WEALTH MANAGEMENT:

SPECIAL REPORT

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Common Pitfalls in Life Insurance Planning

Life insurance is a common asset in many estate and business plans, but improper purchases, transfers, funding, and beneficiary/owner designations can result in unintended and adverse tax consequences. As simple oversights in these areas can lead to big problems later, the following provides a sampling of some basic but easily overlooked rules for typical personal and business life insurance planning transactions.

Gift and GST Tax Planning

√ *Understand the need for accurate policy valuations for policy transfers.*

Determining a policy's fair market value ("**FMV**") for federal transfer tax purposes has recently become more complicated. Typically, the gift tax FMV of a policy is its "replacement cost," which, for older policies requiring further premiums, is the policy's interpolated terminal reserve value plus unapplied premiums ("**adjusted ITR**").

Some carriers, however, are providing multiple valuations for gift tax purposes, including the policy's adjusted ITR, cash value, statutory reserve value, and "PERC" value (required for certain federal income tax purposes). These values can vary significantly. For example, a recent valuation request regarding a $10 million universal life policy yielded two carrier-provided values: an adjusted ITR of $158,500 and an alternate PERC value of $232,700, a difference of $74,200.

Given the above, a policy's gift tax value may be significantly higher than anticipated, and the burden of selecting the appropriate value falls on the client and his or her advisors. Thus, advisors should carefully review valuation issues with the carrier's legal department to identify the appropriate valuation standard prior to the carrier's issuance of the final valuation.

√ *Consider the estate inclusion risk of policy transfers within three years of death.*

If an insured gratuitously transfers a policy within three years of his or her death, Code § 2035(a) pulls the policy proceeds into the insured's taxable estate (the "**3-year rule**"). An exception to this rule applies for a bona fide sale of the policy for "adequate and full consideration" (*i.e.*, the policy's FMV).

Thus, a common method for avoiding the 3-year rule is to have the insured sell the policy for its FMV to an irrevocable life insurance trust ("**ILIT**") created by the insured as

a wholly-owned grantor trust for federal income tax purposes. The sale avoids the potential estate tax inclusion risk and is disregarded for income tax purposes.

Valuation issues, however, become even more important when taking advantage of the sale exception. Selling a policy for less than its FMV will cause a partial gift of the policy, resulting in estate tax exposure if the insured dies within three years of the transfer. Federal generation skipping transfer ("**GST**") tax issues may also arise if the deemed partial gift is made to a GST-exempt trust to which no GST exemption was timely allocated. Thus, advisors should work closely with carriers to determine an accurate sales price (and should understand that the IRS may still challenge the valuation).

√ *Advise clients on the allocation of GST tax exemption to annual exclusion gifts made to ILITs.*

Clients typically make annual exclusion gifts to their ILITs to fund life insurance premiums. Annual exclusion gifts generally do not produce a federal gift tax liability and do not require the filing of an annual federal gift tax return. The Code, however, imposes stricter requirements on annual exclusion gifts for GST tax purposes. Specifically, in order to qualify gifts made to a trust for the annual exclusion from GST tax, the trust must benefit only one individual (who qualifies as a skip person for GST tax purposes) during his or her life, and, if the trust does not terminate before the individual dies, the trust assets must be includible in that individual's gross estate.

Transfers to a typical ILIT will not qualify for the annual GST tax exclusion, since most ILITs have multiple beneficiaries and are drafted to prevent inclusion of the trust assets in a beneficiary's estate. If GST exemption is not allocated to these transfers, the ILIT will not be fully GST-tax exempt, and a GST tax will be imposed when trust property is distributed to a skip person or when the interests of all non-skip persons in the trust terminate. The automatic allocation rules may afford some protection, since they apply to automatically allocate GST exemption to any contribution made to a qualified GST trust. It is up to the taxpayer, however, to confirm the trust's GST status and to track and record the amount of GST exemption automatically allocated each year.

Accordingly, rather than relying on the automatic allocation rules, clients who make annual exclusion gifts to GST-exempt ILITs should ensure the proper allocation of their GST tax exemption to those contributions. This may include the filing of a federal gift tax return for the sole purpose of documenting the allocation of GST tax exemption, even if the client has not made any taxable gifts that would otherwise require a return.

INCOME TAX PLANNING

√ *Review the tax implications of a policy loan prior to any policy surrender, transfer, or exchange.*

The complete surrender of a policy generates ordinary income to the extent the amount received exceeds the owner's "investment in the contract" (*e.g.,* premiums paid less prior amounts received under the policy that the owner did not include in gross income). Discharge of a policy loan upon surrender of a policy (or the transfer of a policy subject to a loan to a person other than the owner's grantor trust) will result in income taxable at ordinary income rates if the total loan exceeds the investment in the contract. Note that a transfer of the policy subject to such a loan could also trigger the transfer for value rule, as discussed below. Thus, the owner should either repay the policy loan prior to the surrender/transfer or factor in the potential tax consequences of the discharged loan.

In addition, a 1035 exchange of a policy subject to a policy loan for another policy not subject to a similar loan will result in "boot" to the owner in the amount of the loan discharged, producing income taxable at ordinary income tax rates. The loan should be repaid prior to the exchange, or the new policy issued subject to the same loan amount.

√ *Consider tax consequences of loans, withdrawals, or pledges related to MECs.*

For most life insurance contracts, owners may withdraw from the cash value of the policy, income tax-free, up to their investment in the contract. A different rule applies to modified endowment contracts "(**MECs**") and taxes lifetime distributions as ordinary income until they exceed the gain in the MEC. Policy loans and pledges of MECs as collateral for loans are similarly taxed as MEC distributions. An additional 10% penalty tax also may be imposed on the amount of MEC distributions (or deemed distributions) included in gross income. There are limited exceptions to the penalty, including for MEC distributions made on or after the policy owner reaches age 59 ½.

Some commentators believe that the pledge of a MEC as collateral in a split-dollar arrangement ("**SDA**") does not result in income taxation, because the policy owner receives no cash at the time of the pledge. In other words, the economics of a SDA differ from a traditional loan, so the pledge of a MEC as collateral for a SDA should not be taxed as a loan against or withdrawal from a MEC. As there is no definitive authority, advisors and clients should note the issue.

Generally, if the client does not anticipate taking loans against or withdrawals from the policy during life, MEC status may not be an issue. A MEC provides the benefit of placing greater amounts in the policy earlier, allowing longer tax deferred growth and likely reducing the overall cost of the coverage. However, a MEC limits flexibility later if client circumstances change and access to cash value is desired. Whether or not MEC status should be avoided will depend on a client's particular needs and objectives.

√ *Advise of potential transfer for value issues prior to any policy transfer.*

Code §101(a)(1) provides that gross income generally does not include death benefits paid under a life insurance policy. In the case of a policy transferred for valuable consideration, however, Code §101(a)(2) provides that the only amounts excludable from gross income upon receipt of the death benefit are the total consideration, subsequent premiums and other amounts paid by the transferee for the policy (the "**TFV rule**").

Several types of transfers are excepted from the TFV rule, including a transfer of the policy to the insured (including to the insured's wholly-owned grantor trust); a transfer to the partner of the insured, a transfer to a partnership (including a LLC taxed as partnership) or corporation in which the insured is a partner or is an officer or shareholder, respectively, and a transfer where the transferee's tax basis is determined, in whole or in part, by the transferor's basis (*e.g.*, a gift).

Accordingly, when transferring a policy, advisors should make sure that they avoid subsequent taxation under the TFV rule by complying with one of the available exceptions. For example, if a client gives a policy to his child, the child's tax basis in the policy will be determined with reference to the client's basis, and the basis exception to the TFV rule should apply. However, if the client transfers a policy subject to an outstanding loan that exceeds his basis in the policy, the transfer will be deemed a sale, not a gift, and the child will take a basis in the policy equal to the sale price (*i.e.*, the loan amount). The basis exception will not apply, and the TFV rule will result in income taxation of the death benefit

ESTATE PLANNING

√ *Coordinate and review policy ownership and beneficiary designations.*

<u>Do not name the estate as the policy beneficiary</u>. Life insurance is a "non-probate" asset that passes automatically to the designated policy beneficiary without the need for potentially expensive and lengthy probate court proceedings. Designating the decedent's estate as the policy beneficiary eliminates this benefit.

If estate tax inclusion is desired, designate a tax-efficient beneficiary. A decedent may desire inclusion of life insurance in his or her taxable estate for estate tax purposes (*e.g.*, to ensure full use of the available federal estate tax exemption). The policy's beneficiary designation should name specific individuals, or, more likely, a trust, as the beneficiary, depending on the potential estate tax consequences to the named recipient. For example, the policy should not designate the spouse as a beneficiary if those assets will potentially increase the size of his or her estate beyond the available estate tax exemption. In this case, a credit shelter trust that benefits the spouse would be the solution.

√ *Make sure the insured does not retain incidents of policy ownership to avoid estate tax inclusion.*

Use a "bare-bone" collateral assignment to secure private SDAs or premium financing. In a typical private SDA or financing arrangement, the grantor/insured's reimbursement or repayment right for premiums paid or amounts loaned to the ILIT is secured by a collateral assignment of the policy. The collateral assignment should be a restricted or "bare-bone" assignment that limits the grantor's right's in the policy solely to his or her security interest. No other rights with regard to the policy (*e.g.*, the right to designate the beneficiaries) should be provided, as they may constitute incidents of ownership. Any "standard form" collateral assignment should be reviewed to confirm that it is sufficiently restricted.

Avoid placing second-to-die policies in ILITs designed for single-life policies. ILITs designed for single-life policies may name the insured's spouse as a trustee without restricting his or her ability to exercise incidents of ownership over the policy, thereby pulling the insurance into that spouse's estate. In addition, single-life ILITs often provide the spousal beneficiary with a limited power of appointment, which also could result in inclusion of the ILIT assets in the spouse/beneficiary's estate at his or her death. Second-to-die policies should only be owned by ILITs specifically drafted for survivorship coverage.

Consider impact of community property laws for married clients in community property states. Generally, a life insurance policy considered community property is deemed owned ½ by each spouse, regardless of whether only one spouse is the named owner. For clients in community property states, ILITs that acquire a policy insuring one spouse and benefiting the other should be funded only with separate property, not community property. The beneficiary spouse should also relinquish any ownership rights in or to the policy. Otherwise, the beneficiary spouse may be deemed to have made a gift to the ILIT in which he or she retains a beneficial interest, causing inclusion of a portion of the ILIT assets in her or her estate. Note that a partition agreement may be required to evidence that the policy is the separate property of one spouse and that separate property funds are used for the ILIT contributions.

√ *Consider private SDAs as an option to fund ILITs acquiring survivorship policies.*

In a typical private (*i.e.*, economic benefit) SDA, the client/insured and his or her ILIT agree that the client will fund all premiums on a policy owned by the ILIT. In exchange, the client receives an interest in the policy equal to the greater of the policy's cash value or the total premiums paid. The annual gift to the ILIT under a private SDA is the term cost of the insurance coverage, less any consideration paid by the ILIT for that coverage. For survivorship policies, the term cost is determined by using the premium rates published by the IRS (which have not been updated since Table 2001).

As the term costs for a survivorship policy can be very low, private SDAs present desirable funding alternatives, particularly when combined with a lump-sum gift of the increased federal gift tax exemption amount to the ILIT. That gift can be invested and the proceeds used later to exit the private SDA and reimburse the client.

For example, assume married clients create a grantor, dynasty ILIT and fund it with $10 million, applying both of their federal gift and GST tax exemptions to shelter the gift. They enter into a private SDA with the ILIT to fund the ILIT's acquisition of a $20 million survivorship policy. The clients pay a total of $4 million in premiums pursuant to the SDA,

and the ILIT, using funds from the gifted assets, pays the annual term insurance cost. While this cost increases each year, it is minimal in the initial policy years, assuming both clients are alive (*e.g.,* $2,000 in year 1; $15,000 in year 10). The private SDA is terminated and the clients repaid several years later, when the annual term costs become uneconomical. In this case, the ILIT benefits from the growth in the $10 million gift, with minimal initial reductions for the payment of the term costs. The gift allows flexibility to determine when to repay the SDA; there is no need to rely on or wait for completion of a separate planned exit strategy (*e.g.,* a GRAT or installment sale). In addition, the ILIT's payment of the term costs eliminates the need to file annual gift tax returns to report the economic benefit.

BUSINESS PLANNING

√ *Consider tax issues when structuring key person and business-owned life insurance.*

Businesses commonly own life insurance on key employees or owners, which can result in varying income and estate tax consequences depending on the business entity (C corporation, S corporation, partnership/LLC), the designated policy owners, and the named beneficiaries. For example, although policy beneficiaries typically receive insurance proceeds income tax-free, the death benefits paid to a C corporation may generate income tax liability due to the alternative minimum tax ("**AMT**"), which applies to a C corporation's alternative minimum taxable income ("**AMTI**"). Life insurance death benefits can be added to a C corporation's ordinary taxable income to determine its AMTI and, thus, its AMT liability. Accordingly, a C corporation may want to "gross up" its insurance coverage in order to cover the potential AMT exposure. An S corporation, however, is not subject to the AMT.

The receipt of life insurance death benefits also may impact the value of business interests for transfer tax purposes. For instance, the proceeds of a corporate-owned policy payable to a corporation should not be included in the insured shareholder's estate. The corporation's receipt of the insurance proceeds, however, may increase the value of the company (and the shareholder's proportionate interest) for federal estate tax purposes, resulting in increased estate tax liability. Use of a buy-sell agreement may mitigate this issue, assuming the agreement is drafted to fix the federal estate tax value of the deceased owner's interest. The preferred structure of an insurance funded buy-sell agreement (*e.g.,* redemption, cross purchase, hybrid), however, will vary depending on the type of business entity involved.

√ *Regularly review the coverage of insurance-funded buy-sell agreements.*

Buy-sell agreements providing for the purchase of a business owner's interest at death are typically funded with life insurance. The required funding may be based on valuation clauses that adjust over time with the value of the business. In these situations, the coverage should be reviewed regularly to confirm that it is kept in force and to verify that the coverage is sufficient to meet the specified funding obligations. If not, additional coverage should be acquired to ensure that the agreement operates as intended. Disability insurance should also be considered to assist with buy-out funding in the event of an owner's disability.

√ *Ensure businesses comply with notice and consent requirements for EOLI contracts.*

Code §101(j), as added by the Pension Protection Act of 2006, limits the tax-free amount of death benefits received by a company under employer-owned life insurance ("**EOLI**") contracts insuring employees to the amount of premiums and consideration paid by the company for the contract. Exceptions to the above apply for (1) a policy insuring a director, a highly compensated employee, one of the top-five highest paid officers, an over-10% shareholder, or an individual among the highest paid 35% of all employees and (2) death benefits that are paid to the insured's estate, family members, or designated beneficiaries or used to purchase an equity interest in the business from any such person.

A business may avail itself of these exceptions only if it ***complies with specific notice and consent requirements prior to the issuance of the life insurance contract***, including notifying the employee in writing that the company intends to purchase and designate itself as beneficiary of a policy insuring the employee's life. The employee must provide written consent to being insured under the contract, and to allowing the coverage under the contract to continue after the employee terminates employment. Thus, it is critical that business clients be advised of and satisfy these requirements before the purchase of any EOLI contract.

CONCLUSION

While a common tool in estate, tax, and business planning, life insurance involves numerous technicalities and complexities. The above is just a sampling of the various issues that can arise if an advisor fails to pay attention to both the small details and the bigger picture when it comes to incorporating life insurance into a client's business or estate plan. Proper guidance from a well-informed advisor is critical to avoiding these mistakes and ensuring that a well-crafted plan achieves it intended goals.

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