Rocky Mountain Estate Planning Council 2020-21

- September 9, 2020

- Zoom Meeting Invitation:

Rocky Mountain Estate Planning Council is inviting you to a scheduled Zoom meeting.

Topic: Rocky Mountain Estate Planning Council - Lawrence Brody
Time: Sep 9, 2020 12:30 PM Mountain Time (US and Canada)

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- Event Agenda
  12:30-12:45 p.m. – Connect – work through any connection issues with members
  12:45-1:00 p.m. – Board Updates, new season, sponsors, membership
  1:00-1:50 p.m. – Speaker presentation, Lawrence Brody, Planning Mistakes and How to Avoid or Fix Them
  1:50-2:00 p.m. – Questions to speaker
  2:00 p.m. – close presentation Zoom

SOME OF MY "FAVORITE" INSURANCE PLANNING MISTAKES, AND HOW TO AVOID OR FIX THEM*

ROCKY MOUNTAIN ESTATE PLANNING COUNCIL
SEPTEMBER 9, 2020
1:00 PM – 1:50 PM

LAWRENCE BRODY
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* A version of these materials was presented at the 2016 Heckerling Institute on Estate Planning by the author and Donald O. Jansen.

SOME OF MY "FAVORITE" INSURANCE PLANNING MISTAKES, AND HOW TO AVOID OR FIX THEM

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SOME OF MY "FAVORITE" INSURANCE PLANNING MISTAKES, AND HOW TO AVOID OR FIX THEM

1. Failing to avoid the three-corner life insurance policy – a different owner, insured, and beneficiary – the Goodman problem.

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

In what was a typical situation, a husband might be the insured, his wife the owner, and their children the policy beneficiaries.[1] Under the holding of the Goodman case,[2/] at the insured's death, in this situation, the wife would be considered to have made a gift of the entire policy death proceeds to the children, because, as the owner, she could have made herself the beneficiary – obviously an unanticipated and undesirable result. If the beneficiary were a trust in which the wife had an interest, the gift would be the actuarial value of the remainder, assuming the wife's retained interest was a "qualified interest" under Section 2702 of the Code; otherwise it would be a gift of the entire proceeds.[3/] If the beneficiary were a skip person from the wife's point of view, or a trust for skip persons, the wife would also have made a generation-skipping transfer of the proceeds at the insured's death as well.

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1 Because of the unlimited Federal estate tax marital deduction for US citizen spouses, this fact pattern is less likely today, but the issue could still occur if the owner were a non-citizen spouse or a child.

2/ Goodman v. Commissioner, 156 F.2d 218 (2nd Cir. 1946).

3/ If she had a power of appointment over the trust, her gift would be incomplete, depending on the terms of the trust, it could be includible in her estate.

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

2. 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,[4/] as ordinary income[5/] to the extent that that amount exceeds his or her "investment in the contract,[6/] 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).[7/]

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.[8/] 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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4/ As an amount not received as an annuity under Section 72(e).

5/ 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.

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

7/ Sections 72(c)(1), 72(e)(6).

8/ Note again the different issues raised on a sale of a policy, where, as discussed below, income tax 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[9/] – without generating any

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[9/] 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.

Note, however, that Section 1234A 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; see also 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 below, requires gain based on cash surrender value (an ordinary income item) to be treated as ordinary.

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 subject to a loan, because in a surrender, the

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.

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

Under Section 1035 and Regulation Section 1.1035-1, a life insurance policy can be exchanged for another policy without recognition of gain or loss, if the policies exchanged "relate to the same insured." If a policy with a loan on it is exchanged for another policy, the amount of the loan on the first policy which is discharged in the transaction will be treated as "boot," money or other property received in the exchange generating taxable income in an otherwise non-taxable exchange without generating any cash to pay the tax.[10/]

To avoid recognition of the gain in such a situation, the new policy has to be issued with a loan equal to the loan on the policy exchanged;[11/] alternatively, of course, the loan on the first policy could be repaid before the exchange.

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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.

Hunt v. CIR, a Tax Court Case, 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.

10/ Treas. Reg. Sec. 1.1035-1, referring to Treas. Reg. Sec. 1.1031(b)-1(c) for the taxation of "boot" (presumably from the phrase "and something to boot") received in an otherwise tax-free exchange.

11/ PLRs 860433 and 8816015.

4. 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, which, in many cases, can be as short as a three or four year test).[12/]

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.[13/] In addition, loans from the insurer against the cash value of a modified endowment contract are treated as distributions for this purpose.[14/]

Finally, there is a 10% penalty tax (actually, an addition to tax) on any withdrawal from or loan against a MEC if the "taxpayer" – presumably the policy owner, 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).

12/ 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.

13/ Section 72(e)(10) applying Section 72(e)(4)(A) as though such income had been distributed from the policy.

14/ That income would be subject to the tax on not investment income, since Section 1411(c) includes gross income from annuities for this purpose.

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 would otherwise be an end-run around the policy loan or withdrawal provisions of Section 7702A, by merely using the policy as collateral for that third party loan.[15/]

Finally, if the pledge were between the insured and his or her grantor trust, the pledge would be ignored for Federal income tax purposes, and therefore there would be no income to recognize on such a pledge, 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.[16/]

Accordingly, any time lifetime loans against, withdrawals from, or use of the policy as collateral for a loan (other than a pledge by a grantor trust to its grantor) 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.

[15/] 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.

[16/] 1985-1 C.B. 184.

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

In many cases, when an existing policy is to be transferred to a new owner, the insured will borrow against the policy to reduce its gift tax value on the subsequent transfer since loans are deducted from the policy's value as reported by the insurer on Form 712. Loans against policy cash values are normally income tax-free, even if in excess of basis, since they are not distributions under Section 72(e), so long as the policy isn't a MEC (as discussed above).

However, if the loan exceeds the insured's income tax basis in the policy[17/] – the transfer will be treated as a sale, with the loan proceeds treated as the amount realized.[18/] That will have two adverse income tax effects – there will be gain to report on the transfer, and, perhaps more importantly, the transfer will be subject to the transfer for value rules (discussed below) at the insured's death (since the normal exception for gift transfers from those rules – the carryover basis exception – will not be applicable, unless, as noted below, the transfer is to a grantor trust), or the transferee is otherwise exempt from the transfer for value rule, as a "proper party" (as also discussed below).

As an alternative, in a universal-type policy, the insured could withdraw from the policy, tax-free, up to investment in the contract,[19/] to reduce the value of the policy prior to the gift, with no such concerns.

17/ Perhaps it is investment in the contract under Section 72, rather than basis, which is relevant here.

18/ Rev. Rul. 69-187, 1969-1 C.B. 45.

19/ Section 72(e)(5).

Finally, if the gift were to a grantor trust, from the insured's point of view, any gain on the transfer would go unrecognized for income tax purposes, under Rev. Rul. 85-13, above, and, because of that, the carryover basis exception to the transfer for value rule would apply.[20/]

6. 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.[21]

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.

20/ Section 101(a)(2)(B). In addition, the transfer would be treated as an exempt transfer to the insured under the transfer for value rule. See Rev. Rul. 2007-13, 2007-1 C.B. 684.

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

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

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

However, the advent of the life settlement market[22/] has meant that, at least for older insureds (probably age 70 and above), with relatively large policies, where the insured's health has declined since he or she took out the policy, a life settlement company may be willing to pay more than the policy's cash surrender value to acquire the policy during the insured's lifetime.[23/]

Accordingly, advisors need to be careful that their older, less healthy clients don't inadvertently surrender a policy which is no longer needed without checking the availability of a life settlement, assuming the insured is comfortable with a third party owning a policy on his or her life,[24/] the risk of a death shortly after the sale, (in some settlement sales, the seller retains some part of the death benefit, to offset that risk) and the fact that the sold policy will "count" against his or her ability to acquire additional insurance – this is sometimes referred to as a sale of future insurability.

22/ Which grew out of the viatical settlement market for terminally or chronically ill insureds.

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

24/ Arguably, not an irrational concern.

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

A life insurance policy is a capital asset (since it is not expressly excluded from the Section 1221 definition of a capital asset). As noted above, if a policy is cancelled or surrendered to the insurance carrier in exchange for cash surrender value, any gain on the policy is ordinary income, despite the fact that the policy is a capital asset, because the transaction does not qualify as a "sale or exchange" of the policy.[25/]

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. [26/], 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.[27/] 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) plus any amounts includable in income from the policy (as well as the step-up in basis for a deceased owner of a policy on the life of another).

[25/] See the discussion of the possible application of Section 1234A to the lapse of a policy subject to a loan, above.

[26/] 356 U.S. 260 (1958).

[27/] 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?

In Rev. Rul. 2009-13, above, the IRS also – controversially – had held that in a policy sale in the life settlement market, [28/] 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 reduced by the cost of insurance protection provided to the insured[29/] (without any guidance on how to measure it). The 2017 Tax Cuts and Jobs Act retroactively repealed that part of the ruling; [30/] Rev. Rul. 2020-5 reflects that provision of the Act, by changing the examples in Rev. Rul. 2009-13 to conform to that provision.

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

Under the Section 2035 "three-year transfer" rule, if the insured has transferred as a gift any interest in a policy to a third party owner (such as a trust) within three years of his or

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28/ 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.

29/ 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.

30/ Another provision of that Act added Section 101(a)(3), making it clear that no exception to the transfer for value rule, as discussed below, 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.

her death, then even if he or she no longer holds any incident of ownership in the policy at death, the policy proceeds will be included in the insured's estate for estate tax purposes. Even momentary ownership by the insured of a policy which was then transferred by him or her by gift within three years of death will require inclusion of the full policy proceeds in his or her estate for estate tax purposes.

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

10. 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. [31/] However, there is an exception to Section 2035 if the policy is sold pursuant to a bona fide sale for "adequate and full consideration". [32/]

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

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31/ Section 2035(b)(1).

32/ Id.

should the insured die within three years of the sale/gift. There are three possible problems to consider.

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").[33/] 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.[34/] 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

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

[34/] 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 what 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.[35/]

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.[36/]

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,[37] 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.[38]

11. **Avoiding the transfer for value rule where the policy is sold to an ILIT to avoid the three year rule of Section 2035.**

As noted, if the insured owns a policy on his or her life, a gift of the policy to an ILIT of his or her incidents in ownership in the policy will result in the inclusion of the death

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35/ 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).

36/ 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).

37 4 T.C. 204 (1944),

38 See PLR 9413045 in footnote 35.

proceeds in the insured's gross estate, if the insured dies within three years of the gift.[39] As also noted, there is an exception to this rule, if the policy is sold for adequate and full consideration.

As discussed in detail below, the sale of the policy to the ILIT has to qualify for an exception to the transfer for value rule of Section 101(a)(2), otherwise the death proceeds in excess of the transferee's policy basis would be ordinary income to the beneficiary.

If the insured sells the policy to the insured's ILIT which is a grantor trust, it is treated as a sale by the insured to himself or herself, and accordingly as a non-taxable event. Thus, the insured's basis in the policy becomes the grantor trust's basis, qualifying for the carryover basis exception to transfer for value under Section 101(a)(2)(A).[40] If the ILIT is not a grantor trust, the ILIT must be a transferee which is exempt from the transfer for value rule, such as where the ILIT is a partner of the insured.[41] However, a sale to a non-grantor trust, even though within a transfer for value exception, would be a taxable event and could result in a gain to the insured seller.

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

Under the Section 2512 Regulations,[42] the gift tax value of a policy transferred during the insured's lifetime is determined by its "replacement" cost, the cost of a "comparable

[39] Section 2035.

[40] Rev. Rul. 2007-13, 2007-1 C.B. 684, in addition, under Situation 2 of the Ruling, the sale would be treated as if made to the insured, qualifying for another transfer for value exception.

[41] Section 101(a)(2)(B).

[42] Reg. Sec. 25.2512-6.

policy". However, the Regulations recognize that for a policy that has been in force for some time (an undefined term) on which future premiums are due, obtaining the cost of a comparable policy would be difficult; accordingly, the Regulations provide that, in this situation, the cost of a comparable policy may be (not must be)[43/] approximated by the so-called interpolated terminal reserve formula – the policy's interpolated terminated reserve plus any prepaid premiums.[44/]

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 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

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43/ 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.

44/ 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.

PERC value (a calculation required for transfers of policies in some income tax situations by the 2005 regulations issued under Section 83).[45/] 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 – 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.[46/]

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

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

There is, however, an exception to that general rule for transfers of the policy for value during the insured's lifetime. If a policy is transferred for value during the insured's lifetime, unless one of the exceptions to the transfer for value rule (described below) applies, the only portion of the death proceeds which will be excludable from the beneficiary's gross income

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[45/] 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.

[46/] 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.

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.[47/]

Fortunately, there are a number of helpful exceptions to the transfer for value rule applicable in an estate planning context.[48/] 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);[49/]
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.

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.[50/]

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

48/ Section 101(a)(2).

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

50/ Section 1041(b)(2) treats any such transfer as a gift, with carryover basis; the same result should apply to a sale to the spouse's grantor trust.

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.[51]

14. 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 would need to be drafted to avoid the grantor trust triggers of Sections 671-677, 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 must be applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, so long as the policy is not irrevocably payable to a charity, or may be so applied 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

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[51] 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 – similar to, but different from, the exceptions to the transfer for value rules, as well as to the state law insurable interest rates).

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.[52/] 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"[53] – a trust beneficiary whose interest would be affected by such a use of trust income – and then not actually use trust income to pay premiums (or, preferably, get such an ongoing consent to do so).

The other issue is that, 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

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

53 As described in Section 672(c).

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 discretionary use of trust income to pay premiums must be consented to by an adverse party (such as a beneficiary). Another grantor trust power, such as a swap power (held in a non-fiduciary capacity) or a power to borrow without adequate security, both of which, as retained powers, could be given up by the grantor, if desired, could be used instead.

15. **Making sure premium gifts to an ILIT with Crummey powers qualify for the gift tax annual exclusion, where the policy won't support the withdrawal power.**

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

A conservative solution is to funnel the premium payment through the trust. The trustee would give notice to the beneficiaries, hold the cash until the Crummey powers lapse and then pay the premium.

For a group term policy, the employer pays the premium directly to the carrier and not through the ILIT. In this situation, the settlor should make a front end gift to the ILIT to create a side fund in the ILIT sufficient to cover future Crummey withdrawal powers.[54/]

The IRS has ruled that the annual exclusion applies if the power holder can withdraw the term policy without any requirement of a side fund.[55/] However, a withdrawal power without a side fund might not be sufficient if the group term policy value does not equal or exceed the amount that can be withdrawn under the Crummey power at all times before lapse of the power. Although the group term policy may have a value equal to the unused premium, the full premium value on the payment date will decline each day during the power lapse period.[56/]

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

If the Crummey power is drafted to apply to gifts to a ILIT, the IRS could argue that premium payments directly to the life insurance carrier, while constituting an indirect taxable gift to the ILIT, do not trigger the Crummey 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.

54/ PLRs 811123, 8103074 and 80006109.

55/ PLR 8021058.

56/ See Rev. Rul. 76-490, 1976-2 C.B. 300.

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.[57/]

In Turner v. Commissioner,[58/] 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).

[57/] 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”).

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

17. 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 what has been called a number of disclosed and undisclosed 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 re-

illustrated 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 and, if not, to pay additional premiums.

SOME OF MY "FAVORITE" INSURANCE PLANNING MISTAKES, AND HOW TO AVOID OR FIX THEM

ROCKY MOUNTAIN ESTATE PLANNING COUNCIL
SEPTEMBER 9, 2020
1:00 PM – 1:50 PM

LAWRENCE BRODY
BRYAN CAVE LEIGHTON PAISNER LLP

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1. Failing to avoid the three-corner life insurance policy – a different owner, insured, and beneficiary – the Goodman problem.

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

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

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

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

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

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

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

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

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

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11. Avoiding the transfer for value rule where the policy is sold to an ILIT to avoid the three year rule of Section 2035.

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12. 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.

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

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