.

(b) Using single life policies (or a policy rider) on each insured in a survivorship policy, to provide proceeds at the first death to repay the premium provider when the economic benefit increases, at the first death.

(c) External policy roll-outs to repay the premium provider.

(i) Using early, leveraged trust funding, to create a side fund which can be used to repay the premium provider without regard to policy cash values – "side funded split-dollar."

(a) Discounted entity gifts.

(1) Installment sales.

(2) Perhaps of discounted entities.

(b) Zeroed-out remainder gifts (depending on the terms of the trust which is the remainder beneficiary).

(1) GRATs

(i) Perhaps using discounted entities.

(2) CLTs.

(c) An up-front loan from the premium provider, with interest paid or accrued at the AFR.

(ii) Using a loan from the insured or a third party lender to repay the premium provider.

(a) With interest paid or accrued at the AFR.

(d) The possible risk of losing grandfathering under the Notice by making any changes to the policy or the arrangement that could be viewed as substantial.

(i) If that concept applies under the Notice.

(e) And the risk of losing pre-final regulation status for the arrangement, by materially modifying the arrangement.

3. What are the choices for new, post-final regulation arrangements?

(a) Where economic benefit taxation makes sense to fund policy premiums for younger insureds and survivorship arrangements, or as a compensation benefit.

(i) Endorsement equity arrangements, intended to provide the equity as compensation.

(a) Taxing the non-owner on the equity, based on access.

(1) But this probably won't make sense in third party-owned arrangements.

(b) Termination at or before equity develops.

(c) Termination after equity develops.

(d) Non-tax issues of endorsement method arrangements.

(1) Subjecting the policy to creditors of the premium provider.

(e) As noted above and discussed below, Section 409A will apply to any equity , unless it is grandfathered.

(ii) Non-equity endorsement arrangements.

(a) Intended as an employment provided death benefit plan.

(b) Section 409A will not apply to these arrangements.

(iii) Non-equity employer/employee or donor/donee collateral assignment arrangements.

(a) Planning for exit strategies, since policy values can't be used.

(1) Early, leveraged gifts to the policy owner, to create a side fund.

(2) Zeroed-out gift transfers – GRATs or CLTs.

(3) Conversion to premium financing.

(b) Controlling shareholder arrangements.

(c) Section 409A will, likewise, not apply here.

(b) Where interest as the benefit makes sense – older insureds in single life arrangements or where tax-free access to equity is important.

(i) Planning for loan regime split-dollar, under Section 7872 to apply will be limited to the use of demand loans or hybrid loans – compensation term loans, or loans that are due at the insured's death – term loans won't be used.

(a) But for hybrid loans, note again the gift term loan issue, discussed above.

(b) Section 409A won't apply unless the loan is forgiven.

(ii) Using premium financing by the insured, an employer, a controlled entity, or a third party lender, with interest paid or accrued at the AFR.

(a) Note the issues of the existence of a plan providing for payment of the interest by the lender and the deferral charge imposed on the tax on any interest forgiven, under the final regulations.

(iii) Avoiding equity taxation.

(a) And allowing use of policy values to effect a rollout without tax consequences.

(c) So-called "switch-dollar."

(i) Beginning with the economic benefit regime.

(ii) Repaying the premium provider with a note, at some point to convert to the loan regime.

(a) Perhaps at the first death in a survivorship arrangement.

(b) Or when term costs get too expensive.

(d) See the attached Decision Trees, summarizing these choices.

4. Split-dollar exit strategies for post-final regulation arrangements (especially third party owned arrangements).

(a) Policy values won't be available.

(b) External policy rollouts to repay the premium provider.

(i) Using a side-fund technique.

(c) Single life policies (or a policy rider) to provide proceeds at the first death in a survivorship arrangement.

5. The bottom line for planning post-final regulation arrangements.

(a) Non-equity, donor-donee or employer-employee survivorship arrangements or single life arrangements for younger insureds (especially where alternative term costs are available), in any case, side-funded when trust owned.

(b) Premium financing, interest accrued at the AFR, for older insureds in single life arrangements, where the death benefit can be arranged to increase, side-funded when trust owned.

(c) Premium financing, interest paid currently at the AFR, in similar cases, especially where the trust has assets to pay the interest without gifts from the insured, also side-funded.

(d) Interest-free demand or non-gift hybrid loans.

(e) Non-equity endorsement method employment-related arrangements; designed as a death benefit plan.

(f) Equity endorsement method employment-related arrangements, designed as both compensation and a death benefit plan.

F. The application of Section 409A to employment-related split-dollar arrangements under Notice 2007-34.

1. The warning in the explanation to the final split-dollar regulations.

(a) They had warned that, notwithstanding their application of both Sections 61 and 7872 to split-dollar arrangements, other Code provisions may also apply to split-dollar arrangements, such as Section 457, which applies to deferred compensation arrangements of tax-exempt organizations.

2. Treasury officials declined to provide a blanket exception from Section 409A for split-dollar arrangements.

(a) They mentioned that Section's possible applicability to endorsement arrangements (presumably only equity arrangements) where the employer is obligated to pay future premiums, or to collateral assignment arrangements where the advances are to be forgiven (presumably by prior agreement).

3. The preamble to the proposed regulations under Section 409A (but not the regulations themselves) dealt with this issue.

   (a) They took the position that employment-related equity endorsement arrangements probably would be treated as deferred compensation arrangements, but collateral assignment arrangements wouldn't be, provided there was no agreement to forgive the advances and no obligation of the employer to advance premiums without charging a "market rate of interest" on the advances.

   (b) Apparently, the application of Section 7872 to impute interest at the AFR wouldn't have been considered an adequate rate for this purpose.

      (i) Which seems unusual, given the general safe harbor of the use of the AFR.

   (c) Treasury requested comments on changes that might be needed to be made to grandfathered arrangements under the final Section 409A regulations to comply with, or avoid the application of, Section 409A, and whether those changes would be material modifications for purposes of the final split-dollar regulations.

      (i) Comments on both were received from a number of industry groups.

4. Notice 2007-34, issued April 10, 2007 accompanied publication of the final Section 409A regulations.

   (a) It provides that Section 409A applies to "certain types" of employment-related split-dollar arrangements, other than those that provide only death benefits (i.e., non-equity arrangements) or only short-term deferrals of compensation.

   (b) If Section 409A applies to a split-dollar arrangement, the document creating the arrangement must provide that amounts payable under the arrangement cannot be distributed earlier than:

      (i) The service provider's:

(a) Separation from service;

(b) disability; or

(c) death;

(ii) A specified time or a fixed schedule specified under the plan at the date the arrangement was entered into that any amount of deferred compensation under the arrangement would be paid;

(iii) A change of ownership or effective control of the corporation or in the ownership of a substantial portion of the assets of the corporation; or

(iv) The occurrence of an unforeseeable emergency.

(v) All of those terms are defined in the Section 409A final regulations.

(vi) It would seem that many arrangements would comply with these requirements, in any event.

(a) Although, for example, the definition of "change of control" in an agreement may not comply with the Section 409A definition.

(b) More importantly, the employee's ability to terminate the arrangement and obtain the policy cash values would appear to violate the provision requiring a fixed date for payment of the deferred compensation.

(c) If the document creating the arrangement doesn't comply with these requirements, it must be amended to comply.

(i) It probably should have been amended to do so by the end of 2007, despite the extension of that date to the end of 2008 by Notices 2007-78 and 2007-96, to be sure the plan is administered in compliance with Section 409A.

(d) If Section 409A applies to the arrangement:

(i) The payments made under the arrangement, unless grandfathered, for the current taxable year and for preceding taxable years (starting in January, 2005) would be includable in the service provider's taxable income.

(ii) And increased by 20%, plus interest determined at the underpayment rate (plus an additional 1%) on any amounts of deferred compensation for prior taxable years that were not reported.

(e) There are four possible exceptions to the applicability of Section 409A to an arrangement.

(i) Under the first exception, any premium payments made prior to January 1, 2005 and any growth in the cash value of the policy allocable to these premium payments will be grandfathered from these rules, and Section 409A will not apply to these amounts.

(a) Accordingly, only those premium payments made after January 1, 2005 and the growth of the cash surrender value of the policy allocable to those premium payments (as determined under Notice 2007-34) will be considered deferred compensation under Section 409A.

(ii) As noted above, under the second exception, the non-grandfathered payments made under the arrangement will meet the requirements of Section 409A if the deferred compensation may only be paid on the earlier of the service provider's:

(a) separation of service;

(b) disability;

(c) or death;

(d) a specified time set forth in the plan at the date of such deferral;

(e) a change of ownership or effective control of the company or in the ownership of a substantial portion of the assets of the company; or

(f) an occurrence of an unforeseeable emergency, as such events are described in the Final Regulations to Section 409A.

(iii) The third exception to the applicability of Section 409A to an arrangement is if the arrangement is a "death benefit-only" plan which provides for no lifetime benefits.

(iv) The fourth exception is if the deferred compensation was subject to a substantial risk of forfeiture or if it was previously included in gross income.

5. The Notice provides guidance on the effect of Section 409A's grandfather protection for pre-January 1, 2005 deferrals in split-dollar plans.

(a) It also provides transitional relief (subject to some seemingly reasonable conditions) for changes made to pre-final regulation split-dollar arrangements required to make them comply with Section 409A.

(b) Earnings on grandfathered amounts include increases in cash values on pre-2005 premium payments.

(i) Amounts deferred before 2005 are not subject to Section 409A, unless the plan was "materially modified" after 10/1/04. Amounts are considered deferred before 2005 if there was a legally binding obligation to pay the amounts and the right was vested.

(ii) Where benefits are both attributable to pre- and post-2005 premiums, the Notice allows any reasonable method that allocates increases in cash values to the grandfathered benefit (so long as it doesn't allocate a disproportionate part of policy expenses to the non-grandfathered portion).

(iii) Again, grandfathered amounts include only those attributable to premiums paid before 2005.

(c) To qualify for the transition relief from the material modification rule of the final split-dollar regulations:

(i) There has to be a reasonable determination that Section 409A applies, the arrangement doesn't comply, and that the modification will cause it to comply or no longer be subject to Section 409A.

(ii) The modification consists of changes to definitions, payment timing, or conditions of forfeiture to conform the arrangement to Section 409A or exclude it from coverage.

(iii) The modification establishes a time and form of payment of the benefit consistent with those applicable before the modification.

(iv) The modification doesn't "materially enhance" the value of the benefits to the employee under the arrangement.

(d) Note that some of the modifications to comply with Section 409A (such as having the employee give up the unilateral right to terminate the arrangement) will likely violate the third requirement of this transition rule.

(i) Why this more restrictive change should pose a problem isn't clear.

6. Arrangements not grandfathered from the application of Section 409A, if they are subject to the final split-dollar regulations, as economic benefit arrangements.

(a) Either because they were entered into after those regulations became effective or were "materially modified" thereafter.

(b) Which would, in a compensatory arrangement, be an endorsement method arrangement or a non-equity collateral assignment arrangement), any policy cash value to which the employee has access or any other economic benefits provided to the employee (other than death benefit protection or the cost of current life insurance protection), will be subject to Section 409A.

(c) Which would limit the practical application of Section 409A to post-final split-dollar regulation endorsement, equity arrangements.

(i) Which have been, and continue to be, unusual arrangements.

7. Arrangements not grandfathered under Section 409A, but subject to the final split-dollar regulations as a loan regime arrangement or treated as a split-dollar loan under Notice 2002-8.

   (a) These arrangements will generally not be subject to Section 409A, but, as the Notice provides, "in certain situations", such as where the loan is waived, cancelled, or forgiven, that amount will be subject to Section 409A.

      (i) Presumably a true loan, which would be treated as a split-dollar loan under the final split-dollar regulations.

   (b) The Notice does not specifically provide, as the explanation to the proposed regulation did, that arrangements where market interest wasn't being charged would be subject to Section 409A.

      (i) Could this be another "certain situation"?

      (ii) A split-dollar loan that provides for an adequate rate of interest (as tested under the rule of Reg. Sec. 1.7872-15) would not result in any transfer of foregone interest with resultant compensatory consequences, since the AFR is considered an adequate rate of interest, for purposes of Section 7872.

      (iii) Accordingly, absent forgiveness of the amount loaned, split-dollar loans at the AFR should not be subject to Section 409A.

8. The Notice also provides grandfather protection from Section 409A for pre-final regulation split-dollar arrangements governed by Notice 2002-8.

   (a) If they are not terminated during the insured's lifetime, and continue as economic benefit regime arrangements; neither the equity in the arrangement nor the cost of insurance protection will be subject to Section 409A while the arrangement continues.

   (b) And, Section 409A will not apply to the grandfathered portion of the equity on termination of the arrangement during the insured's lifetime, if any equity then exists, presumably since it would be current compensation.

(c) But it would apply to any non-grandfathered equity on termination (without any “no inference” protection, since that provision of Notice 2002-8 is not carried over to Notice 2007-34).

9. The taxation of the equity at the termination of a pre-final split-dollar regulation economic benefit split-dollar arrangement under both Notices.

(a) This has always been a subject of debate among practitioners and Notice 2007-34 does not clearly set forth the IRS position. There are several positions that practitioners are taking with respect to the taxation of the equity at the termination of a compensatory pre-Final Split-Dollar Regulation economic benefit arrangement, which are as follows:

(b) The equity at termination is only taxable under Section 409A, so if Section 409A doesn’t apply (because, for example when the deferred compensation is grandfathered under Section 409A or the arrangement is not an employer/employee arrangement), there is no taxation of the equity at the termination of the arrangement. Amounts that are subject to Section 409A, however, will be taxable at the termination of the arrangement.

(i) Notice 2007-34, part III.D. addresses pre-Final Split-Dollar Regulations arrangements that are “not grandfathered under Section 1.409A-6”. The Notice refers to the language in Notice 2002-8 which states “the IRS will not treat the arrangement as having been terminated for so long as the parties to the arrangement continue to treat and report the value of the protection as an economic benefit provided to the benefited person.”

(ii) Notice 2007-34 then states that “in such cases, provided that all other requirements of Notice 2002-8 are satisfied, the IRS will not assert that there has been a transfer of property to the benefited person by reason of termination of the arrangement for purposes of Section 409A.”

(iii) Again, Notice 2007-34 does not contain the same “no inference” language that was included in Notice 2002-8 which permitted practitioners to take the position that there was no taxation of the equity at the termination of the arrangement by relying on older Rulings.

(c) The equity at the termination of a pre-Final Split Dollar Regulation employment related arrangement is taxable, but under Notice 2007-34 only non-grandfathered amounts are subject to the rules Section 409A.

(i) This would be the same situation for a deferred compensation agreement that was partially funded prior to January 1, 2005. When the deferred compensation is paid out, the grandfathered amounts are still taxable but those amounts are not subject to the rules of Section 409A.

(ii) Notice 2007-34 applies to grandfathered and non-grandfathered employment related split dollar arrangements (both pre- and post-final split-dollar regulation arrangements), but to no other type of split-dollar arrangements.

(iii) Therefore the lack of any “no inference” language in Notice 2007-34 does not impact any split dollar arrangement other than employment related arrangements.

(d) The equity at the termination of all pre-final split-dollar regulation arrangements is taxable in all instances, and in addition, the non-grandfathered amounts are also subject to the penalties of Section 409A if the plan is not properly structured.

(i) The ”no inference” language Notice 2002-8 does not prevent taxation of the equity at the termination of the arrangement because older Rulings recognized that such equity was a taxable economic benefit provided to the benefited person.

(ii) Therefore, Notice 2007-34 does not discuss whether the equity is taxable or not, the IRS’ position on that issue was resolved in Notice 2002-8, and the Notice is merely defining what portion of the taxable equity is subject to Section 409A.

(e) The equity at the termination of all arrangements that are pre-final split-dollar regulation arrangements is not taxable due to the “no inference” language of Notice 2002-8, but the non-grandfathered amounts in an employment-related split-dollar arrangement must comply with Section 409A to avoid its penalties.

(f) It is unclear which is the correct position for pre-final split dollar regulation arrangements.

(i) Therefore, in light of this uncertainty, it is possible to continue to take the first position described above, namely, that only the non-grandfathered equity in an employment-related split-dollar arrangement is taxable at the termination of the arrangement, because Notice 2007-34 only addresses the treatment of that equity and then only for purposes of Section 409A.

(ii) It therefore appears possible to continue to rely on the "no inference" language of Notice 2002-8 to take the position that the equity in all other pre-Final Split-Dollar Regulation arrangements, and grandfathered equity in employment-related pre-Final Split-Dollar Regulation arrangements at termination is not taxable.

10. Accordingly, it appears that Section 409A will apply only to a limited number of employment-related split-dollar arrangements.

(a) Pre-final regulation equity collateral assignment arrangements terminated during the employee's lifetime with equity in the policy, to the extent the equity is not grandfathered.

(i) Based on which position described above regarding the taxation of equity on termination of an arrangement is adopted, if the equity would have been income under Notice 2002-8, in any event, the application of Section 409A seems to effectively eliminate reliance on the Notice's "no inference" provision for the non-grandfathered portion of the equity in a compensatory SDA.

(ii) In order to comply with the requirements of Section 409A, these arrangements have to be modified to eliminate non-conforming times of payment (like termination of the arrangement by the employee).

(a) Note the issue of whether that qualifies as a non-material modification for purposes of the final split-dollar regulations under Notice 2007-34.

(b) The risk is that it may not, meaning that the modification would make the arrangement a post-final regulation arrangement.

(b) Pre- and post-final regulation loan arrangements, where the loan is forgiven (regardless of a binding agreement to do so).

(i) If the arrangement included an up-front forgiveness, would it have been split-dollar anyway?

(ii) If not, again, it seems nothing is being deferred, since the deferred compensation element would be taxable when forgiven, not at a later date; however, although it is not clear how it would apply, the IRS stated in Notice 2007-34 that those amounts would be subject to Section 409A.

(c) Pre- or post-final regulation equity endorsement arrangements (again, which were rarely done, even before the final split-dollar regulations).

III. Miscellaneous Life Insurance Planning Techniques.

A. What is the "fair market value" of a life insurance policy for tax purposes?

1. The answer may depend on why the question is being asked.

(a) There is one answer (such as it is) for some, limited income tax purposes.

(i) But not necessarily for others.

(b) There is another answer (such as it is) for gift tax purposes.

(c) There is a developing market for some policies – the life settlement market – which provides what a willing buyer would pay for those policies.

(d) There is no answer specific to determine the donor's income tax deduction for gifts of policies to charity – a qualified appraisal will be required for those purposes.

B. Income tax transactions involving policy valuation.

1. One such transaction involved the purchase or transfer of a policy out of a qualified plan, when its value was, by design, artificially low.

(a) Perhaps reducing its value by imposing large surrender charges in early years, which disappear sometime after the transfer ("springing" cash value policies).

(i) Or by purchasing a large face amount policy and reducing the face amount after the transfer.

(ii) Or by purchasing a policy with high initial costs and exchanging it after the transfer.

(iii) Or some combination.

(b) See Notice 89-25, 1989-1 C.B. 662, and Announcement 94-101, 1994-35 I.R.B. 53, both warning that such springing cash value policies distributed out of qualified plans couldn't be valued using their cash surrender value.

2. Another such transaction involved the acquisition of a similar policy by an employer, which was then transferred to an employee when its value was (again, artificially) low.

3. The income tax and (for plan transactions) ERISA issues of policy valuation for transfers out of qualified plans or as compensation.

(a) What is the fair market value of a policy for these specific income tax purposes?

(i) Cash surrender value vs. reserve value vs. cash value vs. interpolated terminal reserve?

(a) In Rev. Rul. 59-195, 1959-I.C.B.18, the IRS held that a policy's value for income tax purposes should be determined consistent with its gift tax valuation under the Section 2512 Regulations, described below.

(ii) Life settlement "market" values.

(a) Is the "market" organized enough to provide a fair market value for all policies, or only for policies for older, less healthy insureds, or only where a life settlement offer is actually received?

(iii) The Section 83 Regulations had long provided that the fair market value of a policy transferred as compensation was its cash surrender value.

(a) See Reg. Sec. 1.83-3(e) prior to its amendment in 2005 by the final Regulations, discussed below.

(iv) Note the expanded definition of policy fair market value in the Section 61 regulations, issued as a part of the split-dollar regulations (requiring taking into account the cash value and all rights under the policy, other than life insurance protection), and those provisions of those regulations ignoring surrender charges in valuing the transfer of interests in post-final regulation split-dollar policies.

(b) What about for other income tax purposes – such as a sale to a family member – not covered by the safe harbors described below.

(i) Arguably, those safe harbor amounts could be (but need not be) used for other income tax purposes.

(c) In a precursor to the policy valuation rules discussed below, in the Final Split-Dollar regulations, issued in 2003 (T.D. 9092), the IRS defined the value of a split-dollar policy as its cash value and all other rights under the policy as property for Section 83 purposes, Reg. Sec. 1.83-3(e).

(d) The IRS had warned that it would be issuing a pronouncement about valuing policy transfers out of qualified plans; that pronouncement was reported to seek to create a new (and less accommodating) concept for valuing policies – perhaps based on premiums paid – and treat some of these transactions, as "listed" tax shelters.

(i) The threat to list these transactions hasn't yet materialized.

(e) That pronouncement was contained in proposed regulations amending the Section 402, 83 and 79 regulations and a series of rulings, all requiring the use of the "fair market value" of a policy, rather than its cash surrender value, in valuing transfers of policies in those situations.

(i) See Prop. Regs. 126967-03, Rev. Ruls. 2004-20 and 21. See also, Rev. Proc. 2004-16, 2004-1 C.B. 559, revised by Rev. Proc. 2005-25, 2005-1 C.B. 962, providing safe harbor rules; the 2004 safe harbors apply for transfers between 2/13/04 and 5/1/05, and the 2005 safe harbors apply for all periods (including those before 5/1/05).

(a) The safe harbors are values which will be automatically be accepted by the Service.

(b) The safe harbor values are arguably in excess of fair market values.

(ii) Under the Section 83 proposed regulations, the policy cash value (not surrender value) plus all other rights in the policy are treated as property – the same definition as under the final split-dollar regulations.

(iii) Under the Section 402 proposed regulations, the policy's fair market value must be used for distributions or sales of policies to participants.

(f) Generally, the proposed regulations are stated to be interpretations of existing law and apply for transfers of policies after February 13, 2004; there is no "grandfathering" of arrangements in place before the effective date (except perhaps for sales – not distributions – from qualified plans, which would have apparently only be covered if they occurred after adoption of the proposed regulations).

(i) The only exceptions are for grandfathering of pre-January 28, 2002 split-dollar arrangements and transfers of pre-final regulation split-dollar policies (where cash surrender value is used).

(g) The preamble to the proposed regulations also warned that for gift tax purposes, under the long-standing Section 2512 regulations, the unusual nature of a policy (an undefined term) can prevent the use of the usual replacement cost approximation of the interpolated terminal reserve formula, the "ITR" value, if that approximation isn't reasonably close to "full value" (another undefined term).

(i) According to the preamble, that method can't be used where the reserve value doesn't reflect the value of all relevant policy features.

(ii) Why these income tax regulations contain a warning about the gift tax value of a policy is curious.

(h) Under the 2004 temporary safe harbor rules, the fair market value of a policy can be approximated by using its cash value (ignoring surrender charges), if it is at least equal to all premiums paid plus earnings credited (investment results for variable policies), less reasonable mortality and other charges.

(i) Under the 2005 permanent safe harbor rules, the fair market value of a policy is the <u>greater</u> of the ITR value (adjusted for unearned premiums) or what is called the PERC amount - Premiums plus Earnings minus Reasonable Charges (adjusted by an interest factor for Section 402 purposes).

(i) The PERC amount is aggregated premiums plus dividends plus earnings minus reasonable charges and distributions.

(j) Final regulations under Sections 79, 83, 401 and 402 were issued on August 29, 2005, effective on that date, but applicable to policy transfers or distributions on or after 2/13/04, which adopted the provisions of the proposed regulations in all relevant aspects.

(k) See, <u>e.g</u>., Reg. Sec. 1.83-3(e), treating the cash value (not surrender value) and all other rights under the policy (other than current insurance protection) as property under Section 83.

(i) The only exception is for transfers of pre-final regulation split-dollar arrangement policies, where only the cash surrender value is treated as property.

(ii) For sales of policies from qualified plans for less than fair market value, the Section 402 regulations are prospective as to the effect of the sale on plan qualification.

(iii) The preamble to the final regulations contains the same curious warning about gift tax valuation for transfers of "unusual" policies.

C. Gift tax transactions involving policy valuation.

1. These transactions involve transfers of policies from an insured to a third party owner, such as an insurance trust.

(a) Either as a gift, subject to Section 2035.

(b) Or as a "full value" sale, to a grantor trust, arguably not subject to the Section 2035 three year "look back" rule (under its full and adequate consideration exception) nor the transfer for value rule (under either the exceptions for transfers to the insured or for carry-over basis transactions; see Rev. Rul. 2007-13, 2007-11 IRB, relying on Rev. Rul. 85-13, 1985-1 C.B. 184).

(i) But see the discussion below about what "full value" is (or might be) in this context.

2. The usual gift tax valuation of a policy is set out in Reg. Sec 25. 2512-6(a).

(a) That regulation section requires use of the cost of a "comparable" policy, since there traditionally was no market for life insurance policies; this Regulation provision, based on early Supreme Court cases, has been in effect, unchanged for decades. See, Guggenheim v. Rasquin, 312 U.S. 254 (1941) (dealing with a single premium policy gifted when the premium was paid) and U.S. v. Ryerson, 312 U.S. 260 (1941) (dealing with a similar policy gifted later).

(b) See also Reg. Sec. 20.2031-8 (a) (2), the estate tax analog of Reg. Sec. 25.2512-6(a), for valuing a policy on the life of another owned by the decedent.

(c) For a single premium policy, its gift tax value is its replacement cost.

(i) See Rev. Rul. 78-137, 1978-1 C.B. 280, concluding that since there was no comparable contract providing the same economic benefits (the entire bundle of rights provided in the original policy), the I.T.R. approximation of the Section 2512 Regulations, discussed below, had to be used.

(d) For a new policy, its gift tax value would be the premium paid.

(e) For a more usual policy on which further premiums are due and which has been in force for some time (an undefined term), since replacement cost would be hard to determine, the regulations provide that its gift tax value can be <u>approximated</u> by the policy's interpolated terminal reserve ("ITR") plus any prepaid premiums.

(i) See, <u>eg</u>, Rev. Ruls 81-198, 1981-2 C.B. 188 (holding that a policy that had been in force for seven years had been "in force for some time") and 79-429, 1979-2 C.B. 321 (reaching a similar conclusion for a policy which had been in force for only three years).

(ii) The type of policy and the insured's health are not relevant considerations in the ITR determination.

(iii) Note that the ITR concept only applies directly to traditional whole life policies (which were the only kind of permanent policy available when the Regulations were adopted), where policy values are guaranteed to increase at stated intervals during the life of the policy. It is, however, but is used for universal, no lapse guarantee, and variable life policies as well (in which there are no guaranteed increases in the cash surrender values).

(iv) Note the potential effect of a "shadow account" used in a no-lapse guarantee universal life policy to increase the policy's ITR (even when cash values are low or even non-existent); also note that carriers calculate the reserve for such policies using what is known as a deficiency reserve and some don't – the reserve calculation without a deficiency reserve should be lower.

(v) Finally, which "reserve" does the carrier use in determining the ITR – the reserve value for the policy used in determining its income tax liability or the statutory reserve for the policy filed with the state insurance department?

(vi) For level term policies, there is a reserve on the carrier's books which will impact value.

(f) As noted above, Reg. Sec. 25.2512-6(a) also provides that if, “due to the unusual nature of the contract” (an undefined phrase) the regulation formula doesn’t reasonably approximate its full value (also an undefined phrase), it may not be used (with no indication of what may be used instead).

(i) Presumably, a standard policy issued by an insurer would not be subject to this exception.

(ii) Is it possible this phrase limits the use of the ITR formula to traditional whole life policies?

(g) See <u>Pritchard v. CIR</u>, 4 T.C.204 (1944), holding that “normal” policy gift tax values don’t apply if the insured is “near death” (an undefined term) -- at that point, fair market value approaches the full face value.

(i) Here, the insured died within 32 days of the sale of the policy.

(ii) See also PLR 9413045, holding the policy’s gift value controls for a gift of a survivorship policy, if the insureds weren’t “near death”.

3. These valuation rules were developed before the life settlement market, described below, provided any measure of a policy’s value in the market.

(a) Is the value of a policy for gift tax purposes its value in the life settlement market or the regulation formula?

(i) Could we ignore the regulation formula and use a higher life settlement value, even if we wanted to?

(ii) Such as in a gift of a policy to a charity, where we would need an independent appraisal for a gift of a policy worth $5,000 or more to charity, under Section 170(f)(ii)(c).

(b) Does it matter if a settlement offer has been received?

(c) What if the policy would qualify for a settlement, but no offers were solicited?

(d) Could we use an independent appraisal and ignore the regulations altogether?

4. The instructions to Form 712 indicate that for single premium or paid-up policies, the amount shown on the Form may not be relied on where the surrender value of the policy exceeds its replacement cost.

   (a) These instructions seem to imply that for all other policies, the 712 value may be relied on for gift purposes.

5. The practice of carriers in reporting values on Form 712 is apparently not consistent, with some only reporting the ITR and some others reporting the policy cash value or its statutory reserves.

   (a) Should practitioners request all possible values for a policy before deciding what value to use for reporting the transaction?

   (b) Some carriers have begun providing a series of values, leaving the determination (which they take the position is a legal issue) up to the adviser.

      (i) See the sample letters attached, setting out a series of possible values, in response to a request for a policy's gift value.

      (ii) Also note the disclaimers contained in one of those letters about calculating the PERC value.

   (c) The gift value (or values) reported on recent Forms 712 are substantially higher than cash values, sometimes dramatically so, perhaps indicating a new conservatism by carriers.

      (i) These values should be known <u>before</u> the policy transfer, not <u>after</u>.

      (ii) It should be possible to discuss with the carrier the value(s) to be provided, or at least the methodology to be used to determine values, in advance.

6. What is the value of a policy sold to avoid Section 2035 (under its full and adequate consideration exception)?

   (a) Is it the policy's gift tax value or the amount necessary to replace it in the insured's estate for estate tax purposes - an amount equal to the policy proceeds?

(b) Compare TAM 8806004 (dealing with a single life policy owned by the insured), holding that full value was its face amount, with PLR 9413045 (dealing with a survivorship policy owned by one of the insureds), holding it was its gift value (assuming the insureds weren't "near death")

(i) For a survivorship policy sold by one of the insureds, Section 2035 would not seem to apply, since Section 2042 would not apply if the owner were to die within three years of the sale, if the other insured were still alive (because there would be no policy proceeds to which Section 2042 could apply).

(c) TAM 8806004 relied on Allen v. U.S., 293F. 2nd 916 (10th Cir. 1961), for the proposition that adequate consideration to avoid Section 2035 would be an amount which replaced the asset in the insured's estate.

(d) In PLR 9413045, the IRS compared this situation with Allen, above, and held that, although the policy was being sold by trusts that were not included in either insured's estate, since the funding of those trusts had been subject to transfer tax, it didn't matter that the purchases didn't enhance the insured's estates.

D. Viatical and life settlements.

1. Viatical settlements, for terminally/chronically ill insureds, who may need the proceeds to live on.

(a) These transactions are non-taxable, under a relatively recent amendment to Section 101, adding Section 101(g).

2. Life settlements, for non-terminally ill insureds, who may want to sell an existing unneeded policy (even a term policy) for more (sometimes much more) than the surrender value, in the secondary market.

(a) The only choice a policyholder had before the development of the settlement market was to surrender the policy to the insurer for its cash surrender value.

(i) Since there was only one buyer and one price, regardless of the then state of the insured's health, the market was inefficient.

(ii) The settlement industry developed as a result of that inefficiency.

(iii) Because the carrier can't get updated medical information, and the life settlement buyer can, it can make a more informed decision about the policy's real value.

(b) The sales price will depend on the insured's health at the time of sale, based on a medical records review and a life expectancy (L.E.) study.

(i) Obviously, the worse the insured's health, the more the policy is worth to the buyer, but the more likely the insured should want to keep it for the death benefit.

(ii) The sales price is described as a percentage of the face amount of the policy.

(c) These sales are taxable.

(i) Characterization of gain.

(a) Ordinary income for the gain over basis, up to the amount of the cash value (on the substitution of income theory, discussed below, since it represents accumulated investment income).

(1) Gallun v. CIR, below, TAM 200452033, and Rev. Rul. 2009-13.

(b) For the gain in excess of cash values.

(1) A capital gain – it is a capital asset (because it isn't excluded under Section 1221) and there is a supporting sale transaction (which is missing in a surrender).

(i) See Phillips v. CIR, 275 F.2d 33, fn. 3 (4th Cir. 1960), in which the IRS conceded the gain on a policy sale would be capital.

(2) See Ltr. Rul. 9443020, below, using a Section 1001 gain analysis in determining a policy's basis.

(c) Rev. Rul. 2009-13-1, 2009-21 I.R.B., held that gain over basis up to cash value was ordinary (on the substitution of income doctrine of cases like P.G. Lake v. CIR, 356 U.S. 260 1958) and capital above cash value.

(ii) Policy basis is premiums paid, minus any non-taxable dividends received (in whole life policies), and minus the "cost of insurance"; Rev. Rul. 2009-13.

(a) Sometimes discussed as the "aggregate premium" theory vs. the "policy investment" theory of policy basis.

(b) Rev. Rul. 2009-13 held that basis was reduced by the cost of insurance in a sale, without discussing how to determine that cost.

(1) In universal or universal variable policies, that cost is disclosed; in traditional whole life it isn't (and would have to be obtained from the carrier).

(2) In prior private rulings, the Service held that, in the absence of other proof, it would be considered the difference between premiums and cash value – obviously including more than just insurance charges.

(3) See Section 7702(g), for a statutory definition of cost of insurance.

(d) Possible long-term effects of life settlements on valuation of policies for tax purposes, based on this "market," for both income and transfer taxes.

(i) Note the "fair market value" approach to policy valuation under the Sections 83, 79, and 402 regulations, above.

(a) The example in the Explanation to the proposed regulations uses the phrase "willing buyer/willing seller" – what willing buyers for policies are there other than life settlement companies?

(ii) Perhaps the limited availability of life settlements, discussed below, will prevent this market from determining policy values in general.

(a) But in a given case, where a settlement was available, it might be determinative.

(1) Especially if an offer had been received.

(e) Availability.

(i) Life settlements are generally only available for older insureds or those whose health has changed (for the worse) since the policy was purchased.

(ii) The industry generally requires the insured be at least 65, with at least "moderately" impaired health, and the policy have a face amount of at least $750,000.

(a) The older and less healthy the insured, the higher the potential price.

(iii) The extension of life expectancies in life expectancy studies, on which these sales are based, the decrease in available financing, and the withdrawal of many hedge funds from this market have lessened interest in life settlements.

(f) Note that many carriers are uncomfortable with the development of this market, since their policies are priced based on the lapse of a certain number of policies (meaning there will be no death benefit to pay), and policies sold into this market won't be allowed to lapse by the buyer.

(i) Apparently, historically a substantial number of permanent policies don't pay their death benefit (either because they have lapsed or been exchanged into another policy).

(g) It is ever prudent to allow a policy to lapse or be surrendered without checking the availability of a settlement?

(i) Both an issue for the insured's advisors and the trustee of an insurance trust.

(ii) Subject to the risk of selling a policy right before the insured dies.

(iii) Which risk is worse? How do we protect ourselves?

(h) Note the civil complaint (apparently later dismissed) filed by the New York Attorney General against Coventry First, one of the better known settlement companies, alleging fraud against policy holders by colluding to suppress and withhold better offers.

(i) More such administrative action or civil suits in this area should be expected.

(i) Also note the legislation proposed by the New York Insurance Department to regulate life settlements by licensing providers and brokers, and registering intermediaries.

E. Sales of insurability involving charities – SOLI or IOLI transactions.

1. These transactions have become known as stranger-owned life insurance "SOLI" or investor-owned life insurance "IOLI" transactions.

2. Here, an investor group pays the insured (or makes a charitable contribution in his or her name, or makes a part of the policy death benefit payable to charity), for the right to acquire a policy on the life of the insured for its benefit.

(a) The insureds are usually provided by a charity, which will get a contribution or a part of the death benefit.

(b) The purchaser is either a charitable or an off-shore entity (or perhaps an Indian tribe), which is tax-neutral to the transfer for value issue, or is a business which has taken the tax on a part of the death benefits into account in its business plan.

(c) Generally, the insured (or the charity) gets a relatively small part of the death benefit.

(d) In some SOLI transactions, the policy is acquired by a partnership or an LLC of which the insured is a partner or member, or the insured purchases and then sells the policy, to attempt to avoid the insurable interest issue.

(e) Some state insurable interest laws (Tennessee's, for example) were broadened to permit these transactions by charities, even where the insured isn't involved.

3. There is a reputational risk for being involved in a transaction that could look bad when reported on in the press, and which may have negative repercussions for the insurance industry.

(a) Insureds won't care about these risks.

(b) Agents and carriers should.

(i) Apparently, some re-insurers have reconsidered participating in SOLI transactions.

4. AALU and other industry groups have come out against SOLI transactions, because of the potential for a negative and possibly overly-broad legislative reaction.

(a) The risk is that the tax benefits associated with life insurance would somehow be restricted or eliminated, both since the underlying basis for them, protection of survivors (the "widows and orphans" argument) doesn't apply here, and the fact that these transactions seem to "play on" the charity's exempt status without providing much benefit to the charities.

5. There was an administration proposal to impose a 25% excise tax on any death benefit received under an IOLI transaction.

(a) The Senate Finance Committee has proposed a 100% excise tax on all costs associated with IOLI transactions (including any payments to the insured), with an effective date of 5/3/05.

(i) This bill only applies where both an exempt organization <u>and</u> a person without an insurance interest in the life of the insured have an interest, direct or indirect, in a policy.

(b) The Pension Protection Act of 2006 imposes a two year reporting requirement on charities that acquire interests in such contracts where the charity and private investors share an interest.

(i) Treasury is directed to determine whether the use of such contracts is consistent with the tax-exempt status of such organizations.

(ii) The results of that study aren't yet available.

F. Sales of insurability not involving charities – IILI, SILI, or SpILI transactions.

1. One early version of this transaction was known as "wet ink settlements."

(a) They involved an insured purchasing a new policy, with funds provided by the proposed buyer, which was then immediately sold to the buyer.

(b) Because of insurable interest and policy contestability issues, these transactions involved risks to the buyer, which were usually dealt with by the purchase of "gap" insurance.

(c) Generally, these transactions have given way to loans to the insured or a trust created by the insured, designed to acquire the policy and hold it through the contestability period, because of the insurable interest concerns, discussed below.

2. Current versions of these transactions are known as investor initiated life insurance ("IILI"), stranger initiated life insurance "SILI" - (my personal favorite), or speculator initiated life insurance ("SpILI" or "SPINLIFE");

3. In one common version of these transactions, an investor group lends the insured (or his or her trust) two years' (or three or five years) premiums to purchase a new policy, under an interest-accrued, non-recourse note.

(a) At the end of the term, the insured (or his or her trust) can walk away and let the lender foreclose on the policy, or can repay the lender and keep the policy, or can sell it in the settlement market (splitting the sale proceeds with the lender under an agreed-upon formula).

(i) That decision will be driven by the insured's health at that point, and the economics of repaying the loan to keep the policy.

(b) If the owner walks away from the non-recourse liability, a transfer of the policy in satisfaction of the loan (even a non-recourse loan) is treated as a sale of the policy for the loan balance. Reg. Sec. 1.1001-2(a).

(i) The amount realized includes the principal amount and (most likely) any accrued interest.

(a) There is an argument that the accrued interest is a part of the amount realized only if the taxpayer had deducted the interest – the so-called "tax benefit rule," applicable to transfers of property in satisfaction of recourse liabilities.

(1) See Ltr. Rul. 9251023.

(ii) The issue of the basis in the policy under Rev. Rul. 2009-13, is discussed above.

(c) As discussed above, gain on a sale of the policy will be ordinary income up to the cash value and a capital transaction thereafter.

(i) Although the policy is a capital asset and there is a sale, the argument is that the payment for the cash value increases are interest substitutes.

(ii) See TAM 200452033, taking the position that even though a policy is a capital asset, the definition of a capital asset "excludes … accretion to the value of a capital asset properly attributable to ordinary income," based on the "substitute for ordinary income" doctrine of cases like C.I.R. v. P.G. Lake, Inc., 356 U.S., 260 (1958), and holding that gain up to cash value was ordinary.

(a) Would a variable policy sale yield a different result, since there increases in cash values are market, not interest, driven?

(iii) See Rev. Rul. 2009-13 taking this position.

(d) If this were treated as something other than a true loan for tax purposes, based on the parties' intent, the premiums advanced might be treated as part of the purchase price for the policy, or even as ordinary income.

(i) See Sutter v. Cir., TCM 1998-250, based on unusually bad facts – where it was clear neither party intended the "loan" to be repaid; the court held the "loans" were income to the borrower.

(ii) In these transactions, the lender clearly intends to have the loan repaid or to foreclose on the policy.

(a) Although in many of these transactions, it is usually economically impossible for the trust to ever repay the loan and the owner will have to walk away from the transaction.

(iii) See also Reg. Sec. 1.7872-15(a)(2), providing that a split-dollar loan which a "reasonable person" would expect to be repaid is treated as a loan for federal tax purposes, even if it wouldn't be under general tax principles.

(a) Again, will these loans be repaid?

(e) In these transactions, the policy owner is a non-grantor trust, to try to avoid these tax results for the insured.

(i) It isn't clear that such a trust would be respected for income tax purposes, however.

(a) Under Section 677(a)(3), an insurance trust would almost always be a grantor trust, as to fiduciary accounting income, since, normally income is, or can be, used to pay premiums; whether that status can be intentionally avoided where a trust owns insurance on the grantor's life isn't clear.

(1) Perhaps the only way to assure non-grantor status for an insurance trust as to fiduciary accounting income is to avoid Section 677(a)(3) by requiring trust income be used to pay premiums with the consent of an "adverse party" – a trust beneficiary.

(b) See LAFA 20062701F, taking the position that a trust, designed as a non-grantor trust, was a grantor trust under that provision, even when it didn't own any insurance.

(1) Admittedly, a stretch, but indicative of the Service's argument in this area when it wants to find a trust a grantor trust.

(f) Note the insurable interest issue for the lender, discussed below.

(i) On December 19, 2005, the General Counsel of the New York Department of Insurance issued an Opinion raising both the insurable interest issue and the rebate issue for these transactions under New York law.

(a) See also the Utah and Louisiana Insurance Commissioners' Bulletins on these transactions, reaching similar conclusions.

(ii) New York Life has filed a series of lawsuits seeking to invalidate a number of its policies as having been sold – without its knowledge – to trusts that did not have the requisite insurable interest under New York law.

(a) Apparently, these policies were sold before the applications were changed to ask about intended life settlements or third party owners.

(b) It is hard to tell from the petition, but these policies were apparently sold to trusts for the benefit of a family member and the premium provider.

(c) Some of these lawsuits have since been withdrawn, where the insurer's offer of rescission was accepted.

(g) Could the insured have any liability to the lender if the policy wasn't valid or the insured's estate was entitled to the proceeds under state law, because there was no insurable interest?

(i) Do the loan documents cover this; whose risk is it (or should it be)?

(h) See also, LifeProduct Clearing LLC v. Angel, 07 Civ. 475 (2008), known as the Lobel case, in which the New York District Court judge denied a motion for judgment on the pleadings, in a case filed against the insured's estate (to which the proceeds were paid by the carrier) by the purchaser of an interest in a trust created to own a policy arguably purchased with the intent to sell an interest in the trust to an investor.

(i) Based on the language of the order, the judge left no doubt he would find no insurable interest here.

(ii) As discussed below, the industry is opposed to these transactions, many insurers will not support them, and state insurance regulators are acting to stop them.

(iii) But as also noted below, new variations are being developed to respond to these concerns.

(iv) This risk is why most of these transactions are undertaken in non-grantor trusts – to attempt to avoid taxing the grantor on a transaction that produces no cash.

(i) This is sometimes sold as "free" insurance (for the term) plus the chance to participate in a gain on the sale of the policy, to people who don't have a long-term need for the death benefit.

(i) This "free" insurance was what was held to be a rebate by the New York Department of Insurance opinion, discussed above.

(j) Another way to look at these transactions is as a no-premium "call" on the policy (or on the insured's insurability at the end of the term).

(k) In some early versions of these transactions, the insured was advanced more than the premiums – an upfront payment as an additional inducement.

(i) Based on the lender's evaluation of the "real" value of the policy.

(ii) This amount would not constitute basis in the policy for calculating gain on a deemed sale in the event of a foreclosure.

(iii) Could it be treated as a part of the sale price of the policy?

4. In these transactions, the insured "gives up" his or her insurability, in exchange for a payment and/or for the "free" insurance.

(a) Assuming the insured is comfortable with the possibility of an institution owning a policy on his or her life, there are few other apparent disadvantages to the insured, assuming he or she has no liability on the loan if the policy proceeds aren't paid at death (i.e., there really is no recourse), and the insured understands the transaction and its economic and tax effects - which is not always the case – see the allegations in King v. Meltzer (C.D. Cal. 2007).

(i) So long as the buyer takes the risk of insurable interest, suicide, medical report misstatements, or fraud, etc., under the loan documents.

(a) Perhaps by insuring against them, using so-called "gap" insurance.

(b) Or by waiting to buy the policy until the two year incontestability period ends; this is why the buyer will lend the insured the first two years' premiums (or more) to allow the insured to acquire the policy.

(1) Note the issue of fraudulently obtaining the policy by not being "wholly truthful" on the application about the purpose of the insurance, under the expanded application questions designed to discover these transactions, discussed below.

(ii) Could a carrier raise a fraud defense to paying the death proceeds because of a claim the insured lied about the reason for the purchase on the application?

(a) Is answering "estate planning" broad enough to honestly apply to these transactions?

(b) Would the insured have any liability to the lender if the policy were void because of the insured's lack of candor in the application or because of a representation made by the insured in the loan documents?

(c) This all underscores the necessity for independent review of all of the transaction documents.

(1) The effect of the ultimate Lobel decision, above, may test this question.

(iii) Does lying on the application prevent the state law incontestability provision from applying?

(a) Apparently not.

(1) See, e.g., McKinney's New York Insurance Law, Section 3203(a)(3), and West's Ann. Cal. Ins. Code, Section 10113.J(a).

(2) See also Missouri's Insurance Regulations, Title 20, §400-1.010(2)(B)(2006).

(3) The Missouri regulation does not make fraud a defense against incontestability for individual policies, as it does for group policies.

(4) Note, for example, Allstate Life Ins. Co. v. Miller, 424.F.3d 1114 (11th Cir. 2005), applying the incontestability provision of Florida law against the insurer, even where the policy was issued as a result of having an imposter take the physical exam!

(1) California's incontestability provision was subsequently amended to provide an exception in this situation.

(b) However, fraud in the application will likely be a crime, under the state's insurance laws. See Mo. Rev. Stat. 375.991(2005 Supp).

(b) Many insureds and their advisors overlook the risk of death during the term of the loan and don't focus on the terms of the trust which will own the policy and collect the proceeds (most of which are bad, boilerplate trusts), if the insured dies during the term of the loan.

(c) The same can be said about the advisor's potential liability if he or she advised the client not to proceed for any reason other than his or her evaluation of the risks for the proposed insured (as opposed its risks for the insurance industry), and there is a death during the term.

5. An increasing number of major carriers have indicated that they won't accept any future SILI business.

(a) Although their ability to police these transactions has been limited – how would they know a proposed insured was buying the policy to sell it under the traditional insurance application questions?

(i) Most policy applications have begun asking that or similar questions.

(a) Note that the policy application involved in the <u>Lobel</u> case, above, contained these kinds of questions, but they were left blank and the policy was issued nonetheless.

(ii) And some carriers are imposing those restrictions on their agents as a condition of continuing their relationship.

(b) The reasons for carrier opposition to these transactions is less understandable then their opposition to IOLI transactions.

(i) But policies which won't lapse do effect the pricing of their products, because some level of profitable lapses is built into that pricing.

(a) Which is true of policies sold into the life settlement market, described above.

(ii) At least one rating agency has stated this trend may effect carrier ratings, if it continues to grow.

(c) Some carriers have implemented loan programs, in which they will lend against the death benefit, not just the cash value, as they have traditionally done, as an alternative to a SOLI transaction.

(i) Almost like a viatical transaction for a non-terminally ill insured.

6. There has been a rash of administrative and legislative activity in this area.

(a) ACLI has gone so far as to propose a 100% excise tax on these transactions (similar in concept to the Senate Finance Committee bill relating to IOLI transactions, described above).

(b) NAIC, on the other hand, has proposed that a way to control these transactions would be to prohibit any transfer of a new policy for five years, with some exceptions for what it considers legitimate transfers.

(i) Its Life and Annuity Committee has adopted amendments to the Model Viatical Settlements Act making such a sale a violation of the Act, with some exceptions for "legitimate uses of insurance."

(a) The NAIC amendment prohibits transfers for 5 years from issuance (with some hardship exceptions), or for 2 years if there is no agreement evidencing intent to settle the policy prior to the 2 year period, there is no life expectancy evaluation within the 2 year period, and the owner provides collateral for the loan or limits the loan to the cash value of the policy.

(b) It includes an exception where during the first two years, the insured, a family member, or an employer provided the funds for premiums, there was full recourse for any premium loan, there was no understanding to guarantee the loan, and no evaluation of a settlement was made.

(c) A viatical settlement contract would include premium financing loans where the loan proceeds are not used just to pay premiums, there is a guarantee of a future settlement, or an agreement to sell the policy.

(d) Some states have begun adopting this amendment.

(c) The NCOIL has a different proposal; it defines SOLI transactions and prohibits transfers of polices for two years.

(i) The NCOIL proposal defines STOLI as a plan to initiate a policy for a third party investor who has no insurable interest, including policies purchased with resources from a person who could not initiate the policy himself and where there is an agreement to directly or indirectly transfer the policy to a third party. Trusts that give the appearance of insurable interest and are used to initiate policies for investors violate insurable interest.

(ii) It also has reporting and disclosure requirements.

(iii) Some states are adopting this proposal.

(d) This patchwork system doesn't seem to make any sense.

(e) A House Ways and Means Subcommittee has urged Treasury to alert elderly taxpayers about the tax implications of life settlements, because those implications have been the subject of "increasing commentary and concern".

7. For all of these reasons, the ongoing availability of these transactions is likely to be limited.

(a) The effect of the ultimate decision in the Lobel case, discussed above, and other similar cases may prove to be what ends these transactions.

8. However, these transactions are always evolving; these have become known as hybrid arrangements.

(a) One new version requires that 25% of the loan be recourse.

(i) Another version is based on the trust beneficiary selling his or her interest in the trust (which has no spendthrift provision) to the lender/investor, without a transfer of the policy, making the transaction harder for the carrier to identify upfront and to monitor when the sale is made.

(a) It was this kind of transaction that was involved in the Lobel case, discussed above.

(ii) Another version gives the policy owner an ability to put the policy to the investor, like the arrangement in the New York Insurance Commissioner ruling, discussed above.

(b) As noted, the effect of the final decision in the Lobel case, above, may have a negative effect on these transactions, if it holds, as many believe it will, that there was no insurable interest, so that under New York law, the insured's estate - not the purchaser – was entitled to the proceeds.

(i) If the insured warranted insurable interest in the loan/option/sale documents, can the purchaser pursue that remedy to re-obtain the proceeds?

(a) Which party's risk is it?

(b) Was there an opinion on this issue provided to the insured and/or the investor?

(ii) Compare the dicta in Warnock v. Davis, 104 U.S. 775 (1881) with Grigsby v. Russell, 222 U.S. 149 (1911), regarding the purchase of a policy by the insured with an intent to assign it to someone without an insurable interest, in an integrated, pre-planned transaction.

9. The major issue for the investors/lenders is the insurable interest issue.

(a) The first question is which state's law applies?

(i) The state of the insured?

(ii) The state of the lender?

(iii) The state chosen in the documents?

(b) In most states, the requisite interest must only exist at the moment the policy is issued.

(i) Although that concept has begun to be questioned.

(c) In most states, the insured, family members, business associates and some entities have an insurable interest in the insured's life.

(d) It isn't clear whether an acquisition of the policy by the insured with the intent to resell it will be respected for these purposes.

(i) See Ltr. Rul. 9110016, taking the position (without citing any authority) that an insured's acquisition of a policy intending to immediately give it to a charity, which didn't at the time have an insurable interest in his life, wasn't insurance for tax purposes, because the two-step transaction didn't work to create an insurable interest.

(a) The holding of the ruling was revoked by Ltr. Rul. 9147040, issued after New York changed its insurable interest law to give charities an insurable interest in their donors and board members.

(b) Most other states broadened their insurable interest rules for charities at the same time.

(ii) The rationale of the ruling is that although an insured would apparently always have an insurable interest in his or her life, an intent to immediately give it to someone who didn't have such an interest in a pre-arranged transaction shouldn't work to avoid the rules.

(a) There are early cases in some jurisdictions which invalidated purchases by the insured with the intent to immediately transfer it to someone without an insurable interest, as a part of a pre-arranged plan (especially where the third party provides the initial premiums).

(b) See the Warnock and Grigsby cases, above.

(iii) In some of these transactions, there is no immediate assignment of the policy (other than as collateral security for the loan); any sale (either by foreclosure by the lender or in the settlement market) will be only after the policy has been in existence for two years, and only if the owner makes the economic decision at that point not to keep the policy.

(a) That could eliminate any insurable interest concern in most states, at least for those transactions where the economics are such that the owner has a real economic choice to continue to own the policy at that point (i.e., where the interest rate is reasonable).

(1) That can only be determined on a case by case basis.

(b) In any event, the lender should always have an insurable interest, to the extent of the loan.

(1) In other variations, such as a purchase of an interest in a trust, that rule would not protect the purchaser.

(iv) The New York Department of Insurance opinion, discussed above, took a similar position on this issue, stating that the transaction was, in effect, a device to transfer the policy to someone without an insurable interest.

(a) As have the Louisiana and Utah Insurance Commissioners, and an increasing number of other regulators.

(v) If there is no insurable interest, the policy would be void – meaning neither the insured's beneficiaries nor the lender will receive any death benefits, or the insured's estate may be entitled to all of the proceeds – depending on state law.

(a) If the policy was void for lack of an insurable interest, and the death benefit is payable to the insured's estate:

(1) The Section 101 income tax exclusion for the death benefit is unavailable; and

(2) The proceeds will be includable in the insured's estate under Section 2042(1).

(b) Not exactly what the insured bargained for when he or she took out the policy.

(c) Note again the issue of the insured's potential liability under any representations on this issue he or she may have made under the loan documents.

(1) As well as any attorney who opined on this issue for the lender.

(vi) This issue will likely first be presented to the courts when an insured in one of these transactions dies during the term of the loan.

(a) Although note the pre-emptive law suits filed by New York Life, discussed above.

(vii) See the Lobel case, discussed above, in which the District Court held that a trial was necessary to determine if the insured purchased the policy with the intent to assign it (by selling an interest in a trust which owned the policy) to someone without an insurable interest.

(viii) See also Sun Life Assurance v. Paulson, #07-3877 (D. Minn), holding that the carrier did not allege enough facts to show such a pre-arrangement, in a motion for summary judgment proceeding.

(a) The court later refused to certify the case to the Minnesota Supreme Court, since its view was that the law required an identified third party buyer to raise an insurable interest issue.

(ix) Penn – Pacific Life Insurance Company v. Evans (unpublished 4th Cir. 2009), similarly held, the policy was not invalid for lack of insurable interest, where there was no evidence that a specific buyer for the policy was involved.

(x) These cases have been criticized as having been based on the pre-life settlement world, where a third party purchaser would have had to have been lined up in advance in such an arrangement.

(xi) But see Lincoln Natl. Live v. Calhoun (D.N.J. 2009) in which the District Court refused to dismiss the complaint in a similar suit, despite the fact that there was no formal agreement to sell the policy.

G. Insurable interest outside the SOLI/SILI areas.

1. This is a state law issue.

(a) As noted, which states' law will apply isn't always clear.

(b) Note the recent COLI cases involving a purchase by an entity set up in a state with an expansive insurable interest provision, challenged by the insured's family under the law of the insured's domicile.

(i) See, e.g., Tillman v. Camelot Music, Inc., No. 03-5172 (10th Cir. 2005), holding the law of the state of domicile of the insured would be applied – rather than the law of the state chosen in the documents and where the policy was purchased – and that under that law, there was no insurable interest.

(ii) See also, Mayo v. Hartford Life Ins. Co., 354 F.2d 400 (5th Cir. 2004).

(a) Note the related case of Wal-Mart v. AIG Life Ins. Co., Del. No. 172, 2005 (Del Sup Ct 2006), reinstating Wal-Mart's fraud claim against the insurers and brokers involved in its broad-based COLI plan, based on the plan not working as proposed for tax purposes and because of the insurable interest issue.

(c) Many state statutes and case are old, and only focus on family or creditor relationships.

(i) Although many are being re-examined and updated in light of the recent developments in this area.

2. Most practitioners assume that an ILIT has an insurable interest in the life of its creator.

(a) See, however, Chawla v. Transamerica Occidental Life Ins. Co., No. 03-1215 (E.D. Va. 2005), a District Court case interpreting Maryland law.

(i) There, the court, in an alternative to its holding that the policy was void for misrepresentations by the insured, held an insurance trust had no insurable interest under Maryland law (which had a typical definition of insurable interest) because it benefited from, rather than was harmed by, the insured's death.

(ii) The court viewed the issue at the trust level, rather than at the level of the beneficiary (who clearly had none); whether it would have reached a different result if, as would usually be the case, the beneficiary did have such an interest, isn't clear.

(iii) Such a "look-through" approach would appear to be the correct analysis – insurable interest shouldn't be able to be created by using a trust, but it shouldn't be lost by using one either.

(iv) This holding has been called "a disturbance in the force" by one commentator.

(b) The insurable interest portion of the District Court opinion was vacated, as unnecessary, by the Fourth Circuit Court of Appeals, CA-03-1215 (2006) citing the doctrine of judicial restraint in a state law issue of first impression.

(i) Note that this is not a decision on the merits of the issue.

(c) See also, Caso v. First Colony, 2003 WL 21019625 (Ca. App., 2003), an unreported California opinion, containing similarly broad language, in discussing a business trust created by unrelated parties, not a typical insurance trust created for family members.

(d) Some state statutes (including Maryland's) have been, and more likely will be, amended to provide that a trust has an insurable interest in the lives of its creator and its beneficiaries.

(e) Stay tuned; this case may have been a fluke, based on terrible facts, or may be the beginning of a trend.

(f) Note, however, Lincoln National Life v. The Gordon Fishman Irrevocable Trust (D.C., C.D. Cal. 2009, on appeal to the 9th Cir.), a case involving a suit by an insurer to void an alleged stranger-owned policy, in which the court held an insured's family members, as well as a trust for their benefit, had an insurable interest in his life under California law.