LIFE INSURANCE – 18 OF MY "FAVORITE" PLANNING MISTAKES YOU SHOULD AVOID AT ALL COSTS*

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

Any amount received in a single sum under a life insurance contract on its complete surrender, redemption, lapse, or maturity is includible in the gross income of the policy owner, as ordinary income[1/] to the extent that that amount exceeds his or her "investment in the contract,[2/] a basis-like concept. Investment in the contract is the aggregate amount of premiums or other consideration paid for the contract, less any amount received under the contract, to the extent that amount was excludable from gross income (such as dividends received on a participating policy or withdrawals from a universal life policy, so long as they don't exceed basis).[3/]

Accordingly, investment in the contract will be aggregate premiums paid by the taxpayer, reduced by any dividends, unrepaid loans, accumulated interest on loans, and any other amounts received under the contract, such as withdrawals, which were not previously includible in gross income.[4/] If dividends are received in cash or are used to reduce premiums, they will reduce the investment in the contract; presumably, dividends used to purchase term riders will

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1/ Since there is no sale or exchange to support capital gains treatment; however, for the reasons that will be discussed in detail below, there is an argument under Section 1234A that a lapse (or even perhaps a surrender) would qualify for capital gain treatment in any event.

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

3/ Section 72(c)(1), 72(e)(6).

4/ Note again the different issues raised on a sale of a policy, where, as discussed below, basis – not investment in the contract – is the relevant concept.

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

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

Accordingly, any policy loan will be a part of the consideration received by the taxpayer on a policy surrender or lapse, generating ordinary income[5/] – without generating any cash in the case of a lapse, or potentially not enough cash to pay the tax, in the case of a surrender. The Form 1099R issued by the carrier on a surrender or lapse of a policy will include any outstanding loan as part of the proceeds.

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

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

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

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

A modified endowment policy is any insurance policy issued after June 21, 1988, under which the cumulative premium payments in any of the first seven years exceeds the sum of net level premiums which would have been paid to provide a paid-up policy after the payment of seven level annual premiums (the so-called seven pay test).[6/]

Distributions from modified endowment contracts are subject to the same rules as distributions from deferred annuity contracts – income on the contract, rather than a return of premiums, comes out first as a result of any withdrawal or distribution.[7/] In addition, loans from the insurer against the cash value of a modified endowment contract are treated as distributions for this purpose.

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

The pledge of a Modified Endowment Contract as collateral for a third party loan (or even – apparently, and strangely – the agreement to pledge a MEC for such a loan) is treated as a loan against or withdrawal from the Modified Endowment Contract, in order to avoid what

6/ Section 7702A. Once a policy becomes a MEC, no modification to the policy nor exchange to another policy can change that result – once a MEC, always a MEC.

7/ Section 72(e)(10).

would otherwise be an end-run around the policy loan or withdrawal provisions of Section 7702A, by merely using the policy as collateral for that third party loan.[8/]

Finally, if the pledge were between the insured and his or her grantor trust, the pledge would be ignored for Federal income tax purposes, since all transactions between a grantor and his or her grantor trust are ignored for Federal income tax purposes under the theory of Rev. Rul. 85-13, below.

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

3. Surrendering a participating policy without checking the effect of dividends received or other non-taxable distributions on the owner's investment in the contract.

As noted, policy dividends, in some cases, reduce the owner's investment in the contract, as do other non-taxable distributions from the policy, such as withdrawals up to basis or partial surrenders, in universal policies.[9]

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

Accordingly, many commentators feel that pledges of a MEC as collateral for a split-dollar arrangement (either economic benefit or loan regime) to a third party (such as an employer) should not be treated as a loan against or withdrawal from a Modified Endowment Contract (although there is no authority for either position). In any event, using the unsecured documentation method (where the policy is not assigned as collateral for the advances) should avoid this issue.

9 See the discussion of the circumstances in which dividends on participating policies will reduce investment in the contract in item 3, above.

The issue for the policy owner in surrendering a participating policy is determining the amount of gain on the surrender, taking into account that reduction; most owners and their advisors assume their investment in the contract is the total of their premiums. The Form 1099R issued by the carrier to report the surrender only shows the gross surrender amount, not the reduced investment in the contract, putting the burden of correctly reporting the gain on the policy owner.

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

A life insurance policy is a capital asset (since it is not expressly excluded from the Section 1221 definition of a capital asset). As noted above, if a policy is cancelled or surrendered to the insurance carrier in exchange for cash surrender value, any gain on the policy is ordinary income, despite the fact that the policy is a capital asset, because the transaction does not qualify as a "sale or exchange" of the policy.[10/]

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

Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, without citing any authority, said it did not apply; <u>see also</u> TAM 200452033, holding that despite the application of Section 1234A to the surrender of a policy, the substitution of income theory, discussed in the text above, requires gain based on cash surrender value (an ordinary income item) to be treated as ordinary. Note again, the settlement reached in <u>Hunt v. Cir</u>., described above, treating gain on a policy lapse caused by the extinguishment of a policy loan as capital, based on Section 1234A.

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

However, if the policy is sold in the life settlement market (and perhaps in other sale transactions), since it is a capital asset and since the sale would qualify as a sale or exchange, any gain on the sale, in excess of basis, should be capital. Note, however, that based on the substitution of income theory of cases such as CIR v. P.G. Lake, Inc. [11/], gain above basis up to the policy's cash surrender value at the time of the sale is ordinary, since it is, in effect, a payment in lieu of interest earned on policy cash values.[12/] Accordingly, under Rev. Rul. 2009-13, above, gain on a sale of a policy in the life settlement market over basis (or, presumably in any other context) up to cash value is ordinary income and any gain over cash value is capital.

Basis in a policy has traditionally been total premiums minus non-taxable distributions (such as dividends in participating policies or withdrawals up to basis in universal policies).

In Rev. Rul. 2009-13, above, the IRS also – controversially – had held that in a policy sale in the life settlement market, [13/] basis (as opposed to investment in the contract, which is applicable in the case of policy surrenders or lapses, not sales, as discussed above) had to be

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11/ 356 U.S. 260 (1958).

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

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

reduced by the cost of insurance protection provided to the insured[14/] (without any guidance on how to measure it). The 2017 Tax Cuts and Jobs Act retroactively repealed that part of the ruling.[15]

5. Determining adequate and full consideration for the sale of a policy to an ILIT to avoid the three year rule of Section 2035.

As noted above, if the insured transfers an insurance policy on his or her life to an ILIT, the Section 2035 three year rule for including the death proceeds in the insured's gross estate will apply, should the insured die within three years of the transfer. [16/] However, there is an exception to Section 2035 if the policy is sold pursuant to a bona fide sale for "adequate and full consideration". [17/]

The issue is what is "adequate and full consideration" for such sales. If the sales price is as little as one dollar under adequate and full consideration, the entire death proceeds, reduced by the inadequate consideration paid, would be included in the insured's gross estate should the insured die within three years of the sale/gift. There are three possible problems to consider.

14/ In PLR 9443020, the IRS took the position, without citing any authority, that basis in a policy was also reduced by the "value" of the death benefit provided; but see Gallun v. CIR, 327 F. 2d 809 (7th Cir. 1964), in which the court calculated basis on a policy sale without any such reduction.

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

15 Another provision of that Act added Section 101(a)(3), making it clear that no exception to the transfer for value rule would apply to the purchaser in a life settlement or to anyone else without what appears to be a newly defined Federal insurable interest in the life of the insured.

16/ Section 2035(b)(1).

17/ Id.

The first is that the valuation of policies is not always clear, as discussed in more detail below. The value of an existing cash value policy with future premium payments is the interpolated terminal reserve plus the proportionate part of gross premiums paid before the transfer applicable to the time after the transfer (the "unused premium").[18/] However, interpolated terminal makes sense with whole life policies, but not with universal life policies which debuted after the Regulations were issued. Furthermore, the word "reserve" is not defined by the Regulation; for universal life policies, accordingly, insurance carriers use state law reserves, Federal income tax reserves, cash value or accumulation reserves, with widely varying results.[19/] If there is uncertainty about the value of the policy, the insured may want to obtain a policy appraisal to determine the policy's fair market value and accordingly the sales price.

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

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

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

adequate and full consideration under Section 2035 was received in a sale of policies for their gift tax value, rather than their death proceeds.[20/]

In an analogous area under Section 2036, where a remainder interest in a trust was sold for what was argued to be adequate and full consideration while retaining the income interest, a majority of the courts have held that adequate and full consideration was the value of the remainder interest and not the entire value of the property, including the income interest.[21/]

The third is the Pritchard case "near death" exception to the use of gift tax values as adequate consideration in such sales. Estate of Pritchard v. Commissioner,[22] held that since the insured was "near death" at the time of the sale (he died 32 days later), adequate and full consideration for the policy to avoid Section 2035 was its face amount, not its gift tax value. There are no other Federal tax cases dealing with this concept. Note that the Pritchard "near death" concept related to a sale of a policy to avoid Section 2035, but is often misused by applying it to more general gifts of policies.[23]

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

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

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

22 4 T.C. 204 (1944),

23 See PLR 9413045 in footnote 20.

Under the Section 2512 Regulations,[24/] the gift tax value of a policy transferred during the insured's lifetime is determined by its "replacement" cost, the cost of a "comparable policy". However, the Regulations recognize that for a policy that has been in force for some time (an undefined term) on which future premiums are due, obtaining the cost of a comparable policy would be difficult; accordingly, the Regulations provide that, in this situation, the cost of a comparable policy <u>may</u> be (not <u>must</u> be)[25/] <u>approximated by</u> the so-called interpolated terminal reserve formula – the policy's interpolated terminated reserve plus any prepaid premiums.[26/]

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

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

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

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24/ Reg. Sec. 25.2512-6.

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

26/ Policy loans are deducted from that result; surprisingly, the Regulations don't provide for that deduction, but the Instructions to Form 712 indicates loans would be so deducted and there is a line on the Form 712 showing the deduction of policy loans from the ITR value.

possible values for a policy transferred during the insured's lifetime, including the policy's cash or accumulation value, its cash surrender value, its interpolated terminal reserve value and its PERC value (a calculation required for transfers of policies in some income tax situations by the 2005 regulations issued under Section 83).[27/] Most carriers have determined that a policy's "fair market value" is a legal issue to be determined by counsel for the policy owner and its only role is to provide the range of values for counsel.

The warning here is that the fair market value of a policy for gift tax purposes may be significantly higher than its cash surrender value – for example, both no-lapse guarantee universal life policies and level term policies may literally have a zero cash surrender value but a very large ITR value[28/] – the only way to know what the policy's potential gift tax value is to request a Form 712 from the issuing carrier, before the policy is transferred.[29/]

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

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

27/ They don't, of course, report a policy's possible life settlement value (since they won't know it), but that value may be the best measure of its fair market value since it is based on a willing buyer/willing seller determination.

28/ As is true with many level term policies.

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

There is, however, an exception to that general rule for transfers of the policy for value during the insured's lifetime. If a policy is transferred for value during the insured's lifetime, unless one of the exceptions to the transfer for value rule (described below) applies, the only portion of the death proceeds which will be excludable from the beneficiary's gross income is equal to the amount paid by the transferee for the policy plus any future premiums paid by the transferee. The "value" for a transfer which might subject it to the transfer for value rule need not be a cash payment – the mutuality of a contractual agreement to transfer the policy has been held to be enough to support the application for the transfer for value rule.[30/]

Fortunately, there are a number of helpful exceptions to the transfer for value rule applicable in an estate planning context.[31/] Those exceptions include transfers to one of the four "proper party" transferees:

1. A transfer to the insured (including, for this purpose, a transfer to a trust which is a wholly grantor trust from the point of the insured);[32/]

2. A transfer to a partner of the insured;

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

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

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

31/ Section 101(a)(2).

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

In addition, a transfer in which the transferee's basis is determined, in whole or in part, by the transferor's basis (including, for this purpose a transfer to the insured's spouse, or former spouse, if incident to a divorce), is also exempt from the rule.[33/]

The warning here is that, any time a policy is transferred during the insured's lifetime, caution must be exercised to consider whether the transfer for value rule might apply to the transfer, and if so, whether one of the exceptions to its application would be available.[34]

8. Planning around Section 677(a)(3) if an ILIT is intended to be a non-grantor trust or is planned to be a grantor trust in a way that can be "turned off" if needed.

Although it is often advantageous to have an ILIT be a grantor trust, so as to avoid transfer for value issues, avoid gain on sales to or from the settlor, avoid interest income on loans to or from the settlor, and depletion of trust assets by the trust paying its own income taxes, sometimes the grantor does not want to be taxed on the trust income, despite the transfer tax advantages of doing so. Where a trust has significant income producing assets in addition to the life insurance policy, the trust should be drafted to avoid the grantor trust triggers of Sections 671-678, if the grantor wants to avoid being taxed on trust income. The most likely grantor trust trigger for an ILIT is the ubiquitous Section 677(a)(3) provision.

Section 677(a)(3) provides that an ILIT is a grantor trust to the extent trust income is applied or may be applied to the payment of premiums on policies of insurance on the life of

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33/ Section 1041(b)(2).

34 Note again Section 101(a)(3), added by the 2017 Act, which prevents any exception to the rule from applying to a life settlement purchaser (or anyone else without a defined interest in the life of the insured).

the grantor or the grantor's spouse, so long as the policy is not irrevocably payable to a charity and the application of the income does not depend upon the approval of an adverse party.

If the ILIT is silent about payment of premiums with trust income, state law will probably authorize the trustee to make such payments, resulting in a grantor trust. What if the ILIT prohibits the use of income to pay premiums and instead they are paid with principal or contributions to the trust? One old case implied that, even if the trust prohibited the use of income to pay premiums, the breach of trust by the trustee who uses trust income to pay premiums would not prevent grantor trust status treatment.[35/] Also, PLR 8839008 involved an ILIT which prohibited applying "trust income" to payment of premiums, but the IRS held that the trust was a grantor trust, since it construed the document as referring to accounting income and not taxable income.

Possible ways to ensure that an ILIT will be a non-grantor trust are for the ILIT to be drafted so that either income is automatically distributed to the beneficiaries upon receipt, or that income is segregated in a separate accrued income account which cannot, under the terms of the trust, be used to pay premiums. To avoid the rationale of PLR 8839008, the prohibition should expressly apply to taxable income.

Perhaps the best way to ensure that the trust won't be treated as a grantor trust under Section 677(a)(3) is to require that any discretionary use of trust income to pay premiums on a policy on the life of the grantor or the grantor's spouse be consented to by an "adverse party"[36] – a trust beneficiary whose interest would be affected by such a use of trust income –

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

36 As described in Section 672(c).

and then not actually use trust income to pay premiums (or, preferably, get such an ongoing consent).

Similarly, for an ILIT created as an intentional grantor trust, the Section 677(a)(3) power to use trust income to pay premiums is a power which cannot be given up by the grantor (since it isn't retained) nor by the trustee (since it would be a breach of trust, because it would impose a tax on the trust or its beneficiaries, which had been being paid by the grantor), so it should be negated in any ILIT which is a grantor trust where it may make sense to end grantor trust status at some point, by requiring the use of trust income to pay premiums must be consented to by an adverse party.

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

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

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

At least for ILITs funded with group term policies, where the employer paying the premium directly to the insurance company, the IRS has approved Crummey powers which expressly applied to indirect gifts of premiums to the ILIT.[37/]

In Turner v. Commissioner,[38/] the insured paid life insurance premiums for cash value policies directly to the life insurance company. The IRS claimed that the Crummey withdraw right was illusory since this was an indirect gift without notice to the beneficiaries. The Tax Court held the Crummey withdraw power effectively made indirect premium gifts a present interest gift, since the ILIT expressly provided that the power applied to "each direct or indirect transfer to the trust."

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

[37/] PLR 813074 ("contributions directly or indirectly transferred"). PLR 8138102 ("premiums…which are paid, by the settlor or any other person, rather than being paid to the trustee"). PLR 8138170 ("contributions…including…any premiums…that are paid by the taxpayer or any other person directly to the insurance company").

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

10. Failing to recognize that most policies are "buy and manage", not "buy and hold" financial assets.

With the exception of term insurance and nonparticipating whole life insurance policies, every other type of life insurance policy has some "moving parts" which need to be monitored by a policy owner, to be sure the policy is performing as expected.

Too many policy owners rely on the initial policy illustration as a one-time snapshot of policy performance out until life expectancy, based on a number of both express and implied assumptions about policy performance.

As insurance carriers have created new products which shift some or all of the policy investment risk to the policy owner, (such as universal, variable, or equity indexed policies) clients and their advisors have failed to understand that shift, and that, as the owner of the policy, they are responsible for monitoring the performance of that policy. One of the problems is that, although there are a number of people who are happy to (for a commission) help a client buy a policy, it is very difficult to find someone who is willing to help manage the policy.

This issue has been compounded by the sale of flexible premium (universal life policies), with no fixed, required premiums. What carriers are required to call "premiums" in such policies are merely suggestions of how much might (not will) be sufficient to keep the policy in force to (or past) life expectancy, again, based on underlying assumptions. In addition, in these policies, the carrier has the right to increase the cost of insurance to reflect current mortality experience.

The only way for a policy owner to manage a policy which shifts any part (or all) of the investment risk to him or her and which has flexible premiums is to have the policy reillustrated annually, to determine if the amounts being paid as policy premiums will be sufficient, based on current crediting rates and expenses, to sustain the policy to life expectancy and beyond.

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

Under the Final Split-Dollar Regulations, other than donor/donee or employer/employee non-equity split-dollar arrangements, collateral assignment arrangements (where the policy is not owned by the premium provider) must be treated under the loan regime, governed by Section 7872, rather than the economic benefit regime, governed by Section 61.[39/]

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

For a demand loan, the interest rate is based on the short term AFR, which changes every month, and the interest is treated by the lender as received on an annual basis. For a hybrid loan, including for this purpose, a loan payable at the death of an individual, the interest rate is determined based on the term of the loan (the insured's life expectancy, under the IRS Tables), but the interest is treated as received by the lender on an annual basis.[40/] Importantly,

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39/ Treas. Reg. Sec. 1.61-22(b)(3).

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

however, gift term loans are treated as hybrid loans only for income tax purposes; accordingly, while for both income and gift tax purposes, the AFR is based on the term of the loan, for gift tax purposes, all of the interest during the expected term of the loan, discounted back to present value, is treated as received in the year the loan is entered into (bunching the discounted value of all of that interest in the first year of the loan for transfer tax purposes).

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

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

A private pre-Final Regulation split-dollar arrangement which hasn't been "materially modified" (as discussed below) after the effective date of the Regulations is governed by Notice 2002-8.[41/]

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

However, under that Notice, by negative inference,[42] on termination of the arrangement during the insured's life, the IRS will take the position that any such policy equity

41/ 2002-1 C.B. 398.

was a gift by the donor to the owner, subject to the Notice's so-called "no inference" provision. Under that provision, the IRS will not be able to assert those policy values were transferred for transfer tax purposes based on the Notice nor the Proposed or Final Split-Dollar Regulations.

It, however, isn't clear that the IRS wouldn't attempt to trust the equity as transferred on termination of the arrangement, based on prior law;[43/] accordingly, any such termination has to take that possibility into account.[44/]

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

As noted above, a private pre-Final Regulation split-dollar arrangement which hasn't been "materially modified" after the effective date of the Regulations, is governed by Notice 2002-8.[45/] Conversely, a private pre-Final Regulation arrangement which has been "materially modified" after the effective date of the Final Regulations will no longer be governed by Notice 2002-8, but by the generally less favorable rules of the Final Regulations.

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

42 The negative inference results from the Notice's conclusion that, so long as the arrangement is in effect, the IRS will not treat the equity as having been transferred.

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

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

45/ Above.

modifications.[46/] In addition, the IRS has indicated that this is an area in which they will not issue private letter rulings.[47/]

Accordingly, any change to a private pre-Final Regulation split-dollar agreement, the terms of the economic "deal" between the parties, or even a change to the underlying policy needs to be approached as a potential material modification to the arrangement, subjecting the arrangement to the rules of the Final Split-Dollar Regulations from the date of the change. Since most pre-Final Regulation private arrangements were equity, collateral assignment arrangements (where the premium provider was only entitled to recover his or her premium advances), applying the rules of the Final Regulations to that arrangement would require that it be treated under the loan regime (measuring tax consequences of the arrangement by the foregone interest under Section 7872, as described above and creating a gift term loan, with unfavorable tax consequences) rather than the economic benefit regime (measuring the benefit by the term costs, under Section 61).[48/] In addition, this "switch" would likely be treated as a termination of the arrangement under Notice 2002-8, treating any policy equity as having been transferred, subject to its no inference provision.

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

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

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

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

exceptions to the general rule of the Final Regulations that collateral assignment arrangements must use the loan regime to measure the benefit.[49/]

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

Under the Final Split-Dollar Regulations, the general rule is that any collateral assignment arrangement – that is, one where the policy is not owned by the premium provider – must be treated under the loan regime of Regulation Section 1.7872-15, rather than under the economic benefit regime of Regulation Section 1.61-22. The only exceptions to that general rule are arrangements between a donor and a donee or between a service provider and a service recipient; those arrangements – and only those arrangements – treat the premium provider as the deemed owner, allowing use of the economic benefit regime.

Accordingly, any post-Final Regulation non-equity collateral assignment split-dollar arrangement which is neither donor/donee nor service provider/service recipient, must be treated as a loan regime arrangement under the Section 1.7872-15 Regulations.

15. Failing to review and manage private split-dollar arrangements, especially pre-Final Regulation economic benefit arrangements.

As noted above, pre-Final Regulation private economic benefit arrangements, which have not been "materially modified" after the effective date of the Final Regulations, are governed by the rules of Notice 2002-8. Assuming the arrangements had been – as nearly all were – equity arrangements (with the premium provider only entitled to recover its premium

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

advances and the policy owner entitled to retain any policy equity in excess of those advances), the longer the arrangement goes on, the larger the equity, and therefore the more difficult it is economically to unwind the arrangement during the insured's lifetime without adverse tax consequences.

As also noted above, almost none of these pre-Final Regulation private economic benefit arrangements took advantage of the "safe harbors" of Notice 2002-8. Accordingly, the only way to unwind these arrangements during the insured's lifetime, without reporting the equity as a transfer for Federal transfer tax purposes, is to rely on the Notice's "no inference" language (which is both ambiguous and not the grandfathering the insurance industry hoped for).

To the extent the parties terminate a pre-Final Regulation private economic benefit arrangement during the insured's lifetime, relying on the "no inference" provision of Notice 2002-8, to protect the equity from taxation, best practice is to report the termination on a gift tax return as a non-gift transaction, to both start the gift tax statute of limitations and to avoid any possible penalties.

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

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

In one technical advice memorandum,[50/] the IRS took the position that the equity was taxable to the insured employee, under the theory of Section 83 (taxing transfers of property in connection with the rendition of services), as it accrued. In addition, that ruling held that if the policy were owned by an irrevocable insurance trust, the equity that would be income to the employee would also be considered a gift to the trust by the insured employee (and presumably a generation-skipping transfer by the insured employee, if the trust had generation-skipping implications).

Under Notice 2002-8[51/], for pre-final regulation arrangements, policy equity is specifically held to be income only on termination of the arrangement during the insured's lifetime (with two safe harbors for pre-January 28, 2002 arrangements which were converted or terminated by 1/1/04), subject to what has become known as its "no inference" provision.[52/] In a compensatory context, under Notice 2007-34[53/], Section 409A will also apply to treat that policy equity as income at that time,[54] to the extent it is not grandfathered from the application of Section 409A,[55/] without any "no inference" protection.

To manage this risk, pre-Final Regulation equity split-dollar policy illustrations ought to assume that, as a worst case scenario, the equity is income taxable and subject to

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50/ TAM 9604001.

51/ 2002-1 C.B. 398.

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

53/ 2007-17 I.R.B. 996.

54 Subject to a 20% penalty.

55/ Either because the arrangement itself was not grandfathered from Section 409A or to the extent the policy cash value was attributable to premiums paid after 2004.

transfer tax (if the policy is owned by a third party – such as an insurance trust). The creation of policy equity needs to be carefully monitored in such arrangements, and an exit strategy to unwind (roll-out) the arrangement during the insured's lifetime should be considered either before equity develops or at least when it is still at a manageable level; the only safe alternative is to keep the arrangement in effect until the insured's death, with ever-increasing economic benefits.[56/]

17. Not having amended compensatory pre-Final Regulation equity split-dollar arrangements to comply with the requirements of Section 409A and Notice 2007-34.

As noted above, pre-Final Regulation equity split-dollar arrangements are, to the extent not grandfathered, subject to Section 409A on termination, under Notice 2007-34.[57/] In order to comply with the requirements of Section 409A, these agreements had to be amended, no later than 12/31/08. Those amendments had to conform the provisions of the agreement which give the employee access to the equity to the limited number of determinable events allowed by Section 409A. As an example, a common provision which gave the employee the power to terminate the agreement does not comply with the distributions allowed by Section 409A; it would have had to have been eliminated or made only exercisable at a fixed time.

Notice 2007-34 also provides that amendments to such an agreement to comply with Section 409A will not, assuming that the Notice's requirements are met, be treated as

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56/ Reliance on the "no inference" language of the Notice to avoid taxation of the equity may – or may not– prove to be helpful, and note that Notice 2007-34, above, has no similar provision for purposes of applying Section 409A to the arrangement.

57/ Above.

material modifications of the agreement under the Final Split-Dollar Regulations; note, however, that some of those required modifications may raise economic issues for the parties.

If such an agreement had not been amended to comply with Notice 2007-34, all of the non-grandfathered equity would have become taxable in 2008 (or the earliest open income tax year), plus a 20% penalty, plus a penalty interest rate.

18. Failing to manage compensatory split-dollar arrangements, especially pre-Final Regulation economic benefit arrangements.

As noted above, pre-Final Regulation compensatory economic benefit arrangements, which have not been "materially modified" after the effective date of the Final Regulations, are governed by the rules of Notices 2002-8 and 2007-34. Assuming the arrangements are, as nearly every pre-Final Regulation economic benefit arrangement was, equity arrangements, with the premium provider only entitled to recover its premium advances and the policy owner entitled to retain any policy equity in excess of those advances, the longer the arrangement goes on, the larger the equity and the more difficult it is to unwind the arrangement during the insured's lifetime.

As also noted above, under Notice 2007-34, unless the agreement was grandfathered from the provisions of Section 409A, any policy equity subject to Section 409A would be taxable on termination of the arrangement during the insured's lifetime, without any "no inference" protection provided under Notice 2002-8 to other pre-Final Regulation economic benefit arrangements.

While there aren't many good options for these old non-grandfathered agreements, the longer they go on building equity, the more difficult it will be to unwind them on a reasonable basis during the insured's lifetime, meaning they need to be monitored on an annual basis and a determination made as to how much of the equity is or is not subject to Section 409A.