

LIFE INSURANCE

Life Insurance Rules to Live By

CCH: Recently issued IRS Letter Ruling 200627021 involves a relatively obscure rule under Code Sec. 264(f) that was enacted as part of the Taxpayer Relief Act of 1997 (TRA '97) (P.L. 105-34). Could you begin by

A recent private letter ruling involving an employer-owned life insurance policy reminds practitioners of a little-known rule dealing with the deductibility of interest expense. This rule and others concerning policy loans, premium financing, and corporate-owned life insurance are the subjects of the following interview with Lee Slavutin, MD, CLU, who is a principal of Stern Slavutin-2 Inc., an insurance and estate planning firm in New York City, and a member of the CCH FINANCIAL AND ESTATE PLANNING Advisory Board.

giving our readers a brief synopsis of the facts of this private letter ruling?

Dr. Slavutin: The taxpayer in this ruling was an entity engaged in providing consulting services. The consulting firm owned and was the beneficiary of a life insurance contract insuring the life of an em-

ployee. The consulting firm indicated that it intended to exchange the original life insurance contract for one issued by a different insurance company. The new policy was to insure the same individual as the original policy and was to have the same death benefit. However, at the date of the proposed exchange, the insured individual would no longer be employed by the consulting firm. The ruling also indicated that the firm had "substantial" general indebtedness on which it incurred interest expense.

CCH: How did the IRS react to this proposed exchange of life insurance contracts?

Dr. Slavutin: Unfortunately for the taxpayer, not well, in that a portion of the taxpayer's interest expense deduction was denied. Specifically, the IRS noted that Code Sec. 264(f)(1), as added by TRA '97, states that no deduction will be allowed for that portion of the taxpayer's interest expense that is allocable to "unborrowed policy cash values." In this regard, it is significant to note that the rule in question applies to any interest expense, not just that related to insurance. For example, this could include interest expense incurred on a loan to purchase equipment.

CCH: In arriving at this conclusion what authority did the IRS cite?

Dr. Slavutin: The IRS pointed out that, under Code Sec. 264(f)(2), the portion of the taxpayer's interest expense allocable to unborrowed policy cash values is an amount that bears the same ratio to such interest expense as the taxpayer's average unborrowed policy cash values of life insurance policies, and annuity and endowment contracts, issued after June 8, 1997, bear to the sum of (1) the average unborrowed policy cash values of the taxpayer's life insurance, annuity, and endowment policies and (2) the average adjusted bases (within the meaning of Code Sec. 1016) of the taxpayer's other assets.

CCH: And, how is the term "unborrowed policy cash values" defined?

Dr. Slavutin: In defining that term, the Code looks at the excess of (1) the cash surrender value of the policy determined without regard to any surrender charge, over (2) the amount of any loan with respect to such policy. To simplify this concept somewhat, let us assume that a business owns a life insurance policy with a cash value of \$100,000 and the business has \$2 million in assets, including the insurance policy. In this case, the insurance policy represents five percent of the total business assets. Assuming further that the business has a total interest expense of \$200,000, five percent of the interest expense, or \$10,000 would be disallowed unless one of the exceptions to Code Sec. 264(f)(1) applies.

CCH: What are the exceptions to Code Sec. 264(f)?

Dr. Slavutin: Code Sec. 264(f)(4) states that the general rule does not apply to any policy or contract owned by an entity engaged in a trade or business if the policy or contract covers only one individual and if that individual is (at the time first covered by the policy or contract) (i) a 20-percent owner of such entity or (ii) an individual (not described in (i)) who is an officer, director, or employee of such trade or business. In this case, the exceptions were of no help to the taxpayer because, in IRS Letter Ruling 200627021, the insured was no longer an employee of the consulting firm at the time of the proposed contract exchange and, presumably, was also not a director, officer, or 20-percent owner of the entity.

CCH: As a practical matter, what should our readers glean from this ruling?

Dr. Slavutin: At first glance, the ruling appears fairly limited. The facts were arguably somewhat unusual in that the insured would no longer be an employee of the entity when the insurance contract exchange was to take place. The ruling also pointed out that the effective date language Code Sec. 264(f) indicates that the provision is effective for contracts

issued after June 8, 1997. In this case, the proposed exchange would result in a “material change” to the original contract. Consequently, taxpayers who may be similarly situated to the entity in IRS Letter Ruling 200627021, should carefully scrutinize any proposed policy exchanges particularly with respect to the continued employment status of any insured parties.

Beyond that, however, I believe that the ruling does point out a potential problem for some types of entities, specifically partnerships. For example, let us say we have a partnership with more than five equal partners. To make the math simple, let us assume the total number of partners is 10 and each holds an equal 10-percent interest in the partnership. In such a case, none of the exceptions would be available because no one would be considered a 20-percent owner of the entity, nor would they be an officer or director and, finally, a partner is not considered an employee. Depending on the overall debt of the partnership, disallowance of a significant amount of interest expense could be quite costly.

Policy Loans

CCH: With respect to a different, but related topic—policy loans—why is it important for advisors to be aware of the existence and status of a client’s policy loans?

Dr. Slavutin: In general, advisors need to be sensitive to issues concerning policy loans because they can lead to serious problems that can often go undetected and which cannot be corrected after the fact. Let me suggest a possible scenario to illustrate this point. Consider a client who has a whole life policy with a large cash value and who, for whatever reason, decides not to pay the premiums any longer. The insurance contract includes an automatic premium loan provision. Ordinarily, such a provision would be considered a benefit because it would prevent the policy from lapsing if the insured inadvertently forgot to pay the premiums.

However, in a case where the client allows this feature to be triggered and continues to allow it to be triggered year after year, a serious problem can develop. For one thing, interest is accrued on the loan. In addition, the interest rate charged can be relatively exorbitant. In some old whole life policies, for example, the loan interest rate is fixed at eight percent. Accordingly, if years pass with interest accruing on the loan at a high interest rate, the loan amount can become a very large sum. At some point, your client may receive a letter from the insurance company indicating that the policy is soon going to lapse because the amount of the loan will exceed the policy’s cash value. The client’s reaction is that they do not care because they did not want the

policy anymore. However, that is not the end of the story. The following year, the client will receive a Form 1099 from the insurance company showing cancellation of indebtedness income. The amount of income equals the amount of the loan minus the basis in the policy. If the policy lapsed when the loan amount was \$400,000 and \$150,000 had been paid in premiums, this will result in \$250,000 of income that is treated as ordinary income, not capital gain. By the time the Form 1099 is received, it is too late to do anything to correct the situation.

This illustrates why it is so important for advisors to be aware of their clients situation in regards to policy loans. If such a situation is detected early enough some form of corrective action, whether it is to start paying premiums, or to consider replacing the policy, could be initiated before the loan amount outstrips the cash value.

CCH: Are there any other considerations involving policy loans that you would like to stress?

Dr. Slavutin: Another significant issue with respect to policy loans that is often encountered in the context of estate planning concerns the transfer of a life insurance policy from one person to another. For example, a parent might want to transfer a life insurance policy on his life to a child for the purpose of removing it from the parent’s estate, assuming the three-year period after the gift is satisfied. What if someone advises the client to take out a large loan against the policy prior to the transfer to reduce the amount of the taxable gift? Under these circumstances, there are two possible tax consequences. First, the transferor would be subject to cancellation of indebtedness income in the amount of the debt forgiven minus the transferor’s basis in the policy. Second, the transferee could be exposed to transfer-for-value problems when the insured dies, if the amount of the debt at the time of the transfer exceeds the basis in the policy. The lesson here is that when contemplating a transfer of life insurance policies for estate planning purposes, do not transfer a policy that is subject to a loan that exceeds the transferor’s basis.

Premium Financing

CCH: Following the 2003 regulations that curtailed the use of split-dollar life insurance arrangements, there has been considerable activity in the area of premium financing. Could you shed some light on the status of this particular technique?

Dr. Slavutin: Yes, you are correct in stating that premium financing has become more prevalent over the past three years since the split-dollar regulations were adopted. Those regulations effectively made split-dollar arrangements much less attractive than they had been previously.

Premium financing involves an insurance trust borrowing money from the client, the client's business, or a third party, such as a bank. Generally, it is a technique that is more appropriate for older clients. The reason I say this is because, if you were to use this technique for a younger client, for example someone in their fifties with a life expectancy of 30 years or more, the interest expense over time will simply become too great. We did a projection several years ago for a 51-year old client contemplating premium financing and we found, assuming that he lived into his nineties, the amount of the loan plus the accrued interest would have exceeded the amount of the insurance. In other words, not only would there be no insurance proceeds to pay his family at his death, his family, or the insurance trust, would have actually owed money to the lender.

CCH: Besides the age issue, are there any other guidelines practitioners should be aware of when contemplating a premium financing arrangement?

Dr. Slavutin: One point I would like to stress is the need to pay any interest on the loan as it is incurred. We do not recommend accruing the interest expense. At least one way to pay the interest as it is incurred would be for the client to make gifts of cash or other property to the insurance trust every year using the client's annual gift tax exclusion or lifetime exemption.

Another important guideline is to make sure that the policy is designed so that the death benefit does not remain level, but rather increases each year as the amount of the loan increases. For example, a \$10 million dollar life insurance policy might require a \$100,000 annual premium financed by a loan each year. After 10 years, there would be \$1 million in loans outstanding. After 20 years, there would be \$2 million in loans outstanding. One would not want the insured's family to receive \$10 million in insurance proceeds minus \$2 million in loans. Consequently, it is necessary to design the policy so that the death benefit keeps pace with increases in the cumulative premium balance over time. Accordingly, in this example, the death benefit after the first year should not be \$10 million, but should be \$10,100,000. In the second year, it should be \$10,200,000, and so on. There are many policies available today that provide this feature.

Finally, I think it is very important to have a clear exit strategy in mind before entering into a premium financing arrangement. No matter how old the client is, it is not advisable to have one of these arrangements continue for years and years. One possible scenario would be to establish a grantor retained annuity trust (GRAT) simultaneously with the premium financing

arrangement. The insurance trust would be named as remainder beneficiary of the GRAT. At the termination of the GRAT, whatever remains in trust would go to the insurance trust to pay premiums and, if the amount is large enough, to also pay off the loan. This is a way to pay the premiums and repay the loan in a very tax efficient way because the GRAT can be set up so as to result in little or no gift tax cost.

Two-Year Nonrecourse Premium Financing

CCH: A subset of the general concept of premium financing that has received some press coverage recently is two-year nonrecourse premium financing. Could you describe how this is to be distinguished from premium financing in general?

Dr. Slavutin: As the name implies, in two-year nonrecourse premium financing the lender has no recourse against the trust or the individual insured. Typically, these deals were structured so that at the end of two years, the policy could be sold in the life settlement market leaving enough to pay off the debt on the loan and, possibly, even a surplus.

These transactions received considerable scrutiny from the insurance industry. Today, most, if not all, of the major insurance companies will no longer participate in such a transaction and have issued some form of communication to insurance agents and brokers indicating that to be the case. However, I still occasionally hear about such a transaction being proposed, which leads me to believe that some transactions are not being properly disclosed to the insurance companies. In fact, many companies have added a question or questions to their life insurance application forms specifically asking whether a nonrecourse premium financing arrangement or a life settlement is being contemplated by the parties. As a final point, I want to stress that the two-year nonrecourse premium financing strategy should not be confused with what I would call "vanilla" premium financing or life settlements. Life settlements are perhaps the most significant change in the life insurance industry in the past 10 years and have become an extremely useful planning tool.

Life Insurance Provisions in PPA 2006

CCH: On the subject of business-owned life insurance, prior to leaving Washington for their August recess, Congress passed the Pension Protection Act of 2006 (P.L. 109-222). That law includes a new provision dealing with corporate-owned life insurance (COLI). Could you give our readers your views on the significance of this law change?

Dr. Slavutin: First, I would like to put this issue in perspective. In recent years, there has been considerable

adverse publicity that led to litigation on what some people have referred to as “janitor life insurance.” A number of large corporations in various industries were accused of taking out life insurance policies on low-level employees who were not even informed that the policies existed. This practice came to the attention of Congress and the IRS, which eventually led to the legislative changes I am about to describe.

In this regard, the Pension Protection Act adds new Code Sec. 101(j). In general, this provision is intended to assure that COLI is purchased for a legitimate purpose and not just as a part of a tax-motivated transaction. Code Sec. 101(j) provides that the amount of death benefits excluded from the gross income of an applicable policy holder will not exceed the premiums and other amounts paid by the policyholder for the life insurance policy, unless certain exceptions apply. The first set of exceptions concerns the identity of the insured party. This set of exception covers an individual who was an employee of the policy holder at any time during the 12-month period prior to his or her death or who was, at the time the contract was issued, a director, a highly-compensated employee under Code Sec. 414(q) (without regard to the election under paragraph (1)(B)(ii) of that section), or a highly-compensated individual under the rules of Code Sec. 105(h)(5) (substituting 35 percent for 25 percent in subparagraph (C) of that section). Written notice and consent requirements are also applicable.

A second set of exceptions depends on the identity of the beneficiary of the policy proceeds or the purpose of the insurance proceeds. Policy proceeds payable to a member of the insured’s family, to a designated beneficiary of the insured, to the estate of the insured, or a trust for the benefit of the insured’s family or a designated beneficiary would not be subject to the general rule of income inclusion. Similarly, if the policy proceeds are being used to purchase an equity interest in the policyholder entity (e.g., as part of a buy-sell or shareholder redemption agreement) from an heir of the insured, the general rule will not apply. The bottom line with respect to this provision is that all new policies issued after August 17, 2006, will have to conform with the new requirements, including those pertaining to written notice and consent, in order to qualify for an exclusion from gross income.

IRS Pronouncements

CCH: Before we conclude, are there any new rulings or pronouncements from the IRS dealing with life insurance issues?

Dr. Slavutin: Yes, a Technical Advice Memorandum (not yet released to the public) concerns the issue of

whether a qualified plan that contained a “sub-trust” to hold life insurance policies payable to the beneficiaries of a participant resulted in disqualification of the plan. This issue has been debated for some time in the insurance community and we now finally have a ruling from the IRS. The TAM concludes that the presence of the sub-trust feature did disqualify a defined benefit plan because, for one thing, it discriminated in favor of a highly compensated employee. The IRS also concluded that the sub-trust violated the incidental benefit requirement of Reg. §1.401-1(b) by preventing the cash value of the insurance policy from being used to provide benefits to the participant during his lifetime. In reaching this conclusion, the TAM cites Rev. Rul. 56-656 (1956-2 CB 280) for the proposition that such a feature violates the principle that payments to persons other than the participant should be merely incidental to the plan’s purpose of distributing benefits to the participant. ♦

Fifth Circuit

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gifts of hard-to-value assets (like partnership interests) in terms of dollar amounts, rather than in traditional percentage terms. With the use of a residual charitable donee, donors can set a cap on the amount of taxable gifts for gift tax purposes, providing greater certainty in devising wealth transfer strategies. A defined value clause, with its dollar formula, enables taxpayers to transfer any type of property with the same valuation certainty as that which characterizes cash. The more uncertain the value of the property to be gifted, the greater the utility of a defined value clause, it would seem.

However, despite the apparently sweeping victory for the taxpayers in *McCord*, caution may well be in order when it comes to the use of defined value clauses. The Fifth Circuit did not substantively address the applicability of the equitable doctrines of form over substance, violation of public policy, and reasonable probability of receipt to the donors’ gifting arrangement. The appellate court plainly stated that the IRS waived those theories by not raising them on appeal. As previously noted, the Tax Court majority did not reach these doctrines, instead ruling on other grounds; the focus of the IRS in the Fifth Circuit was supporting the methodology of the majority. Therefore, due to the IRS’s appellate strategy, it remains uncertain whether a *McCord*-style defined value clause is safe from doctrinal attack. Could the public policy concerns raised in *Procter* or *Ward* be used to negate a defined value clause of the type found in *McCord*? The answer to that all-important question is not yet known. Until the issue is clarified, estate planners may be well advised to tread carefully in the fields of defined value clauses. ♦