

UNWINDING LIFE INSURANCE TRANSACTIONS
AND KEEPING A POLICY:
DEALING WITH ILITS, SPLIT DOLLAR AND BUYOUT
AGREEMENTS WHEN THE BUSINESS OWNS THE POLICY

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DEALING WITH EXISTING LIFE
INSURANCE POST-TAX REFORM

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Facing the Issues

- Current economic climate (low interest; volatile (but increasing) equity markets) and recent tax reform affect the why and how of life insurance policy acquisition, ownership, payment, and management
- Create a multitude of uncertainty about existing policies going forward:
 - Are they still needed/wanted after doubling of transfer tax exemptions until 2026?
 - Should they still be financially supported? If so, to what extent and/or by what method?
 - How should they be managed economically (in many cases, you can forget that these are investment products)?
 - How should they be used for wealth transfer planning (analyzing available structures)?
 - Do the current policies and financing/payment arrangements still work?

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Understanding the Situation

- Does it hurt?
 - What is the real motivation?
 - Consider client's objectives, priorities and constraints, including current and future insurability
- The vintage, type and construct of the policy
 - Unlike wine – they don't get better with age – appreciate the risk inherent in the contract
- The ILIT's terms and tax characteristics
 - Do they still make sense in the current and likely future environment?
- The type and vintage of any split-dollar/premium financing arrangement
 - Does it still make sense in this current tax, legal and financial environment?

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Whose "View" Matters?

- Collaboration needed
 - Don't let the client (or yourself) drive with only one mirror
- The attorney
 - Family advisor, wealth transfer consultant or estate planner
- The investment advisor
 - Whose money is it really?
- The accountant
 - Again, family advisor or reactive tax preparer?
- The insurance advisor
 - Proactive, knowledgeable, advanced market support? Need to be part of the solution

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Range of Potential Outcomes

- Based on the situation, collaborative discussions may lead to one or more of the following:
 - Grin and bear an increased premium to keep the policy in force
 - Surrender the policy
 - Manage "the investment" to reduce the outlay, stabilize performance, etc.
 - Redeploy certain funds (or all) for other investment purposes
 - Replace the current policy with another policy or an annuity
 - Sell it in a life settlement – Not every wine is a good wine...
 - Donate it to charity
 - Leave the policy alone, but fix the problem – the ILIT (use court reformation, modification or decanting)
 - Leave the ILIT alone, but fix the split-dollar or other financing arrangement
 - Fix both (carefully...)

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JUST THE FACTS MA'AM

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The 'As-Sold' Illustration

- Start with what the client originally bought
- If available, will show the key salient facts:
 - Underwriting classification
 - Policy construct
 - Current assumptions (at the time)
 - Premium and planned duration
 - Pattern of projected cash value and death benefit at 'relevant' ages
 - Age policy matures, etc.
- MUST understand these contractual terms
- **Consider: Is there an accelerated death benefit provision to fund long-term care cost?**

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The Inforce Illustration

- Like an as-sold illustration but starts with current year
 - Should include (when available) a report detailing annual policy charges for costs of insurance and other policy expenses
 - Also get the current policy statement from the carrier
- Watch out for:
 - Any planned changes in policy structure, death benefit options, etc.
 - Anticipated time frame for current premium to support the death benefit
 - Is the policy underfunded? Overfunded?
 - When (if ever) will the policy be self-sufficient?
 - Any loans against the cash value (if so, is loan "problematic"?)
 - For IUL or VUL policies, applicable index or investments of cash value
- **DON'T FORGET – confirm current policy owner and beneficiary**

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Rounding Third but Not Yet Home...

- If ILIT/other entity owns policy, obtain:
 - Copy of trust agreement/governing documents
 - Any gift tax returns reflecting reportable gifts to the ILIT
- For ILITs, review:
 - How premium gifts have been treated (e.g., annual exclusion, use of exemption)
 - Prior allocation of gift tax/GST tax exemption and amount remaining for use by client/grantor (and spouse)
 - Grantor trust status of ILIT
 - If so, how and as to whom? Not as easy as you may think...
 - Critical to "fixing" problems (e.g., maybe next premium should be a loan)

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Rounding Third but Not Yet Home (cont.)

- If policy is subject to a split-dollar or other financing arrangement:
 - Get a copy of the agreement and all related documents
 - For any economic benefit ("EB") arrangement, get an in-force illustration
 - Should show the annual EB through policy maturity and if based on carrier term costs or Table 2001
 - **Remember:**
 - Projections of future annual EBs are guidance only
 - Need to obtain EB cost **EACH YEAR**

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It Should be Betting Clearer Now...

- Does the client still need (or want) all the insurance?
 - If so, to what age?
 - If not, need (or want) a lesser amount? If so, to what age?
- Is it about cash flow or the policy itself?
 - If cash flow, let's see what we can do (and what the client will give up or postpone)
 - If the policy, is it the basic construct, which can't be fixed (absent an exchange) or a the policy's management, which can be managed?
- Is it about the carrier?
 - Have ratings have dropped, doesn't answer the phone, etc.?
 - Has the carrier changed?

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It Should be Betting Clearer Now (cont.)

- Is it about the gift/GST tax implications of paying premiums?
 - Take into account the increased available exemptions
- Is it about the premium payment arrangement or plan?
 - A split-dollar arrangement, with no end in sight except death?
 - Was there a prior planned "exit," and is so, is it working or can it be fixed?
- Is it about the ILIT (and not the policy)?
- Is it a combination of several of these factors?

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EXPLORING THE AVAILABLE OPTIONS

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If It's About Cash Flow...

- Identify the cause of the pressure/crunch to help determine an appropriate solution
 - Client just doesn't have the cash flow (now or in the future),
 - Client has too many competing needs for the cash, and/or
 - Drop in dividend or crediting rates requires:
 - Increased premiums to support the death benefit or
 - The same premium to be paid for (way) longer than anticipated

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Cash Flow (cont.)

- Certain policies may provide solutions:
 - Whole Life:
 - Get an illustration that reflects a change of dividend option from buying paid-up additions to reducing premium. Client will need to pay the net premium.
 - **PRACTICE TIP:** Confirm if client can change the option back without evidence of insurability
 - *Be sure client understands the long-term impact of this change*
 - Whole Life/Term Blend:
 - Can payments for cash building riders be reduced (and then resumed, if and when)?
 - Don't be surprised if the premium cannot be reduced for the foreseeable future!

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Cash Flow (cont.)

- Current Assumption Universal life (CAUL)
 - Confirm how much the premium can be reduced while still supporting the death benefit to a targeted age
 - Explore whether a change from an increasing death benefit option to a level death benefit option will make a significant difference in the annual premium(s)
- Guaranteed Universal Life (GUL)
 - Revisit the duration of the no-lapse guarantee
 - Does client still need to support the death benefit to that age?
 - Ask the agent to illustrate a reduction/cutback in the premium followed by a "catch-up" premium in the future that **MAY OR WILL** restore the guarantee
 - Consider getting a letter from the carrier supporting the illustration and the "toggle" of the guarantee

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Cash Flow (cont.)

- Variable Universal Life (VUL)
 - Assume client is comfortable with VUL as an investment product but wants to manage the policy differently (better?) to reduce some of the inherent performance volatility
 - Revisit the asset allocation of the cash value, then, depending on policy's features:
 - Reallocate a growth portfolio to a more balanced fund/portfolio offered by the carrier or constructed by the client (with investment advisor assistance)
 - Explore automatic rebalancing feature, if available
 - Allocate a portion of the cash value to a fixed account from which the carrier will take monthly costs-of-insurance and expenses, rather than taking those charges *pro-rata* from all the funds

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Redeployment: Make Your Dollars Work For You

- May be able to “redeploy” a policy purchased for traditional death benefit use as an investment/retirement vehicle
 - **Crucial for taxpayers experiencing much higher income taxes in April 2019**
- Policy may be an attractive investment vehicle under current tax law, depending on type and construct
 - Cash value grows tax-deferred
 - Client can access cash value for income via partial surrenders, withdrawals (but only up to basis) or loans (even in excess of basis) on a tax-free basis, assuming not a modified endowment contract (MEC)

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Redeployment (cont.)

- How to Start
 - Ask the agent to illustrate how the policy can be used for retirement savings/income
 - Note that this involves much more than just picking an age and showing a series of partial surrenders/withdrawals and then loans
 - Might involve, for instance, increased premiums, decreased death benefit and a carefully calibrated approach to “tapping” into the policy for future income
- Trust-Owned Policies:
 - Consider how (and at what tax cost) it can be “owned” by the insured or “benefit” the grantor and/or spouse
 - Can you use the swap power in the ILIT? If none or not applicable for life insurance, will the trustee agree to sell it (assuming complies with fiduciary duties to beneficiaries)?
 - In either case, at what value? Valuation is always an issue when dealing with policies

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Redeployment (cont.)

- Policy Type Matters:
 - Whole life
 - Likely little flexibility with regard to the premium or other aspects of policy design
 - Exchange?
 - Whole life/term blend
 - Might be able to increase the premium (to build more cash value) without evidencing insurability
 - GUL
 - Likely can increase the premium (now viewed as investment contribution) without any such evidence
 - But policy may not generate “robust” increases in cash values on a *current assumption* basis
 - Again, is an exchange the answer?

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Redeployment (cont.)

- If a CAUL or VUL policy, more fundamental design changes may be feasible:
 - Consider combination of increasing premiums for a certain number of years and reducing death benefit to limit "drag" of cost of insurance on cash value accumulation
 - Must be within carrier and tax guidelines
 - Must also determine any requirements for underwriting, imposition of surrender charges, possible FOG tax consequences of a death benefit reduction, etc.
 - Illustrate the maximum tax-free cash flow that the policy can generate at retirement by loan and/or withdrawal
 - For a given number of years, without requiring more premiums to support the death benefit well beyond client's life expectancy
 - And be sure the illustrations show how any loan and interest works!

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Sweet Surrender?

- Ask the carrier for a "surrender quote"
- But be aware:
 - Cash surrender value in excess of investment in the contract (i.e., premiums paid less non-taxable distributions) is ordinary income, not capital gain
 - If the policy is a MEC, 10% penalty tax also applies on the amount of income realized, if the "taxpayer" (not necessarily the "insured") is under 59½
 - BE CAREFUL with non-grantor trusts (DINGS)
 - Outstanding policy loans at time of surrender will generate tax to the policyholder on the excess of the gross cash value (including loan amount) over investment in the contract
 - BE WARY - Can produce less cash but large income.

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Consider an Exchange...

- When client still wants insurance but is unhappy with the carrier, the policy type, the required (and immutable) outlay, etc.
- One significant reason -- coverage for potential long-term care costs
- Some CAVEATS:
 - Is the new really better than the old?
 - Timing is everything -- maintain the current policy until replacement is in force
 - Consider all affects of exchange
 - e.g., is it a material modification of a pre-final regulation collateral assignment split-dollar plan?
 - Must be insurable to exchange

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Consider an Exchange (cont.)

- Applicable Tax Laws
 - If transaction qualifies under IRC §1035, no gain or loss is recognized on exchange of one life insurance contract for another on the same insured or for an annuity so long as no "boot" is received
 - Different insurance carriers and types of policies can be involved in the exchange
 - To qualify under §1035, old and new policy must be on the same insured or insureds
 - Basis in old policy carries over to new policy
 - A 1035 exchange may be helpful to preserve basis even if there is no gain in the policy
- Be careful! If an outstanding policy loan is extinguished in the exchange, that is "boot" and will be taxed as ordinary income (without generating any cash)
 - If loan is carried over to the new policy, there is no boot

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Consider an Exchange (cont.)

- Internal vs. External Exchanges
 - Internal exchange involves same carrier
 - External exchange involves new carrier
- Always start with existing carrier – may have an internal exchange program
 - **Practice Tip:** Even if carrier is the same, check the illustration to be sure it is coded as an internal exchange
- Potential benefits of internal exchange
 - Less rigorous underwriting
 - *Surrender charge on old policy might be waived*
 - *Commission on new product reduced or eliminated*
 - *Sales loads and premium tax may be reduced or eliminated*

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Consider an Exchange (cont.)

- Trust but Verify:
 - After all illustrations and supporting material about products and carriers have been received – does an exchange really make sense?
 - It depends...
 - Does everyone really understand all the working parts of the comparison policies?
 - Have the usual "what ifs" been covered?
 - All premiums, cash values and death benefits considered, do they clearly understand what they might be gaining vs. losing?
 - DATA VS. KNOWLEDGE – they are very different

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Consider an Exchange (cont.)

- Exchange for an Annuity
 - The tax aspects
 - Exchange can be tax-free under §1035, assuming again no “boot”
 - Basis in policy carries over to annuity
 - Exchange for an immediate annuity
 - To guarantee a lifetime income
 - But compare to a systematic approach to taking income from the policy
 - Exchange for a deferred annuity
 - Maintains the tax deferral
 - But client must understand key tax differences between cash value life insurance and deferred annuity
 - To the owner during lifetime
 - To the beneficiary

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Sell the Policy (Life Settlements)

- Life Settlement
 - Sale of a life insurance policy (past the contestability period) insuring a person who does not have a condition likely to result in death within 24 months
 - Price is less than the policy's face value **but more than the cash surrender value**
 - Generally for older insureds who have had a decline in health
- Based on various criteria for the client/insured, policy, etc., agent can advise:
 - How the marketability of the policy is determined
 - The steps involved in (and after) a life settlement
- Meanwhile, client should see all bids for policy, compensation that the agent (and others) will receive, etc.

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Life Settlements (cont.)

- Taxation
 - IRC §72(e):
 - Applies to surrenders not sales
 - For sales, what matters is income tax basis
 - Remember Rev. Rul. 2009-13...
 - Gain above basis is **ordinary** to the extent of “inside build-up” that would have been ordinary income upon surrender, then capital gain thereafter
 - Based on “substitution of income” theory.
 - Contested part of the ruling - life insurance policies are capital assets **AND** policyholder must reduce basis by the “cost of insurance” charges
 - Little Secret:
 - Tax Cuts and Jobs Act of 2017 (the “Act”) **revoked retroactively** the contested part of Rev. Rul. 2009-13
 - BUT the Act also **eliminated exceptions to the transfer for value rule** for the purchaser
 - Final Regulations were published on October 31, 2019 regarding reporting obligations related to certain life insurance contract transactions, including reportable policy sales and payments of reportable death benefits. **READ CAREFULLY.**

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Life Settlements (cont.)

- As always, it depends...
 - If there's a lucrative settlement offer, some life expectancy analyst doesn't think insured has long to live
 - Will the sale and reinvestment of the after-tax sale proceeds leave a larger amount of money to the survivors than if the insured had kept (and, if necessary, supported) the policy?
- Your part...
 - Ask agent to determine lowest premium outlay projected to support the death benefit to just beyond LE
 - Compare, on an annual basis, the "premium-cost-adjusted" death benefit to after-tax result of investing (after-tax) sale proceeds to see "crossover" year – collaborate with investment advisors and accountant
- Ask the tough questions
 - What if you die shortly after the sale (some settlements provide part of death benefit to the family)?
 - Are you going to be comfortable with an institution owning your policy?
- **Practice Tip:** Life settlements likely will affect future insurability

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Donate to Charity...

- Can be a low cost means of making a potentially significant gift to charity
- **Will the charity accept the gift?**
 - Check the charity's internal policy on acceptance of insurance policies
 - Charities vary widely (some state no policy, others have detailed requirements for the policy and an agreed upon plan to cover/pay future premiums)
- Will this insured/policy meet the requirements of the particular charity?
 - Many request gifts of future premium payments – can lead to donor dissatisfaction

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Donate to Charity (cont.)

- Basic Tax Implications
 - Donor may be entitled to a current income tax deduction for the gift
 - Transfer must include all the donor's incidents of ownership in the policy
 - Must comply with the partial interest rule – if violated – deduction denied
 - If only life were that easy -- the "amount" of the deduction is not necessarily clear

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Donate to Charity (cont.)

• Basic Tax Implications

- Determining Deduction Amount - IRC §170(e)(1)(A)
 - If policy is "ordinary income property", then donor only entitled to an immediate income tax deduction equal to lesser of insured's income tax basis in the policy or its fair market value (however determined)
 - Don't forget Rev. Rul. 2009-13 -- a policy is a capital asset with some aspect of ordinary income
 - Query: The deduction should be fair market value less ordinary income portion (gain above basis up to cash value)?
 - And the impact of the life settlement market on valuation?
 - In any event, donor must observe applicable reporting requirements
 - Filing Form 8283, obtaining and paying for formal qualified appraisal from a qualified appraiser (both terms of art) if the value exceeds \$5,000, etc., to get the deduction

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POST-TAX REFORM: DEALING WITH EXISTING ILITs & SPLIT- DOLLAR ARRANGEMENTS CREATING NEW ILITs & SPLIT-DOLLAR ARRANGEMENTS

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Setting the Stage...

- Transfer taxes and step up at death STILL remain, but...
 - Exemptions are doubled (currently) through 2025, when increases will "sunset", as indexed from the base year of 2016, using a slightly lower "chained CPI" index –
 - *Unless changed by future legislation*
 - \$11,400,000 per person in 2019 (doubled for married couples), less prior use
- IRS pronouncement on "claw-back" – The Emperor says NO
- **Remember?**
 - The Act's corporate tax rate reduction and pass-through deduction will have indirect effects on business valuations
 - Will complicate use of split-dollar arrangements for employer arrangements

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Dealing with Existing ILITs

- Many clients established ILITs when the estate tax exemption was a fraction of what it is today
- Now doubled exemptions in effect through 2025 many who have ILITs regard them as albatrosses around the necks of their financial and tax lives
 - Don't forget – new products have matured considerably.

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Dealing with Existing ILITs (cont.)

- Consider "undoing" the ILIT
 - Remembering it is an otherwise irrevocable trust - generally, this means something
- Also consider "fixing" an existing ILIT, using the increased exemptions
 - Additional gifts now could mean no more premium payments
 - They could go into the policy or could be held in trust to pay premiums as they come due
 - Or they could be used to terminate old split-dollar or other financing arrangements
- Or "fixing" it by changing its terms
 - Remembering, again, it is irrevocable (this does mean something)

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Options for "Undoing" or "Fixing"

- Decanting to another "better" ILIT (if and as permitted under local law)
 - Generally requires trustee to have broad discretionary distribution powers
 - May require notice to the beneficiaries of the old or new trust (or both); may require both trusts have the same beneficiaries, etc.
 - Cannot be generalized – the power to decant depends exclusively on local law
 - Consider moving the trust situs, if necessary

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Options for “Undoing” or “Fixing” (cont.)

- Termination or amendment by a non-fiduciary trust protector (if the trust provides for one with this power)
 - Termination would result in a distribution of the policy or policies to the beneficiaries
 - Taking the policy(ies) out of a creditor and spouse protected entity
 - And putting the policy(ies) in the hands of a group of beneficiaries, all of whom would have to act together to exercise incidents of ownership

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Options for “Undoing” or “Fixing” (cont.)

- Court reformation/non-judicial modification (as and to the extent permitted under local law)
 - Generally requires settlor and beneficiary (and sometimes trustee) consent
 - Again, it depends exclusively on local law

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Options for “Undoing” or “Fixing” (cont.)

- Distribute the policy to adult beneficiaries (if possible under the trust)
 - Raises fiduciary duty issues for the trustee, without beneficiary consent
 - Raises the same beneficiary-owned issues described above

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Options for “Undoing” or “Fixing” (cont.)

- Distribute the policy to a new ILIT (if possible under the trust)
 - Raises fiduciary duty issues for the trustee, without the consent of all beneficiaries, unless the new trust has identical beneficiaries
 - Raises the same beneficiary-owned issues described above.

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Options for “Undoing” or “Fixing” (cont.)

- Sell the policy to a new ILIT (if a grantor trust, to avoid gain on the sale and be exempt from the transfer for value rule), based on FMV
 - Raises fiduciary duty issues for both trustees, with a similar exception
 - How does the trustee determine FMV?
 - Can the trustee use gift tax value?
 - Does it require an appraisal?
 - If so, who pays the appraiser?

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Options for “Undoing” or “Fixing” (cont.)

- Sell the policy to the grantor, based on FMV
 - Raises fiduciary duty issues for the trustee, with a similar exception
 - How does the trustee determine FMV?
 - Same questions
 - Again, takes the policy(ies) out of a creditor and spouse protected entity (except to the extent policies are exempt under state law)

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Split-Dollar Life Insurance

- What is a Split-Dollar Arrangement (SDA)?
 - Agreement between two parties to “split” costs and benefits of life insurance
 - Employer-employee relationship
 - Family relationship (e.g., grantor & trust)
 - Normally temporary financing – need exit plan
 - **Practical Advice: Always consider exit planning AT INCEPTION**

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Split-Dollar Life Insurance (cont.)

- Pre-Final Regs: Before Sept. 18, 2003
 - Based on 1960's Revenue Rulings
 - Advantageous for “primary beneficiary” of policy benefits

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Split-Dollar Life Insurance (cont.)

- Post-Final Regs: After Sept. 17, 2003
 - Split dollar not dead, but rules changed dramatically
 - Provide roadmap but uncertainty remains – little guidance after Final Regs
 - Transitional relief for pre-Final Reg “grandfathered” SDAs
 - IRC §409A (2005–2007) also impacts - topic for another time
 - But many were not amended to comply with Notice 2007-34 and pose substantial income and transfer tax risks, as well as income tax penalties and increased interest charges, even if not terminated
 - Worst possible result, with retroactive application back to the most recent “open” tax year for income or transfer taxes, probably three years for income taxes, *probably back to 2005 for transfer taxes*
 - Sarbanes-Oxley Act (SOX) negatively impacted collateral assignment plans for executives of public companies, most of which were terminated or frozen after its effective date

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Split-Dollar Life Insurance (cont.)

- SDAs still attractive post-tax reform?
 - Historically used to pay large life insurance premiums with minimal gift tax implications
 - Still advantageous with “temporary” enhanced gift/estate exemptions
 - Can structure with higher probability of success
 - *i.e.*, exit strategies actually contemplated and funded

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Split-Dollar Life Insurance (cont.)

- Types of SDAs – Tax Regimes
 - Economic Benefit (EB) Regime
 - Loan Regime
- **Owner named on policy** determines regime
 - Two exceptions (Reg. §1.61.22(c)(1)(ii)(A)(1) &(2)):
 - *Private SDA*: Donor is deemed policy owner under non-equity SDA between donor and donee (e.g., irrevocable life insurance trust (“ILIT”))
 - *Compensatory SDA*: Employer/service recipient is deemed policy owner in non-equity SDA for performance of services

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Split-Dollar Life Insurance (cont.)

- Tax Regimes – Which One Applies:
 - EB regime applies if:
 - Premium payor owns policy and the non-owner (e.g., an ILIT) has right to designated death benefit payment
 - or
 - ILIT owns policy and deemed owner rules for private SDAs apply
 - **Otherwise, it is a loan arrangement**

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Split-Dollar Life Insurance (cont.)

- Tax Regimes
 - Loan Regime - Applies to a loan if:
 1. Payment made by lender to/for policy owner (ILIT)
 2. Payment is loan under general federal tax law principals or a reasonable person would otherwise expect full repayment; and
 3. Repayment is to be made from or secured by the policy death benefit, cash value or both
 - Application very broadly construed
 - Final Regs allow SDA parties to make a "Split-Dollar Loan Representation" (Reg §1.7872-15(d))

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Split-Dollar Life Insurance (cont.)

- Tax Regimes
 - EB
 - Taxed based on annual cost of current life insurance protection – EB cost
 - Determined using lower of Table 2001 or carrier's *qualifying* alternative term insurance rates
 - Loan
 - Taxed based on adequacy of interest charged on loan:
 - Adequate interest: General tax rules for debt instruments apply, except as modified in final regs
 - Inadequate: Generally treated/taxed as a below-market loan

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Split-Dollar Life Insurance (cont.)

- Current Problems with Your SDA
 - EB Problems - Increasing Annual EB Cost
 - Carrier changes
 - May no longer provide annual required reporting of alternative term rates
 - » Query: Do the annual term rates qualify under the Final Regs?
 - **Concern:** Future alternative term rates will no longer be provided or will not qualify
 - » Forces use of much higher Table 2001 rates

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Split-Dollar Life Insurance (cont.)

- Current Problems with Your SDA
 - EB Problems - Increasing Annual EB Cost
 - Insured continues to age
 - Better health care, medical advancements, etc. = longer life expectancy (LE)
 - Concern: Annual EB cost increases each year with age – may become impractical if death is only exit
 - Note: even a current “good” policy issued in the 90’s can become a “poor” policy if insured’s LE is getting closer to policy maturity or end of contractual rights as opposed to guarantees in GUL in later policies
 - Survivorship policy - death of one insured
 - Concern: Immediate, substantial increase in annual EB cost

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Split-Dollar Life Insurance (cont.)

- Current Problems with Your SDA
 - EB Problems – Equity Build-Up
 - Substantial equity in grandfathered EB SDA due to impressive policy performance over term
 - EB costs are about to increase (likely death of one insured) and survivor no longer wants SDA
 - Concern: How do the parties address termination or roll-out?
 - Query: “No inference”...

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Split-Dollar Life Insurance (cont.)

- Current Problems with Your SDA
 - Loan Problem – Potentially Increasing AFRs
 - AFRs had been trending slowly upward but there has been a recent sustained slowdown

| AFRs | Long-Term | Mid-Term | Short-Term |
|------------|-----------|----------|------------|
| Dec. 2012 | 2.40% | 0.95% | 0.24% |
| Dec. 2014 | 2.74% | 1.68% | 0.74% |
| Dec. 2018 | 3.31% | 3.07% | 2.76% |
| Jan. 2019 | 3.15% | 2.89% | 2.72% |
| Aug. 2019 | 2.33% | 1.87% | 1.91% |
| Sept. 2019 | 2.21% | 1.78% | 1.85% |
| Oct. 2019 | 1.86% | 1.51% | 1.69% |
| Nov. 2019 | 1.94% | 1.59% | 1.68% |

- The potential for increasing AFRs over time and the impact due on the loan amount should be monitored/assessed regularly

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Split-Dollar Life Insurance (cont.)

- Current Problems with Your SDA
 - Loan Problem – Potentially Increasing AFRs
 - Increases annual costs of annual loans to pay required policy premiums
 - Also, new “large” loans for multi-year funding of premiums require a much higher annual interest cost
 - **Concern:** Prior solutions to address/plan for either annual debt service or long-term interest repayment are not working as smoothly

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Split-Dollar Life Insurance (cont.)

- Current Problems with Your SDA
 - EB/Loan Problem – Delayed Switch Dollar
 - EB but should have switched to Loan years ago
 - EB costs rose faster than parties realized
 - But now new loan is more expensive
 - Analysis is harder as both EB and loan costs appear to be increasing in the near term
 - Particularly true on survivorship policies upon death of one insured
 - *Query: Switch now or wait until required? But what will relevant AFR be then?*

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Split-Dollar Life Insurance (cont.)

- Current Problems with Your SDA
 - EB Problem – Poor Management
 - Annual EB costs were not used (or never)
 - Alternative term rates used were not qualified
 - Improper accounting for EB on either income or gift tax side
 - Equity build-up in EB regime post-Final Regs not being reported properly, but.....
 - Remember special deemed owner rule - non-equity treatment should apply IF: (1) donor (deemed owner) is entitled to greater of premiums or policy cash value; and (2) non-owner (ILTT) only receives current life insurance protection
 - However, with positive policy performance, this causes an annually increasing (equity) includible part of SDA reimbursement in gross estate of donor

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Split-Dollar Life Insurance (cont.)

- Current Problems with Your SDA
 - Loan Problem – Poor Management
 - Failure to file required Split-Dollar Loan Representation either annually or at inception (if only applicable at such time)
 - Still loan under general tax principles?
 - “Bona Fides” never did or no longer appear to justify reasonable person would expect repayment
 - Likely still OK based on Preamble to Final Regs
 - Interest charge, if applicable, was not properly reflected, treated, or cured if non-grantor trust owner

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Split-Dollar Life Insurance (cont.)

- Problems with Your Current SDA
 - Grandfathered Problem - Material Modification
 - Modification has occurred or is required
 - Prior or recent 1035 exchange was performed
 - Remember so-called “Angel List” was non-exclusive list of non-material changes. But...
 - IRS will not rule and never issued any helpful guidance
 - Equity build-up is about to be rolled out
 - Ancient Employer Plan about to terminate upon retirement, sale, or liquidation of Employer
 - Arguable income/gift taxation, but... Query: “No Inference”
 - Remember for 409A - Notice 2007-34 did not provide any “no inference” protection for that part of the equity to which it applies

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Split-Dollar Life Insurance (cont.)

- Problems with Your Current SDA
 - Third-Party Premium Financing Problems:
 - Interest costs have become excessive
 - Third-party financing is no longer desirable
 - Collateral, if any, outside of policy may be declining or no longer sufficient

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Split-Dollar Life Insurance (cont.)

- Problems with Your Current SDA
 - Any SDA/Premium Finance – Global Problems
 - Exit strategy did not perform as planned or is no longer feasible
 - Change in circumstances for the client or economic/legal/tax environment:
 - Design now determined to be too risky or aggressive (e.g., intergenerational split-dollar, particularly if formed as EB SDAs)
 - Estates of *Cahill*, *Morrisette*, *Levine* (ruling still is expected soon)

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Split-Dollar Life Insurance (cont.)

- Possible Solutions
 - Use Enhanced Lifetime Gift Tax Exemptions
 - Can mitigate economic pressures
 - Solve for future required premiums
 - May be able to restate or “refinance” post-Final Regs EB or Loan SDA
 - Can unwind transaction in its entirety BUT
 - Carefully analyze applicable income, gift, and employment tax issues
 - Address consistently

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Split-Dollar Life Insurance (cont.)

- Possible Solutions
 - Modify, Decant, Terminate ILIT
 - Address any trust concerns (beneficiary, trust provisions, lack of flexibility, etc.)
 - Roll-Out Policy
 - If only viable planning option
 - Parties must review all tax issues and address consistently
 - Must consider valuation
 - Consider creditor protection alternatives to owning policy outright

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Split-Dollar Life Insurance (cont.)

- Possible Solutions
 - Exit Third Party Premium Finance Arrangement
 - Use available assets to pay-off financing
 - Alternatively, use policy and contract rights thereunder, including potential life settlement
 - Switch to Loan SDA, where applicable and practical

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Split-Dollar Life Insurance (cont.)

- Termination of SDA – Practical Planning Issues
 - Repayment of Receivable or Loan
 - Make sure you address income, gift and valuation issues
 - Release of collateral assignment
 - Timing between gift and repayment (practical, optics – best practices)

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Split-Dollar Life Insurance (cont.)

- Termination of SDA – Practical Planning Issues
 - Termination of Agreement
 - Consider same income, gift and valuation issues.
 - Transfer of Policy
 - Insurance paperwork
 - Consider transfer-for-value concerns
 - Address equity roll-out, if any
 - Consider same income, gift and valuation issues

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Split-Dollar Life Insurance (cont.)

- Constructing New Purchases
 - Options
 - Private non-equity EB split dollar or loan regime financing
 - Employer/employee non-equity EB split-dollar or loan regime split-dollar
 - Compare use of the increased gift/GST exemptions to fund premiums for ILIT instead of SDA
 - SDAs can reduce or eliminate gift and GST costs of ILIT funding the ILIT
 - Trade-off is the cost of inclusion of the receivable the premium provider's estate in private arrangements (or in the value of the entity for compensatory arrangements)
 - SDAs also can allow use of increased exemptions for transferring other assets (perhaps at a discount) to trusts, by not using the funds solely on transfers of cash to make insurance purchases/payments

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Split-Dollar Life Insurance (cont.)

- Private EB Non-Equity, Collateral Assignment SDA
 - Alive but less sexy
 - Uses include when tax economics of EB regime will be better than loan regime at outset
 - Particularly attractive with a survivorship policy, while both insureds are alive
 - Keys:
 - Insured is entitled to all cash value
 - Insured is secured by 'bare-bones' collateral assignment (or is unsecured)
 - Insured treats imputed economic benefit as a gift to the ILIT (and a GST transfer)
 - Practice Tip:
 - EB is lower of Table 2001 or insurer's one-year term cost that qualifies under Notice 2002-8
 - Must be updated annually.

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Split-Dollar Life Insurance (cont.)

- Private EB Non-Equity, Collateral Assignment SDA
 - Planning Milestones
 - Consider change to loan at earlier of when: (1) policy is on cusp of equity or (2) EB will exceed interest cost, likely at first death
 - "Switch dollar" - note the potential transfer tax on the "switch"
 - » Policy is "deemed" transferred
 - Initial loan will be for aggregate premiums advanced
 - Subsequent premium payments will be new loans
 - Consider use of promissory notes for lump sum funding
 - Continue to create and fund an exit strategy (side fund, continued gifts, etc.)

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Split-Dollar Life Insurance (cont.)

- Private Loan SDA
 - Insured is lending funds (annual premiums or lump sum) to the ILIT
 - No annual economic benefit determined by term costs
 - Each premium is a new loan, governed by terms and AFR rate(s) at time of each loan
 - Upfront loan fixes the interest at today's rate
 - Loan must provide for sufficient AFR interest, either paid currently or accrued
 - So the §7872 below-market loan rules will not apply – if they do, it would be a gift term loan, with unfavorable transfer tax consequences
 - If interest is accrued at the AFR, there can be no gift
 - ILIT should be a grantor trust, to avoid tax on interest paid or accrued

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Split-Dollar Life Insurance (cont.)

- Private Loan SDA
 - Keys
 - Type of loan(s) – Demand, term, safe harbor?
 - Always charge AFR (paid or accrued) to avoid an upfront gift of imputed interest under §7872
 - Debt service?
 - Secured?
 - Exit Strategy?
 - Policy selection?
 - Don't forget the special (and sometimes unusual) rules under the Final Regulations
 - Representation Statement

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Split-Dollar Life Insurance (cont.)

- Private Loan SDA
 - Where's the Exit?
 - Will loan be repaid during insured's lifetime?
 - Any planned roll-out of policy?
 - Reduced or limited death benefit design?
 - How will interest be serviced to allow loan payoff amount to remain fixed?
 - Can anticipated increases in policy cash value accomplish payoff?
 - Some combination of approaches?
 - If designed from inception, a flexible premium product might allow adjustments to premiums to achieve targeted objectives and/or to adapt to future circumstances

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Business Uses of Life Insurance

- Reminders
 - Closely-held businesses and business owners use life insurance for a variety of reasons
 - The policy premium can be paid in the following ways:
 - Out of the assets of the business,
 - With a cost sharing arrangement,
 - With compensation paid to the employee; or
 - Premium financing arrangements or other loan arrangements
 - C Corporations can effectively utilize the new 21% tax rate with SDA planning
 - Lower corporate tax rates and pass-through deductions can lower the effective cost of the non-deductible advances for insurance premiums (or with loans the cost of the interest income). As always, know where the exit is located when utilizing SDA.

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Business Uses of Life Insurance (cont.)

- If Business/Business Owner Had No Life Insurance
 - Continue to pay expenses as they arise
 - But, can the business can support it? Now, but always? Risky
 - Borrow funds
 - Consider costs, even if a lender is willing to lend money to business when the owner has died
 - Create an investment fund in the business
 - However, investments in a C corporation could be subject to accumulated earnings tax
 - Requires company to set aside funds on a regular basis that may be needed for the business
 - Also requires a great deal of discipline and foresight on the part of the owners
 - Sell the business
 - If estate or family takes back a note, the estate or family becomes a creditor of the business
 - Family also may not be able to wait for payments to pay estate taxes or meet family needs

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Business Uses of Life Insurance (cont.)

- If Business/Business Owner Decides Policy No Longer Needed in Company
 - Distribute policy to insured
 - If owner, it could be a dividend (S corporation issues) if corporation owns policy
 - If employee, it could be compensation
 - If partnership owns policy, effect on capital accounts, permissible under agreement? Consent of other partners may be required
 - Sell Policy
 - To insured
 - To third parties
 - Retain Policy
 - Does insured own business
 - Cost of premiums

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Business Uses of Life Insurance (cont.)

- **BE CAUTIOUS - Transfer-For-Value Considerations**
 - **General Rule:** *With proper planning, the death benefits paid under a life insurance policy or contract are not typically subject to income tax when they pass to designated beneficiaries. Internal Revenue Code Section 101(a)(1).*
 - *However, income tax may apply to death benefits of a policy that is (1) transferred (by assignment or otherwise) for (2) valuable consideration. Code Section 101(a)(2).*
 - *The beneficiary pays income tax on the part of the death benefit that exceeds the sum of (1) the initial consideration paid for the policy plus (2) any later premiums and other amounts paid to maintain the policy.*
 - **Many exceptions MAY apply if structured properly.**
 - **Most common - Transfer of Policy to the Insured**
 - Also excludes policy transfers to and between wholly-owned grantor trusts for income tax purposes, including sales of a policy:
 - By the insured to his wholly-owned grantor trust
 - Between two wholly-owned grantor trusts of the same grantor
 - From a non-grantor trust to the insured's wholly-owned grantor trust

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Business Uses of Life Insurance (cont.)

- **Specific Transfer-For-Value Considerations and Exceptions**
 - **Transfer to a Partner of the Insured**
 - Partner of insured can own a very small partnership interest (e.g. 1%)
 - Example: Frank and his non-grantor trust are partners in Doe family limited partnership (FLP). Frank sells a \$5 million policy on his life to the trust
 - Even though the trust is a non-grantor trust, it is a partner of the insured, so the policy transfer qualifies for an exception to the TFV rule
 - **Transfer to Partnership in which Insured is a Partner**
 - Example: If, above, Frank sold his policy to Doe FLP instead of the trust, the purchase by the FLP also would be excepted from the TFV rule
 - CAUTION: The partnership should have a legitimate business purpose. It's unclear if the exception will apply if a partnership is created solely to buy the policy

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Business Uses of Life Insurance (cont.)

- **Specific Transfer-For-Value Considerations and Exceptions**
 - **Transfer to Corporation in which Insured is Shareholder/Officer**
 - Note: life insurance is often used to cover key employees or to fund shareholder agreements.
 - Example: Harry, a shareholder of Newco, Inc., owns a \$5 million policy on his life. Harry sells the policy to Newco, Inc. as part of a plan to fund a stock redemption agreement by Newco at Harry's death.
 - » The exception to the TFV rule applies because Harry is a shareholder of Newco.
 - CAUTION: The exception does not apply to policy transfers from corporate employees to a corporation or between shareholders of a corporation.
 - If in the above example, (1) Harry sold the policy to another shareholder of Newco as part of a cross-purchase agreement or (2) Harry was only an employee of Newco when he transferred the policy, no exception would apply.

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Business Uses of Life Insurance (cont.)

- Specific Transfer-For-Value Considerations
 - Transfers of policies for business succession/buy-sell planning
 - Common trap - cross-purchase buy-sell arrangements among corporate shareholders.
 - Each shareholder owns a policy on the lives of the other shareholders and uses the policy proceeds to buy a deceased shareholder's shares.
 - The mutual shareholders' promise to buy the stock of the other after death is consideration
 - The release from such obligations can also be consideration.
 - Examples:
 - Reciprocal Agreement: *Ex:* A and B are unrelated shareholders and each owns a policy on his/her own life.
 - › They switch policies to fund a cross-purchase agreement, so that A owns, and is the beneficiary of, the policy on B's life and vice versa.
 - › These transfers are TFVs as their reciprocal actions constitute valuable consideration.
 - › The same result applies even if A and B retained ownership of their policies and just named each other as the policy beneficiary.

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Business Uses of Life Insurance (cont.)

- Specific Transfer-For-Value Considerations
 - Transfers of policies for business succession/buy-sell planning
 - Examples:
 - **Buy-Sell Restructure:** X Corp. owns policies on shareholders A, B, and C as part of a stock redemption arrangement, which requires X Corp. to buy a deceased shareholder's shares.
 - The shareholders want to convert to a cross-purchase arrangement and have X Corp. transfer 1/3 ownership of the policy insuring A to B and C, 1/3 ownership of the policy on B to A and C, etc.
 - Each such transfer by X Corp. would be a TFV, because X Corp. is released from its obligations to buy the shares (valuable consideration).
 - There is no exception from the TFV rule for a transfer of a policy from a corporation to a shareholder (unless the shareholder is the insured or a partner of the insured in a separate partnership).

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Business Uses of Life Insurance (cont.)

- Specific Transfer-For-Value Considerations
 - Transfers of policies for business succession/buy-sell planning
 - Examples:
 - **Policy Sale to Other Shareholders:** Assume A, B, and C, as shareholders of X Corp., have created a cross-purchase arrangement, with A owning life insurance policies on B and C, B owning policies on A and C, etc.
 - A dies, and A's estate wishes to sell the policy it owns on B to C and on C to B (so each can use it later to buy the other's shares at their deaths).
 - Each sale by the deceased shareholder's estate of a policy to the surviving co-shareholder(s) of the insured is a TFV.
 - As there is no exception for sales of insurance policies to shareholders of an insured, the TFV rule will tax the death benefit, unless another exception applies.

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Business Uses of Life Insurance (cont.)

- Specific Transfer-For-Value Considerations
 - Transfers of policies for business succession/buy-sell planning
 - Corporate Reorganizations and Asset Sales
 - Life insurance policies on shareholders, officers, and employees may be part of the assets transferred in corporate reorganizations or take-overs.
 - If a tax-free reorganization, transfers of the corporate policies, even on employees, should take a carry-over basis and qualify for the carry-over basis exception to the TFV rule.
 - If the insured is a shareholder or officer in the new corporation, the exception for transfers to a corporation in which the insured is a shareholder/officer should apply to the TFV rule.
 - If there is neither a tax-free reorganization nor an insured who is an officer or shareholder, the TFV rule will likely apply without exception.
 - » The death benefits under those policies will be income taxable to the extent they exceed the purchase price and other premiums paid by the new corporation for the policy.

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Business Uses of Life Insurance (cont.)

- Specific Transfer-For-Value Considerations
 - **Potential Planning for Prior TFVs?**
 - Once the TFV rule applies, all subsequent transfers remain tainted *unless the final* transfer for value is to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer.
 - But, make sure this is still true after the Final Regulations just published on October 31, 2019 under Sections 6050Y and 101 – no longer may be an option in certain situations.
 - **Be aware, then be creative, if necessary, but always be cautious.**

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Tax-Exempt Planning

- Highly Compensated Employee Loan Split-Dollar
 - Again, each annual loan has its own term and AFR rate
 - Interest could be imputed and taxed to the employee during employment and accrued after retirement
 - Would be taxable as income annually while imputed and not taxed when accrued
 - Loan might be due on termination of employment or might continue until death
 - If continued after employment, interest should be paid or accrued, rather than imputed, to avoid any element of deferred compensation

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Tax-Exempt Planning (cont.)

- Highly Compensated Employee Loan Split-Dollar
 - The tax-exempt employer has no interest income to report
 - Might be an interesting way to compensate highly-paid employees without violating §457 or new 21% excise tax imposed on compensation for such employees under the Act
 - Theory is that the only compensation element in such a loan is the interest imputed, not the loan itself
 - IRS Notice 2019-09
 - Recent guidance on §4960
 - Good faith, reasonable interpretations until proposed regulations are issued
 - Must also comply with state law restrictions on loans to officers or directors

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FINAL REMARKS

THANK YOU FOR ATTENDING

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