IS LIFE INSURANCE STILL RELEVANT IN 2013?

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1. How it works

A private placement life insurance policy is an individually tailored variable life insurance policy that is offered only to accredited investors. A minimum cash investment in the policy is typically required (sometimes as low as $1 million, sometimes as high as $5 or $10 million) initially or over the first few years of the policy's existence. Because private placement life insurance policies can only be offered to accredited investors, the cost of the policy and the agent commissions may be negotiated and are often much lower than "off the shelf" variable universal life policies and, as a result of these lower associated costs, private placement life insurance policies typically perform better than comparable "off the shelf" variable universal life policies. A private placement life insurance policy owner benefits from considerably broader investment options available under such policies.

2. Diversification rules under Section 817(h).

a. Investments in variable life insurance contracts which are based on a segregated asset account must be "adequately diversified" as defined in Sec. 817(h) and the accompanying regulations in order for the earnings under the variable contract to accumulate on a tax-free basis. Specifically, investments of a segregated account are considered "adequately diversified" only if (i) one of three tests (described below and known as the "general diversification test", the "safe harbor test" and "the alternative test for variable life contracts") are met, and (ii) the contract holder does not have "investor control" over the assets (and "investor control", discussed

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[1] The author would like to acknowledge the important contributions of Lawrence Brody, Esq., and Caitlin Orr, Esq. to this outline.

below, is dominion and control over the assets sufficient to cause the contractholder, rather than the insurance company, to be treated as the owner of the assets for federal income tax purposes).

i. The General Diversification Test[2] is satisfied if all of the following requirements are met:

a. No more than 55% of the value of the total assets of the account is represented by any one investment;

b. No more than 70% of the value of the total assets of the account is represented by any two investments;

c. No more than 80% of the value of the total assets of the account is represented by any three investments; and

d. No more than 90% of the value of the total assets of the account is represented by any four investments;

ii. The Safe Harbor Test[3] is satisfied if both of the following requirements are met:

a. The account meets the diversification requirements of a regulated investment company under Code Sec. 851(b)(3) and the associated regulations, and

b. No more than 55% of the value of the total assets of the account are cash, cash items (including receivables), government securities and securities of other regulated investment companies;

iii. The Alternative Test for Variable Life Contracts[4] is met if and to the extent that such segregated account is invested in securities issued by the U.S. Treasury, and such investments made by such account are treated as adequately diversified without regard to whether the General Diversification Test or the Safe Harbor Test are met.

b. These rules require the separate asset accounts to be adequately diversified, as required by the above-described mechanical test. Section 817(h)(4) provides a "look-through" rule for Regulated Investment Companies ("RIC"). Under Reg. Sec. 1.817-5, the look-through rule applies if all interests in the RIC are held by insurance company separate accounts and public access to the RIC is exclusively through an insurance policy.

c. The second requirement for investments of a segregated account to be deemed "adequately diversified" is that the contractholder must not have "investor control", meaning, essentially, that the contract must be considered an asset of the life insurance company that issues the contract, rather than an asset of the contractholder. In a series of revenue rulings issued over the past twenty-five years, the IRS has shed light on what constitutes "investor control" for purposes of adequate diversification.

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[2] Code Section 817(h)(1); Treas. Reg. 1.817-5(b)(1).

[3] Code Section 817(h)(2); Treas. Reg. 1.817-5(b)(2).

[4] Code Section 817(h)(3); Treas. Reg. 1.817-5(b)(3).

(1) Generally speaking, investor control exists when the contractholder has the power to direct the life insurance company (or an agent thereof) to sell, purchase or exchange specific assets in a segregated account. Investor control will also likely be deemed to exist where the contractholder has some power that allows him/her to control or influence investment in a less direct way, for example, where the contractholder possesses the power to select investments, the power to change the terms of the investment guidelines, or where the contractholder retains any interest in the underlying assets themselves.

(2) Further, the contractholder may be deemed to have "investor control" if he or she is able to communicate with the investment advisor regarding the investments of the segregated account or if he or she is seemed to have influence over the investment advisor's decisions. This issue is likely to arise if the contractholder's personal money manager as also serving as one of the managers of the funds offered under the policy. The contractholder will not necessarily be deemed to have investor control if he or she retains the power to allocate the premium payments and the cash value among broad categories of investment options, provided that the contractholder's retention of such power is consistent with the insurance provider being treated as the "owner" of the funds. In other words, to avoid having "investment control", the contractholder can only choose from funds offered under the policy, and cannot choose or influence the choosing of investments. No "whispering in the manager's ear."

(3) Rev. Ruls. 2003-91 and 2003-92 and the amendments to Reg. Sec. 1.817-5(f) and (g) spell out the current IRS position. Only "insurance only" non-registered funds can be treated as pass-throughs to meet the diversification rules. This rule would retroactively apply to all variable policies, with no grandfathering. This change eliminates any arguable inconsistency between the diversification rules and the investor control rules.

d. What is left after these developments?

(1) Use of insurance dedicated funds.

(2) A fund of fund manager offered only under the policy.

(3) A "clone" fund of a publicly available fund.

3. These policies are more likely to be planned to be MECs, because the investment aspect of the policy is paramount.

B. Offshore variable insurance policies.

1. Advantages.

a. Lower costs.

(1) No State premium taxes, lower entity taxes, no SEC compliance costs, etc., (to the extent these savings are passed along). Note that some states have reduced (or eliminated) their state premium tax.

(2) Offset by the 1% premium excise tax, if the insured is a U.S. person and the carrier has not made a Section 953(d) election to be taxed as a U.S. carrier

b. More investment choices. Including many not otherwise available to U.S. investors.

2. Disadvantages.

a. There is an increased risk of non-compliance with the life insurance and MEC definitions of the Code. Especially if the carrier isn't affiliated with a U.S. carrier.

b. All policy sales activities (including solicitations, physicals, etc.) must take place off-shore.

c. Carrier choices are limited.

d. The owner must be an off-shore entity – a corporation, partnership, trust, with the additional costs of creation and maintenance of the entity.

C. Life Insurance and the Net Investment Income Tax.

1. Beginning on January 1, 2013, a new and separate income tax regime went into effect and applies against many trusts, as well as against individuals and estates. The Net Investment Income Tax, as it is called (hereinafter "the NIIT"), is codified at Code Section 1411, which was enacted as part of the Health Care and Education Reconciliation Act of 2010. Treasury recently proposed regulations that provide guidance as to how this tax will be applied. The NIIT is required to be reported annually on the Form 8960, a draft of which has been developed by the IRS and was recently released to the public.

2. The NIIT applies at a rate of 3.8% to certain net investment income (described below) of individuals, estates and trusts that have income in excess of certain statutory threshold amounts. However, the statutory threshold amount applicable to trusts and estates is much lower than the statutory threshold amount applicable to individuals when determining NII subject to the new tax:

a. An individual is subject to the tax on NII above an adjusted gross income threshold of $200,000 ($250,000 if married filing jointly).

b. However, estates and trusts are subject to the tax on undistributed NII above the threshold level at which the top federal income tax rate begins, which is $11,950 in 2013. (Note that individual beneficiaries will be subject to the tax on distributed NII if their NII exceeds their own threshold for the NII tax.) Because the threshold level for trusts that must be reached before the NIIT will apply is so low, it is crucial that Trustees be made aware of the potential application of the tax and plan accordingly.

3. The NIIT is imposed on "net investment income", which is comprised of three categories of gross income (referred to as "gross investment income"), the aggregate amount of which is then reduced by specified "NII deductions" that are properly allocable to such gross income or net gain (described below).

a. Specified income, which includes gross income from interests, dividends, annuities, royalties, rents and other passive income other than excluded business income (described below);

b. Covered business income, which is gross trade or business income that falls within one of these three sub-categories (and all other income derived in the ordinary course of a trade or business that is not described below is "excluded business income", and is not subject to the NIIT):

(1) Derived in the trade or business of trading in financial instruments or commodities,

(2) Earned in a passive activity of the taxpayer within the meaning of Code Sec. 469,[5] and

(3) Produced from the investment of working capital; and

c. Covered gain, which is net gain (to the extent taking into account in computing taxable income) from dispositions of property other than gain comprising excluded business income.

4. Exclusions: Specific types of income are specifically exempted from the NIIT under Code Sec. 1411, including:

a. Employment income and compensation (which are subject to the hospital insurance Medicare tax and, therefore, are not subject to the NIIT);

b. Qualified plan distributions; and

c. Income excluded from taxable income (such as tax-exempt interest on state and municipal bonds, life insurance proceeds, and deferred or excluded gain such as that from a like-kind exchange or the sale of a personal residence)

5. NII Deductions: Deductions that can be used to reduce "NII include:

a. investment interest expense,

b. investment advisory and brokerage fees,

c. expenses related to rental and royalty income, and

d. state and local income taxes properly allocable to items included in net investment income.

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[5] Note that Congress adopted the passive activity loss rules, including the material participation concept, for determining the NIIT under Code Sec. 1411. Thus, the discussion above regarding the ambiguity in the law regarding how material participation is determined for trusts under the passive activity loss rules takes on even greater importance this year as those same rules will apply to determine the amount of undistributed income of a trust that is subject to the NIIT. Note also that, prior to enactment of the NIIT, income classified as passive activity income was generally favored by taxpayers, as it could be used to offset passive activity losses to the extent they existed. However, now that passive activity income will be subject to the 3.8% NIIT, taxpayers may desire to convert passive income into non-passive income to the extent it is not needed to offset passive activity losses.

6. Three Step Computation of the NIIT of a Non-Grantor Trust[6]

a. Step One: determine adjusted gross income, as defined under Code Section 67(e), for the taxable year. AGI for a trust is the same as for an individual, except that Code Sec. 67(e) permits three additional deductions for (1) administration expenses unique to the fiduciary arrangement, (2) the distribution deduction, limited to DNI, and (3) the trust's personal exemption. If the trust's AGI exceeds the applicable threshold amount, the Trustee will need to move on to Step Two.

b. Step Two: determine undistributed NII, which is equal to a trust's net investment income (as described above) less any distributions of NII made to beneficiaries under Code Sections 651 and 661 and by deductions for amounts set aside for a charitable purpose under Code Sec. 642.

c. Step Three: apply the 3.8% tax rate to the <u>lesser</u> of the two numbers derived under steps one and two.

7. Investment Planning Opportunities.

a. Barring any Congressional action changing the manner in which the NIIT applies to trusts and estates, as a result of the disparate application of the NIIT to trusts and estates versus application thereof to individuals, Trustees will likely feel more pressure (and may be more inclined now than in prior years) to distribute net investment income to its beneficiaries to avoid imposition of the NIIT. This plan, however, may not be what the Settlor of the trust intended and exposes such assets to the creditors of the recipient beneficiary or the beneficiary may not be able to handle the funds responsibly.

b. Alternatively, Trustees may aim to reduce the trusts' net investment income by reducing its passive activity income or by employing a new investment strategy for the trust that will allow the trust to avoid generating net investment income.

c. A trustee may consider acquiring a life insurance policy that has investment features and taking advantage of the income-tax free build up in such a policy to handle some of its investing that would otherwise give rise to NII, however, the trust's insurable interest in the insured for such policy may be an issue.

III. VALUATION OF LIFE INSURANCE POLICIES

A. What is the "fair market value" of a life insurance policy for tax purposes?

1. There are different methods of valuing policies based on the reason the policy is being valued.

a. Income tax transactions involving policy valuation.

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[6] Grantor trusts are disregarded for purposes of the NIIT, and the NIIT on grantor trusts is computed as the same manner as the NIIT is computed for individuals. (Prop. Reg. Sec. 1.1411-3(b)(5)). Note also that special computational rules apply for charitable remainder trusts and electing small business trusts, which rules can be found in the proposed regulations.

(1) The purchase or transfer of a policy out of a qualified plan or the purchase by an employer of a policy that will be transferred to an employee (upon retirement or after a period of employment).

(a) When these transactions were planned in the past, the value of the policy, by design, was artificially low at the time of the transaction, usually by imposing large surrender charges in early years, which would disappear sometime after the transfer ("springing" cash value policies) or by purchasing a policy with high initial costs and exchanging it after the transfer.

(b) See Notice 89-25[7] and Announcement 94-101[8] both warning that such springing cash value policies distributed out of qualified plans couldn't be valued using their cash surrender value.

(c) Prior to this Notice, taxpayers followed Rev. Rul. 59-195,[9] the IRS held that a policy's value for income tax purposes should be determined consistent with its gift tax valuation under the Section 2512 Regulations, described below.

(d) The Section 83 Regulations had long provided that the fair market value of a policy transferred as compensation was its cash surrender value.

(e) Proposed Regulations were issued in 2004 amending the Section 402, 83 and 79 regulations and a series of rulings, all requiring the use of the "fair market value" of a policy, rather than its cash surrender value, in valuing transfers of policies in those situations.[10]

(i) These are safe harbor values which will automatically be accepted by the Service.

(ii) Under the Section 83 proposed regulations, the policy cash value (not surrender value) plus all other rights in the policy are treated as property – the same definition as under the final split-dollar regulations.

(iii) Under the Section 402 proposed regulations, the policy's fair market value must be used for distributions or sales of policies to participants.

(iv) Under the 2004 temporary safe harbor rules, the fair market value of a policy can be approximated by using its cash value (ignoring surrender charges), if it is at least equal to all premiums paid plus earnings credited (investment results for variable policies), less reasonable mortality and other charges.

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[7] 1989-1 C.B. 662.

[8] 1994-35 I.R.B. 53.

[9] 1959-I.C.B.18.

[10] See Prop. Regs. 126967-03, Rev. Ruls. 2004-20 and 21. See also, Rev. Proc. 2004-16, 2004-1 C.B. 559, revised by Rev. Proc. 2005-25, 2005-1 C.B. 962, providing safe harbor rules; the 2004 safe harbors apply for transfers between 2/13/04 and 5/1/05, and the 2005 safe harbors apply for all periods (including those before 5/1/05).

(v) The preamble to the proposed regulations also warned that, for gift tax purposes, under the long-standing Section 2512 regulations, the unusual nature of a policy (an undefined term) can prevent the use of the usual replacement cost approximation of the interpolated terminal reserve formula, the "ITR" value, if that approximation isn't reasonably close to "full value" (another undefined term).

(f) Under the 2005 permanent safe harbor rules, the fair market value of a policy is the greater of the ITR value (adjusted for unearned premiums) or what is called the PERC amount - Premiums plus Earnings minus Reasonable Charges (adjusted by an interest factor for Section 402 purposes).

(i) The PERC amount is aggregated premiums plus dividends plus earnings minus reasonable charges and distributions.

(ii) Final regulations under Sections 79, 83, 401 and 402 were issued on August 29, 2005, effective on that date, but applicable to policy transfers or distributions on or after 2/13/04, which adopted the provisions of the proposed regulations in all relevant aspects.

(iv) The preamble to the final regulations contains the same warning about gift tax valuation for transfers of "unusual" policies.

b. Gift tax transactions involving policy valuation.

(1) The gift tax valuation of a policy is set out in Reg. Sec 25. 2512-6(a), which was written when there traditionally was no market for life insurance policies and was based on early Supreme Court cases dating from the 1940s.[11]

(a) The regulation states that the fair market value of a policy for gift tax purposes (and presumably for (a) income tax purposes under Rev. Rul. 59-195 [unless the 2005 Regulations discussed above apply] and (b) estate tax purposes[12]), is the cost of a "comparable" policy.

(b) For a new policy, its gift tax value would be the premium paid.

(c) For a single premium policy, its gift tax value is its replacement cost.[13]

(d) For a more usual policy on which further premiums are due and which has been in force for some time (an undefined term), since replacement cost would

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[11] See, Guggenheim v. Rasquin, 312 U.S. 254 (1941) (dealing with a single premium policy gifted when the premium was paid) and U.S. v. Ryerson, 312 U.S. 260 (1941) (dealing with a similar policy gifted later).

[12] Reg. Sec. 20.2031-8 (a) (2), the estate tax analog of Reg. Sec. 25.2512-6(a) for valuing a policy on the life of another owned by the decedent).

[13] But See Rev. Rul. 78-137, 1978-1 C.B. 280, concluding that since there was no comparable contract providing the same economic benefits (the entire bundle of rights provided in the original policy), the I.T.R. approximation of the Section 2512 Regulations, had to be used.

be hard to determine, the regulations provide that its gift tax value can be approximated by the policy's interpolated terminal reserve ("ITR") plus any prepaid premiums.[14]

(e) The type of policy and the insured's health are not relevant considerations in the ITR determination.

(2) Interpolated Terminal Reserve

(a) Note that the ITR concept only realistically applies to traditional whole life policies (which were the only kind of permanent policy available when the Regulations were adopted), where policy values are guaranteed to increase at stated intervals during the life of the policy. ITR is, however, used as the method of valuation for universal, no lapse guarantee, and variable life policies as well (in which there are no guaranteed increases in the cash surrender values).

(b) Reserves:

(i) Note the potential effect of a "shadow account" used in a no-lapse guarantee universal life policy which can increase the policy's ITR (even when cash values are low or even non-existent).

(ii) Note that some carriers calculate the reserve for such policies using what is known as a deficiency reserve and some don't – the reserve calculation without a deficiency reserve should be lower.

(ii) Which "reserve" does the carrier use in determining the ITR – the reserve value for the policy used in determining its income tax liability or the statutory reserve for the policy filed with the state insurance department?

(iv) For level term policies, there is a reserve on the carrier's books which will impact value.

(c) Form 712

(i) The practice of carriers in reporting values on Form 712 is apparently not consistent, with some only reporting the ITR and some others reporting the policy cash value or its statutory reserves.

(ii) Some carriers have begun providing a series of values, leaving the determination (which they take the position is a legal issue) up to the adviser.

(iii) The instructions to Form 712 indicate that for single premium or paid-up policies, the amount shown on the Form may not be relied on where the surrender value of the policy exceeds its replacement cost.

(3) Reg. Sec. 25.2512-6(a) also provides that if, "due to the unusual nature of the contract" (an undefined phrase) the regulation formula doesn't reasonably

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[14] See, eg, Rev. Ruls 81-198, 1981-2 C.B. 188 (holding that a policy that had been in force for seven years had been "in force for some time") and 79-429, 1979-2 C.B. 321 (reaching a similar conclusion for a policy which had been in force for only three years).

approximate its full value (also an undefined phrase), it may not be used (with no indication of what may be used instead)."

(a) Consider whether this phrase limits the use of the ITR formula to only traditional whole life policies.

(b) See Pritchard v. CIR,[15] holding that "normal" policy gift tax values don't apply if the insured is "near death" (an undefined term) -- at that point, fair market value approaches the full face value.

(c) See also PLR 9413045, holding the policy's gift value controls for a gift of a survivorship policy, so long as the insureds aren't "near death".

(4) Two alternative methods of valuation would be the market (life settlement values) and an independent appraisal.

(a) A gift of a policy worth more than $5,000 to charity requires an independent appraisal, under Section 170(f)(ii)(c).

(b) Establishing the market is difficult. Does it matter if a settlement offer has been received? What if the policy would qualify for a settlement, but no offers were solicited?

(5) Should practitioners request all possible values for a policy before deciding what value to use for reporting the transaction?

2. What is the value of a policy sold to avoid Section 2035 (under its full and adequate consideration exception)? Is it the policy's gift tax value or the amount necessary to replace it in the insured's estate for estate tax purposes, which would be the face amount of the policy.

a. *Allen v. U.S.*[16] held that when a person with a retained interest in a trust (a life estate) the existence of which would cause the entire trust to be includable in the person's estate, sold the life estate for its actuarial value, the sale was not for full and adequate consideration as required under Section 2035 and therefore, upon the person's death within three years of the sale, the entire value of the trust was includable in the person's estate. The court held that Section 2035 was designed to ensure that the taxable estate of the decedent would be the same amount, whether or not a sale for full and adequate consideration took place within three years of death (since the sale proceeds would be equal to the value of the asset, if the asset had not been sold).

b. In PLR 8806004 a corporation sold a policy on the life of the controlling shareholder for its reserve value (not the face amount) two years prior to the shareholder's death and the IRS held, citing *Allen v. U.S.*, that the death benefit of the policy was includable in the shareholders estate under Section 2035, since the sale was not for full and adequate consideration.

c. In PLR 9413045, the IRS held that when trusts holding second to die life insurance policies (trusts through which the insureds held incidents of ownership under Section 2042(2) in the policies) sold the policies to another trust for an amount equal to the policies'

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[15] 4 T.C. 204 (1944),

[16] 293F. 2nd 916 (10th Cir. 1961)

interpolated terminal reserve, that sale was for full and adequate consideration for purposes of Section 2035. At that time, however, both insured's were alive and if one of them had died, what would have been included in such insured's estate (had no sale taken place) is the value of the policy, not the death benefit, since the second insured would still be alive.

IV. LOANS TO TRUST HOLDING POLICY TO PAY PREMIUMS

A. Description of "premium financing" of life insurance.

1. Generally, the insured, as grantor, will create an irrevocable insurance trust to become the owner of a new policy on his or her life (or on the lives of the grantor and his or her spouse on a survivorship basis). The insurance trust will pay all or a portion of the premium payments due on the policy with funds that it borrows (the lender could be a family trust, the grantor or the grantor's spouse, or LLC or a completely unrelated lender, such as a bank). The trust will pay interest on the loan usually with funds received directly or indirectly from the grantor, either as part of the initial trust funding or as annual gifts; the principal of the loan will be repaid at the end of the term of the loan or at the insured's death. If the loan is from a third party, the grantor might guarantee the third party's loans to the trust and/or pledge assets as security for its loans.

2. The transaction could be a series of loans as each premium comes due, or one large loan designed to cover all future premiums (with growth assumptions built into the amount) or to cover a single premium policy. The second alternative allows the grantor to capture current low interest rates.

3. A more complicated alternative involves the insurance trust acquiring both the policy and an annuity, both on the insured's life (from different carriers) and borrowing the single premium for the annuity. The annuity payments would pay the premiums on the insurance policy.

B. The Final Split Dollar Regulations and Loans.

1. The final split-dollar Regulations define a split-dollar arrangement as one between an "owner" and a "non-owner" of a life insurance contract, pursuant to which either party pays all (or a part) of the premiums and at least one party is entitled to recover all or a portion of those premiums and that recovery is to be made from or is secured by the proceeds of a policy.

a. Loans used to pay premiums that are secured by the policy (premium financing arrangements) are included in this broad definition, although, in most cases, so long as interest is paid (or accrued) at the AFR, the general tax rules governing loans, and not the special split-dollar loan rules of the final Regulations, will apply.

b. However, as described below, there are special rules for loans with interest paid at the AFR where the lender is "to pay" the interest to the borrower, for interest which is forgiven, and there are special filing requirements for non-recourse loans, as well as payment ordering rules, all of which could apply to premium financing transactions (especially those where the grantor, his or her spouse, or a controlled entity is the lender).

2. If a payment made under a split-dollar loan is non-recourse, Reg. Sec. 1.7872-15(j) treats the loan as a loan that provides for contingent payments (increasing the complexity of calculating the tax consequences and testing for the adequacy of interest), unless the parties to the arrangement provide a written representation with respect to the loan that indicates that a "reasonable person" would expect all payments under the loan to be made.

a. The word "non-recourse" is not defined in the Regulations; it isn't clear if it is broad enough to mean a recourse loan to a trust with no assets other than a policy.

b. The Regulations require that, subject to future IRS rules, that representation be attached to both parties tax returns for each year such a loan is made.

3. The Regulations ignore the stated interest on a loan document (which would cause the loan to be considered a below-market split dollar loan), if "all or a portion of the interest is to be paid directly or indirectly by the lender or a person related to the lender."

a. The result would be imputed interest as well as possibly reclassification of the loan as a hybrid loan under the split dollar Regulations that, if considered a term loan, will have gift tax consequences equal to the present discounted value of all imputed interest for the term deemed to be transferred to the borrower at the outset of the loan.

b. A "facts and circumstances" test will be used to determine if the interest is "to be paid" by the lender; there is no definition in the Regulations of the phrase "to be paid."

c. The example in the Regulations provide that amounts to be paid by an employer under a fully vested non-qualified deferred compensation arrangement that will pay the employee an amount of the interest due under the split-dollar loan will be disregarded. However, a fully vested non-qualified deferred compensation arrangement that provides for payment equal to the employee's salary, which the facts and circumstances show is not related to the employee's interest obligations, will not be disregarded.

4. The split dollar Regulations also provide that stated interest that is waived or forgiven by the lender will be treated as transferred from the lender to the borrower and is subject to a deferral charge equal to the underpayment of tax interest penalty.

a. If the loan is a nonrecourse loan where the parties have made the representation described above, then if interest is waived or forgiven, the amount forgiven or waived will still be considered transferred from lender to the borrower, but no deferral charge will be imposed. This is another reason for the parties to execute the representation.

5. Finally, the split dollar Regulations also provide that when repaying a series of loans, the repayment must be in the order the loans were made. So there is no ability to pay off loans with higher interest rates first.

C. Income Tax Consequences of Premium Financing Arrangements.

1. The income tax consequences of these transactions are dependent upon whether the trust (or a portion of the trust) is classified for income tax purposes as a "grantor trust" or a "non-grantor trust." If the grantor is the lender and the borrower/trust is a grantor trust, then the arrangement is ignored for income tax purposes.

a. A grantor trust power that is unique to trusts holding insurance: the Section 677(a)(3) power.

(1) Under Section 677(a)(3), the grantor of a trust is treated as the owner of any trust (or a portion of any trust) as to which the grantor or a non-adverse party may

apply trust income to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.

(2) The Sections raises certain questions:

(a) Does the term "income" in this Section referring to fiduciary accounting income or taxable income? Fiduciary accounting income does not usually include capital gains, a principal item.

(b) Is it sufficient that the trust may pay the expenses out of taxable income to cause the trust to be a grantor trust, or must it in fact pay such premiums out of such income (and not principal that is not taxable income)?

(c) What if the premiums are less than the income of the trust? Is the trust only partially a grantor trust?

(3) While trust provisions preventing trust income from being used to pay insurance premiums would seem to make Section 677(a)(3) inapplicable to such an insurance trust, there is very little authority on this issue, and much of the authority which does exist is based on the predecessor to Section 677(a)(3).

(a) The Service will not issue private letter rulings regarding the status of irrevocable insurance trusts where the trustee has the power to use trust income or principal to pay premiums on policies insuring the grantor's life.

(b) Ltr. Rul. 8839008 raises the issue of whether an insurance trust can ever be treated as a non-grantor trust. There, grantors, husband and wife, created two irrevocable trusts that did not, at that time, own, nor pay premiums on, any life insurance policies on the life of either grantor. The trust instruments provided that "Trust income shall not be applied toward the payment of insurance premiums for policies on the life of any contributor to Trust." Further, any undistributed income was to be accumulated and added to corpus. Several years later, each trust purchased a survivorship policy on the lives of the grantors, paying the single premium out of the trust principal. The amount of the premium exceeded each trust's total taxable income for that year.

(i) In ruling on whether these trusts were grantor trusts under Section 677(a)(3), the Service began by drawing a distinction between trust accounting income and income as determined for tax purposes.

(ii) The Service concluded that the trust instrument prevented only the use of trust accounting income from being used to pay premiums, but that the source of premium payments for trust accounting purposes is immaterial for purposes of Section 677(a)(3). Therefore, because the amount paid for the insurance premium exceeded the taxable income of each trust during the year the policies were purchased, the grantors were treated as owners of the entire taxable income of the trusts for that year.

(iii) If Congress in enacting Section 677(a)(3) had intended for the source of premium payments to be immaterial, it could have written Section 677(a) to apply to both trust income and corpus, rather than just income, as it did in Section 677(b) where it states that to the extent that the grantor's legal obligation of support is "paid out of corpus or out of other than income for the taxable year," such amounts will be taxed to the grantor under Section 662 and not under the grantor trust provisions.

(iv) The courts have generally restricted attempts by the Service to expand the predecessors of Section 677(a)(3). While most of the cases interpreting the predecessor to Section 677(a)(3) date from the 1930s and 1940s, they are helpful in interpreting Section 677(a)(3) because of the relatively minor differences between Section 677(a)(3) and its predecessors. In these cases, there were three variables that determined the results in the case law under the predecessors of Section 677(a)(3), namely (1) the ability of the trustee to use trust income to pay premiums; (2) whether the trust held an insurance policy on the life of the grantor; and (3) whether the trustee actually paid premiums on such an insurance policy out of the income of the trust.

(v) The easiest cases to resolve were those where: (1) the trustee was not prohibited from using trust income to pay premiums, the trust owned an insurance policy on the grantor's life, and the trustee paid premiums on that policy out of the trust income, and those where (2) the trustee was prohibited from using trust income to pay premiums, the trust did not own an insurance policy on the grantor's life, and the trustee did not pay premiums on that policy out of the trust income. These two cases fall directly inside or outside, respectively, the scope the predecessor of Section 677(a)(3).

(vi) If a trust were to allow the trustee to pay premiums on and were to hold an insurance policy on the grantor's life, but not pay premiums on it out of the trust income, then under the holding of *Chandler v. Comm'r*[17], the trust would not be a grantor trust under Section 167(a)(3). There, the trust instrument provided that premiums should be paid out of trust income only to the extent not paid by insurance policy dividends and contributions from the grantor. If the income had been used to pay the premiums on the insurance policy held by the trust, that income would have been taxable to the grantor, but since no income was used to pay the premiums, the court held Section 167(a)(3) did not apply.

(vii) A trust that granted the trustee the ability to pay premiums but which neither held an insurance policy on the grantor's life nor used its income to pay premiums will not be considered a grantor trust under Section 167(a)(3). This situation arose in both *Moore v. Comm'r*[18] and *Weil v. Comm'r*[19], in which the Service attempted to extend the application of Section 167(a)(3) to trusts that simply allowed for trustees to pay premiums on insurance policies, regardless of whether the trusts actually held insurance policies or paid any premiums. In *Moore*, the trust instrument provided that the trustee "may invest in and/or pay the premiums on policies." In *Weil*, the trust provided that the net income of the trust property should be used to pay the premiums on policies. In neither case did the trusts hold insurance policies or pay premiums.

(viii) In *Rand v. Comm'r*[20], the court considered the situation where the trust owned an insurance policy and the trustees paid premiums on the policy out of trust income, even though the trust did not specifically allow for the payment of premiums out

[17] 119 F.2d 623 (3rd Cir. 1941).

[18] 39 B.T.A. 808 (1939), *acq.*, 1939-2 C.B. 25.

[19] 3 T.C. 579 (1944), *acq.*, 1944 C.B. 29.

[20] 40 B.T.A. 233 (1939), *acq.*, 1939-2 C.B. 30, *aff'd*, 116 F.2d 929 (8th Cir. 1941), *cert denied*, 313 U.S. 594 (1941).

of income. The taxpayer argued that, although nothing under state law prohibited a trustee from investing in life insurance and the trust was silent on this issue, the use of trust income to pay insurance policy premiums was not authorized by the trust instrument and was therefore a breach of trust. The court found this result inconceivable, noting that the taxpayer was both grantor and trustee and that it was unlikely that the taxpayer, as trustee, would administer the trust against the wishes of the taxpayer, as grantor. The court concluded that, even where a trust was silent as to whether income could be used to pay premiums, Section 167(a)(3) dictated grantor trust status for a trust that held an insurance policy on the grantor's life, the income of which was used to pay premiums.

(ix) Finally, there is a question as to how a trust will be treated under Section 677(a)(3) if it owns an insurance policy on the grantor's life, the trustees are specifically prohibited from paying premiums out of trust income, and no such premium payments are made out of the trust income. As discussed above, *Chandler*, *Moore* and *Weil* can all be read to stand for the proposition that a trust is a grantor trust only to the extent that trust income is used to pay premiums on an insurance policy on the life of the grantor. In addition, *Rand* indicates that whether a trust expressly provides the trustee with the power to pay premiums out of trust income is immaterial. The court in *Rand* also seemed to imply that even if the trust specifically prohibited the use of income for the payment of premiums, the breach of trust by the trustee who uses trust income to pay premiums would not prevent grantor trust treatment for the trust under Section 167(a)(3).

(c) Accordingly, the case law applying Section 167(a)(3) is in conflict with the Service's position in Ltr. Rul. 8839008. Although, in the ruling, the Service tried to eliminate the distinction between principal and income under Section 677(a)(3) by creating a "trust accounting income" and "taxable income" dichotomy, the general weight of the prior case law is that the trust must own an insurance policy on the life of the grantor and the premiums on that policy must be paid out of the trust income during the taxable year in order for the trust to be considered a grantor trust. The assertion that it is immaterial whether the payments were actually made out of income or principal, so long as the amount of the payments exceeded the taxable income of the trust, is an excessively broad reading of Section 677(a)(3) in light of the substantial precedents under the predecessor to Section 677(a)(3) holding to the contrary, as well as a literal reading of the statute.

(4) Drafting to avoid grantor trust status under Section 677(a)(3).

(a) Draft the trust agreement so that either income is automatically distributed to the beneficiaries upon receipt, or so that income is segregated in a separate accrued income account and is prohibited under the terms of the trust from being used to pay premiums on policies on the grantor's life (or his or her spouse). To the extent that Ltr. Rul. 8839008 is correct with regard to its "taxable income" versus "trust accounting income" dichotomy, any prohibition on the use of trust income, or any automatic distribution of trust income, should be drafted in such a way that the income to which the prohibition or distribution applies is the "taxable income" of the trust.

(b) Require that any discretionary use of trust income to pay premiums on a policy on the life of the grantor or his or her spouse be consented to by an "adverse party" – a trust beneficiary whose interest would be effected by such a use of trust income.

(c) See Ltr. Ruling 9227017 which addressed a CRT holding life insurance and avoiding Section677(a)(3).

b. Another grantor trust power that causes an issue for a trust holding an insurance policy.

(1) If it is important to be sure the entire trust will be treated as a grantor trust for income tax purposes, adding an additional grantor trust power, which would not be estate tax sensitive, should be considered and one such commonly used grantor trust power is the administrative power to reacquire trust assets by substituting assets having an equivalent fair market value, held in a non-fiduciary power (by the grantor or by any other – presumably, non-adverse person). The court in *Jordahl v. CIR*[21] held that such a power held by the grantor-insured was not an incident of ownership in the policy owned by the trust for purposes of Section 2042(2). In *Jordahl*, however, that power was held in a fiduciary capacity; would the court find the same way for a power held in a non-fiduciary capacity?[22]

(2) Rev. Rul. 2008-22 held such a power of substitution would not be a Section 2036 nor a 2038 power, so long as the trust instrument or local law required that the trustee has a fiduciary duty to ensure that the properties are, in fact, of equivalent value, and the substitution power cannot be exercised so as to shift beneficial interests. The ruling did not, however, refer to Section 2042.

(3) Rev. Rul. 2011-28 extended the holding of Rev. Rul. 2008-22 to section 2042, which should put that issue to rest, so long as the power is similarly limited.

2. Income tax consequences on the termination of the trust's status as a grantor trust (either at the grantor's death or during his or her lifetime) since the Trust has a loan payable to the Grantor in the Transaction.

a. The trust will cease to be a grantor trust upon the death of the grantor, or upon termination of the power(s) which caused it to be treated as a grantor trust during the grantor's life. As a result, the trust will no longer be disregarded for income tax purposes, and instead will be treated as a separate taxable entity.

(1) Upon the termination of the trust's grantor status during the grantor's lifetime, the termination of that status will be treated as a sale of the policy by the grantor for the outstanding loan. That deemed sale would generate gain under Section 1001 Regulations, to the extent the outstanding liability exceeded the grantor's basis in the policy.

(a) Under the general rule of Treas. Reg. Section 1.1001-2(a)(1), the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of such sale or disposition; in this case, the trust's deemed assumption of the grantor trust's loan by the new non-grantor trust will be treated as a discharge of the grantor's liabilities in consideration for the assets (the policy) that the grantor is deemed to have transferred to the new non-grantor trust.

(b) However, Treas. Reg. Section 1.1001-2(a)(3) provides an exception to this rule when a liability is incurred for purposes of acquiring property and is

[21] 65 TC 92 (1975).

[22] See also Ltr. Ruls. 9413045 and 9227013.

not taken into account in determining the transferor's basis in such property (for example, where the loan is between the grantor and the trust and thus is ignored for income tax purposes under Rev. Rul. 85-13). Under these circumstances, the assumed liability will not be included in the amount realized by the transferor and therefore will not cause recognition of gain.

(i) Example 5 of Treas. Reg. Section 1.1001-2(c) illustrates what is deemed to occur on termination of grantor trust status during the grantor's life. In the Example, a grantor was considered to be the partner of a partnership in which the grantor trust held an interest. Upon termination of grantor trust status on the renunciation of a grantor trust power, a constructive transfer of the partnership interest to the trust was deemed to occur. The Example concludes that the grantor is required to recognize gain to the extent the allocable share of partnership liabilities assumed by the trust exceeds the grantor's basis in the partnership interest.

(ii) Similarly, in *Madorin v. Commissioner*[23], a grantor transferred to a grantor trust an interest in a partnership that held encumbered assets. The grantor deducted the net losses from the partnership until the trustee renounced a power that had caused the trust to be a grantor trust. The court held that the grantor was released from his share of the underlying liabilities and recognized a gain to the extent that these liabilities exceeded the basis of the partnership interest.

(iii) See the issue with the Grantor's basis discussed below under Rev. Ruling 2009-13.

(c) In applying the general rule of Treas. Reg. Section 1.1001-2(a)(1) to a premium financing transaction, on the termination in status of the trust as a grantor trust, the grantor will be deemed to have transferred the life insurance policy to the trust in exchange for the trust's assumption of the loan incurred in connection with the trust's acquisition of the policy. Under the general rule, the grantor will realize income to the extent the liability (i.e., the amount of the loan on termination of the trust's grantor trust status) assumed by the trust exceeds the grantor's basis in the policy. If the exception of Treas. Reg. Section 1.1001-2(a)(3) applies, because the liability (the loan) was incurred in connection with the acquisition of the policy and is not taken into account in determining the grantor's basis in the policy – which would be true of a loan between a grantor and his or her grantor trust – then no income will be realized by the grantor on termination of the trust's grantor trust status, even if the liability deemed assumed by the trust exceeds the grantor's basis in the policy.

(2) There is even less certainty about the income tax consequences of termination of grantor trust status as a result of the death of the grantor, where the trust has outstanding liabilities (to the grantor or to a third party).

(a) Some commentators believe that the grantor's death has no tax consequences; under that analysis, death is not an event that triggers gain recognition. Another possible result, and the one which the IRS would likely endorse, is that the income tax consequences on the death of the grantor follow those that are deemed to occur when grantor trust status is terminated during the grantor's life, as set forth in the regulations under Section 1001 and other authorities. Under that analysis, the income tax consequences would be the same whether termination of grantor trust status is a result of the grantor's death or a termination of the applicable grantor trust power(s) during the grantor's life.

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[23] 84 T.C. 667 (1978).

(b) The other open issue here is when the "transfer" takes place – at the moment of, the moment before, or the moment after the event ending grantor trust status, in this case, the insured's death. There isn't any direct authority on this issue, but there is an arguably analogous area – the termination of grantor trust status of a foreign trust taxed under Section 679. There, on the one hand, Reg. Sec. 1.679-2(c)(2), provides that the deemed transfer there takes place the moment after grantor trust status ends, but on the other hand, Reg. Sec. 1.684-2(e) provides upon the death of the grantor, he or she is treated as having transferred the property to the trust immediately before death. In the transfer for value situation, it would seem that, if that the rule is that the policy would be deemed to be transferred after death, there would not have been even a deemed transfer of the policy during the insured's life.

(3) One issue that may arise upon the termination of the trust's grantor trust status and the resultant deemed transfer of the policy in exchange for the release of the grantor's liability, is that a transfer for value of the policy under Section 101(a)(2) has occurred upon such transfer when the grantor trust becomes a non-grantor trust. If a policy is transferred for value, the amount includable in taxable income is the death benefit minus (i) actual value of any consideration received (in this case, relief from the liability), and (ii) premiums and other amounts subsequently paid by transferee (which, in this case would not occur).

(a) Under the transfer for value rules of Section 101(a)(2), life insurance proceeds in excess of the owner's investment in the contract will be taxed as ordinary income if there has been a transfer of the policy or any interest in the policy for valuable consideration.

(b) Transfers for value include the sale of the policy, the transfer of rights to the policy proceeds for consideration and transfers of policies subject to loans. Transfers are broadly defined under this Section, but it isn't clear that they are so broadly defined as to include a deemed transfer for income tax purposes that does not involve a physical transfer of an interest in a policy – this deemed "transfer" does not change who will benefit from the policy proceeds, which is the concern which underlies the transfer for value concept.[24]

(c) There are five exceptions under Section 101(a)(2). If a policy is transferred for valuable consideration, but the transfer fits within one of these exceptions, the death benefit will not be subject to income tax. Only one of the five exceptions would be applicable in the context of a deemed transfer that would occur when a grantor trust becomes a non-grantor trust and the non-grantor trust is obligated on a note. If the basis in the hands of the recipient (the non-grantor trust) is determined, in whole or in part, by reference to the original owner's basis (the grantor trust), the transfer for value rules will not apply. This exception can protect part-sale, part-gift situations where the transferor's basis (the grantor's basis in the assets held in the grantor trust) is greater than the consideration paid by the transferee (the amount of the liability). Tax-free transactions, such as contributing policies to an entity, transfers to spouses under Section 1041, and transfers in a tax-free corporate reorganization will also be protected.

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[24] See PLR 9410034, which held that where a partnership was terminated for tax purposes because 50% of the partners (who would have benefited from the proceeds) changed, there was a transfer for value of its policies; here, however, there is no change in the trust beneficiaries as a result of the grantor's death.

(d) If a previously tainted policy (considered transferred for value) is subsequently transferred under one of the five exceptions to the transfer for value rules exceptions, it can lose its taint.[25]

(4) For these reasons, consideration should be given to creating the trust as a non-grantor trust.

3. Estate tax consequences of premium financing

a. In Ltr. Rul. 9745019, the Service considered the implications of a private split-dollar arrangement between a husband and wife as the premium providers and their irrevocable insurance trust, with respect to a policy insuring the lives of the husband and wife, on a survivorship basis.

(1) The premium providers initially funded the trust with a cash gift, with which the Trustee purchased and paid for the first premium on a survivorship policy covering their lives. The trust was named as initial owner and beneficiary of the policy. Under the proposed collateral assignment split-dollar agreement, the Trustee was designated as the owner of the policy. The trust would pay the smaller portion of the annual policy premiums and the insureds would pay the balance of the annual premium. The split-dollar agreement was terminable at will by either the Trustee or the insureds, so long as the value of the trust assets (based on the loan value of the policy) equaled or exceeded the amount to be repaid to the insureds on termination of the arrangement. In all other cases, the agreement could be terminated only by mutual consent of the Trustee and the insureds. The agreement would also terminate upon the bankruptcy of the insureds, failure of the Trustee to reimburse the insureds, failure of the insureds to pay their share of the premiums, or the death of the survivor of the insureds. If the agreement terminated prior to the death of the survivor of the insureds, the survivor would be entitled to receive an amount equal to the cash value of the policy, net of the cash surrender value at the end of the initial policy year. If the agreement terminated as a result of the death of the survivor of the insureds, the estate of the survivor would be entitled to receive an amount equal to the cash value of the policy immediately prior to the survivor's death, again, less the cash surrender value at the end of the initial policy year. In order to secure the insureds' interest in the policy, the Trustee assigned to the taxpayers limited rights under a "restricted" collateral assignment. The only rights assigned to the insureds were the right to receive a portion of the death proceeds payable on the survivor's death and the right to receive the cash value of the policy if the policy were surrendered by the Trustee. All other rights under the policy were reserved to the Trustee under the collateral assignment.

(2) One of the issues on which the Service was asked to rule was whether the insurance proceeds payable to the trust under the split-dollar agreement would be includible in the gross estate of the surviving insured. The Service held that the insureds retained no incidents of ownership in the survivorship policy on their lives, as a conclusion, and without any analysis. Although the ruling discusses the broad nature of the phrase "incidents of ownership" under the Section 2042 regulations, the ruling goes on to apparently hold that the restricted nature of the collateral assignment to the insureds was enough to prevent their interest in the policy from rising to the level of an incident of ownership in the policy. Thus, even though the insureds had a security interest in the policy (although with few of the rights which would normally be granted a secured creditor), they were not deemed to hold any incidents of ownership in the policy which would cause its inclusion in either of their estates under Section 2042. Similarly, the insured's guarantee of a loan

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[25] Treas. Reg. Section 1.101-1(b)(2) and (3).

used to pay premiums on a policy on the insured's life (or pledge of assets as security for such a loan) should not cause inclusion of the policy proceeds in the insured's estate under Section 2042, so long as the guarantee does not directly grant incidents of ownership in the policy to the guarantor, in the form of subrogation or other similar rights. Since a guarantee typically includes rights of subrogation, however, any guarantee agreement must specifically limit these subrogation rights, as they apply to the policy, so that the insured's rights in the policy as subrogee are limited to the right to receive a portion of the policy cash value, if the policy is surrendered, or to receive a portion of the policy death benefit upon the insured's death.

b. The fact that the source of the policy premiums could be argued to be coming indirectly from the decedent should likewise not cause inclusion of the policy proceeds in the decedent's estate under Section 2042.

(1) In Ltr. Rul. 9809032, the Service considered a situation in which the decedent had directly loaned funds to an irrevocable insurance trust he created, which were used by the trustees to pay the premiums on a policy insuring the decedent's life which was owned by the trust. The executors of the decedent's estate requested a ruling that the decedent did not hold any incidents of ownership in the policy for purposes of Section 2042(2) as a result of having loaned the funds used to pay the premiums on the policy. The Service noted that under the terms of the trust, the decedent held no incidents of ownership in the policy, nor did he transfer any incidents of ownership in the policy during the three year period prior to his death. Therefore, none of the policy proceeds was included in his estate under Section 2042(2).

(2) The Service further noted that the fact that the decedent, through loans, had provided the funds for payment of the policy premiums was irrelevant, since "payment of premiums is irrelevant in determining whether a decedent retained any incidents of ownership in the policy proceeds."

D. Will the loan be treated as bona fide debt for federal tax purposes?

1. Under the Final Split-Dollar Regulations, as discussed above, a payment made pursuant to a split-dollar life insurance arrangement is treated as a loan for Federal tax purposes, and the owner and non-owner are treated, respectively, as the borrower and the lender, if, among other requirements, the payment is a loan under general principles of Federal tax law, or, if it is not a loan under general principles of Federal tax law (for example, because of the nonrecourse nature of the obligation or otherwise), a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest).

2. Such a loan, since the parties in a premium financing arrangement expect repayment of the amounts loaned, if respected under the split dollar loan regulations will also be respected for gift tax purposes, since the Preamble to the regulations state that regulations apply for gift tax purposes, including private split-dollar life insurance arrangements. Therefore, under these circumstances, the loan likely constitutes a split-dollar life insurance arrangement and is likely treated as a "loan" for Federal income and gift tax purposes.

3. Even if the repayment obligation were to be characterized as something other than debt under the more general principles of Federal tax law (e.g., characterized as proceeds from the sale of the Policy, or a fee payment for the use of the Insured's life) an argument could be made, based on the plain language of the Regulation, that the payment is nevertheless treated as a loan for all Federal tax purposes. The Preamble to the Regulation, in response to commentators questioning whether the provision was necessary, states:

"[t]he IRS and Treasury recognize that, in the earlier years during which a split-dollar life insurance arrangement is in effect, policy surrender and load charges may significantly reduce the policy's cash surrender value, resulting in under-collateralization of a non-owner's right to be repaid its premium payments. Therefore, so long as a reasonable person would expect the payment to be repaid in full, the payment is a split-dollar loan under §1.7872-15, rather than a transfer under §1.61-22(b)(5) on the date the payment is made."

E. Does Federal Reserve Board Regulation U apply to insurance premium financing of variable policies?

1. In some larger cases, if the policy being financed is a variable policy, the loan may be considered a loan to purchase margin stock that is secured, directly or indirectly, by margin stock (the underlying securities in the separate accounts), and will require compliance with Regulation U of the Board of Governors of the Federal Reserve System (the "Board").

a. According to the Board's Staff, the policy itself isn't margin stock, only the underlying funds.

b. If 75% or more of the investments in the policy at the time of the loan are pure bond or money market funds (which are not considered "margin stock"), the loan would not be subject to the loan-to-value limitations of Reg. U, but might require the preparation of a purpose statement.

c. What about a later change in the underlying policy investments, from non-margin to margin securities? Under 12 C.F.R. Section 221.3(a)(2)(iii), that would appear not to create a margin arrangement, but if the change could be shown to have been contemplated at the outset, as a way to circumvent the rule, it likely would be found to have created a margin arrangement.

2. The Staff of the Federal Reserve Board has concluded that a loan to acquire a variable policy by a lender, other than the insurer, is indirectly secured by margin stock, at least where the policy is pledged as collateral. A loan by the insurer against the policy would not be, since while that loan is outstanding, the separate accounts do not participate in the performance of the underlying investments. FRRS 5-919.111 (1987), reconsidered and confirmed by FRRS 5-917.191 (1988).

a. Such a loan, to purchase and secured by a variable policy, is "purpose credit" – a loan for the "purpose" (whether immediate, incidental, or ultimate) of purchasing or carrying margin stock under Regulation U. 12 C.F.R. §221.2 and FRRS 5-878.1 (1987)

(1) A loan used to purchase or carry a variable policy but not secured by the policy would not be considered to be directly or indirectly secured by the policy (unless the policy accounted for a significant portion of the assets of the borrower in violation of the safe harbor rule). If the lender, in good faith, has not relied on the margin stock as collateral in extending the credit, the arrangement is not a margin loan. 12 C.F.R. Section 221.2.

(2) However, a so-called "negative pledge" of the policy – a provision of the loan agreement preventing the owner from pledging or accessing the policy – would likely be enough to treat the policy as having been indirectly pledged for the loan. 12 C.F.R. Section 221.2. Similarly, other covenants that limit the borrower's actions with respect to the policy

(such as requiring prepayments of the loan in certain circumstances, or limiting other debt) might likewise be enough to treat the loan as being indirectly secured by the policy.

(3) For related-party loan transactions, not taking a security interest in the policy (useful for other reasons, as discussed below), would apparently avoid this issue (unless it violated the safe harbor or contained covenants limiting the borrower's access to the policy).

(4) What about a loan to a trust which owns nothing but a variable policy – even without a pledge of the policy, is the loan indirectly secured by the margin stock, as a practical matter? Can it be said the lender isn't, in good faith, relying on the margin stock as collateral? Would it matter if the trust owned other assets, in addition to the policy, or if the loan were guaranteed by the beneficiaries?

b. Under the safe harbor rule, if the policy is not more than 25% of the value of the trust, the loan is not a margin loan.[26] Under the safe harbor, there is an irrebuttable presumption it isn't a margin loan if the margin securities account for less than 25% of the borrower's assets; above 25%, there is no presumption either way – it is a facts and circumstances test. Would a guarantee of 25% of the loan satisfy this requirement?

c. What about using only the death benefit as collateral for the loan – would that avoid the issue, since the policy itself isn't margin stock?

(1) As noted above, only the underlying funds are considered margin stock.

(2) What about using an equity indexed universal life policy as an alternative to a variable policy?

(a) They are not treated as securities for securities law purposes.

(b) But see SEC Rule 151A(2008), prospectively treating equity indexed annuities as securities, where it was likely the annuity amounts would exceed the amounts guaranteed under the contract, and also the SEC's position on total return equity swaps.

3. Importantly, in order to be considered a "lender" for this purpose, the lender would have to extend credit of $200,000 or more for such purpose in any calendar quarter or have $500,000 or more in margin credit outstanding.[27] This threshold will insulate most such loans from these rules.

4. Under Regulation U, the amount of any such loan treated as a margin loan will be limited to 50% of the value (at the date of the transaction) of the margin stock securing the loan.[28]

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[26] 12 C.F.R. Section 221.2. See FRRS 5-917.23.

[27] 12 C.F.R. Section 221.2 and Section 221.3(b).

[28] 12 C.F.R. §221.3.

a. For a variable policy acquired with such a loan, it isn't clear whether the value takes into account surrender charges.

b. In any event, in the early years of the transaction, only a fraction of the premiums could be loaned under this limit.

5. Once the loan is made, there is apparently no further requirement under Regulation U to monitor the value of the policy for compliance with the 50% requirement, unless the underlying investments are sold, in which case there may need to be replacement collateral, under 12 FRRS 221.3(f).[29]

a. However, each time a loan is made, under a so-called "true-up" provision, the total loan and the then value of the property must meet this test again.[30]

6. The lender, if not a broker or bank, may have to register with the Federal Reserve if the loan meets the threshold dollar amount test, described above, unless the loan is outside the "ordinary course of business" (which is an extremely narrow exception).

a. A loan by an employer to allow an employee or his or her trust to acquire a variable policy would likely be considered in the "ordinary course" of the employer's business and require registration.[31]

b. A loan by an individual to his or her trust to acquire a variable policy could be considered in the "ordinary course of business" for the management or the preservation of property, although there is no direct authority for that.

c. Informally, the Staff of the Federal Reserve Board has confirmed that conclusion.

d. A non-bank lender must register with the Board and file annual reports if the lender extends $200,000 of more of credit in a calendar quarter or has $500,000 or more in margin credit outstanding; the lender and the borrower must also keep a purpose statement in their own files (i.e., not filed with the Board, but maintained in the credit file and available to be reviewed by the Board upon request) to disclose the purpose of the credit.[32]

7. Accordingly, premium financing will less likely be used with variable policies, especially where third party financing is involved, since there, the policy will always be pledged as collateral.

V. CHARITABLE GIFTS OF LIFE INSURANCE POLICIES

A. There are a number of possible reasons to consider gifting an existing policy to a charity.

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[29] 12 C.F.R. Section 221.3(a)(2).

[30] 12 C.F.R. Section 221.3(d)(2).

[31] FRRS 5-925.2 (1992).

[32] 12 C.F.R. Sections 221.2 and 221.3(b).

1. Old policies may no longer be needed by the donor/insured.

2. As discussed below, future premium payments by the donor – either directly or as gifts to the charity – will fully be deductible.

3. The policy gift replaces other assets that may have been pledged to the charity.

4. The gift allows a larger gift to charity with little or no impact on other assets going to the insured-donor's spouse or children.

a. But the policy proceeds will no longer be available to the insured's estate for liquidity or to his or her spouse and children for support or other needs.

5. There is no insurable interest issue with such gifts, as there might be if the charity acquired a new policy on the life of a donor.

B. Considerations from the Charity's Perspective

1. The charity may have to deal with the issue of paying premiums out of its funds to keep the policy in force if the donor stops making gifts to do so – called "donor fatigue" – or selling or surrendering the policy.

2. The charity should have both intake guidelines for which types of policies it will accept and guidelines for administering policies it owns.

a. Without a set of guidelines as to which types of policies a charity will consider accepting, it runs the risk of owning and having to manage policies which will require premium gifts by the donor for his or her life, which may increase over time, and/or policies which are unstable and may expire before the insured.

b. Without a clear message to potential donors of policies, a charity risks alienating donors who might expect their favorite charity to automatically accept – with thanks – any policy they wish to donate.

3. The charity should also consider a pre-gift letter or memo to prospective donors about accepting policy gifts.

4. Finally, the charity should consider the internal administrative issues raised by managing policies it owns on its donors.

a. Will it sell a policy to an investor if it becomes unproductive or too expensive to maintain?

b. Are there investment guidelines for the investment of cash value held in policies?

C. Income tax implications for the donor/insured.

1. If a policy is unconditionally assigned to the charity and there are no incidents of ownership retained by the donor/insured (so that the partial interest rule, described below,

isn't violated), the question has to be asked what kind of asset is an insurance policy before you can determine the amount of the deduction.

a. If a life insurance policy is "ordinary income property," (property which, when sold, won't produce capital gain income), then, under Section 170(e)(1)(A), the donor would only be entitled to an income tax deduction equal to the lesser of:

(1) The insured's income tax basis in the policy - the total premiums paid to the date of the gift, less dividends received in cash on a participating policy (and, as discussed below, also less the "value" of the insurance protection provided); or

(2) The fair market value of the policy, determined as discussed below.

b. If life insurance is a capital asset, the deduction would be for the "fair market value" of the policy.

(1) Reduced, however, by the portion of the policy value which would generate ordinary income if sold.

c. For AGI deduction limitation purposes:

(1) If a policy were ordinary income property, the AGI deduction limit would be 50%;

(2) If it were capital gain property, the AGI limit would be 30%.

2. Is a life insurance policy ordinary income or capital gain property?

a. Until recently, there wasn't any direct authority.

b. On the one hand, a policy always generates ordinary income under Section 72 (for any gain over the owner's "investment in the contract" – a basis concept under Section 72(e)) - if it is surrendered to the issuer or if it lapses.

c. However, a policy would generate a capital gain, under Section 1001, to the extent the sale proceeds exceed basis.[33]

(1) But, that is true only for gain that exceeds the policy's cash value, based on TAM 20452033, which held that gain over investment in the contract, up to cash value was ordinary income, since it was a substitute for interest, under the substitution of income line of cases.[34]

d. Accordingly, a sale of a permanent insurance policy with cash value to a third-party buyer would produce both ordinary income and capital gain; it therefore would appear to be a combination of ordinary income property and capital gain property.

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[33] See Gallun v. CIR, 327 F2d 809 (7th Cir. 1964) and Rev. Rul. 2009-13, 2009-21, I.R.B. 1029.

[34] See, e.g., P.G. Lake v. CIR, 356 U.S. 260 (1958). Rev. Rul. 2009-13.

3. The result for charitable contribution deduction purposes should be based on the policy's fair market value reduced by what would be the ordinary income portion of any gain on a policy sale (gain over investment in the contract, up to cash value) and the AGI deduction limitation purposes, the AGI limit would be that applied to capital gain property or 30%.

a. For a term policy, the deduction would be for the policy's fair market value (determined as discussed below), but there should be no reduction of the deduction for any ordinary income element, since there is no cash value.

b. See Reg. Sec. 1.170A-4(a)(1), requiring a reduction in the charitable deduction for a gift of capital gain property by any ordinary income which would have been generated had the property been sold.

4. Since the deduction will be for the policy's fair market value, the issue will be establishing the "fair market value" of a life insurance policy for tax purposes, something that is not that easy (see beginning of outline).

D. The partial interest rule.

1. An income tax deduction is disallowed for gifts of a partial interest in property to charity. The basic rule requires a donor to gift all of the donor's interest in property or an undivided portion of each and every substantial interest in the property.[35]

a. The donated interest must extend over the entire term of the donor's interest.

b. The gift does not have to extend to complete dominion and control over the asset exclusive of the donor, but can be shared with the donor.

2. The partial interest rule, as it is applied to gifts of life insurance, prohibits the donor from the following actions:

a. Retaining the right to borrow on or withdraw from the cash value of a gifted policy.

b. Retaining the right to the policy proceeds of a gifted policy in excess of the cash value.[36]

c. Retaining the right to purchase term insurance at discount rates in conjunction with a gift to charity of an annuity policy.[37]

d. However, the donor could divide a policy into two new policies, retain one and gift the other, without violating the partial interest rule.[38]

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[35] Rev. Rul. 79-9, 1979-1-C.B. 1; Sections 170(f)(3)(A) and 170(f)(3)(B)(ii).

[36] Rev. Ruls. 76-143, 1976-1-C.B. 63; and 76-200, supra.

[37] Rev. Rul. 76-1, 1976-1-C.B. 57.

[38] IRS Information Letter, 2009-0127, dated 4/2/09.

3. The IRS has ruled that a completed gift of a policy to a private foundation, in which the donor retained the power to add or substitute other charitable beneficiaries, satisfied the partial interest rule.[39]

E. A gift of a policy subject to a loan.

1. Such a gift will constitute a bargain sale - it is treated as if the policy were sold, to the extent of the loan balance, with the gift portion being only the excess of fair market value over the loan balance.

2. If the fair market value of the policy (as determined as described above) is more than the donor's basis in the policy (as discussed below), the contribution deduction would be limited to the basis allocable to the gift portion, if the policy were ordinary income property; as discussed above, that is likely not the result.

3. If the policy's fair market value is less than basis, the deduction will be limited to the fair market value, less the policy loan, on the same assumption.

4. Assuming the policy is a capital asset, under Rev. Rul. 2009-13, the deduction will be equal to the fair market value in excess of the loan.

5. If the basis allocated to the "sale" portion is less than the balance of the loan, the donor will recognize income to the extent of such excess.

6. A gift of a policy subject to a loan to a private foundation by a disqualified person will constitute an act of self-dealing.[40]

a. However, a gift of a policy that has no loan to a private foundation will not constitute self-dealing, nor will it be a jeopardy investment (even though future premiums will have to be paid by the foundation).[41]

b. In any event, the deduction would be limited to the donor's basis in the policy.[42]

F. Designation of a Charity as the Beneficiary of a Policy Owned by The Donor.

1. Possible benefits.

a. This serves the same function as a bequest of an equivalent amount from the insured's estate, but avoids probate.

b. It enables the donor/insured to change his or her mind about the gift.

c. The donor/insured owns and can still utilize the cash values.

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[39] Ltr. Rul. 8030043.

[40] Rev. Rul. 80-132, 1980-1-C.B. 255.

[41] Ltr. Rul. 8909037.

[42] Section 170(e)(i)(b)(2).

d. The donor/insured will be able to get an income tax deduction if and when the policy is later gifted to charity.

2. Tax consequences.

a. There is no income tax deduction to the donor for the value of the premiums paid, since the donor has retained incidents of ownership in the policy, in violation of the partial interest rule.

b. There are no gift tax implications, since the gift is incomplete.

c. The estate of the insured will include the value of the proceeds, under Section 2042, but will receive an offsetting estate tax deduction for the proceeds passing to charity. Sections 2042(2) and 2055(a).

3. An irrevocable designation of a charity as beneficiary.

a. Such a designation of a policy in which the donor/insured retains an incident of ownership is a nondeductible gift.

b. There is no income tax deduction under the partial interest rule.

c. There is likewise no gift tax deduction, for the same reason but there is likely a completed gift for gift tax purposes each year, perhaps measured by the "economic benefit" of the death benefit assigned, which would not qualify for the gift tax charitable deduction (again, because of the partial interest rule).

d. Future premiums paid to the insurer on behalf of the charity would also not be deductible, for the same reason.

e. There will be estate tax inclusion of the policy proceeds in the insured's estate for estate tax purposes, with an offsetting charitable deduction.

G. Insurance in a Charitable Trust.

1. Section 170(f)(10) states that no charitable deduction will be allowed for any transfer to or for the benefit of a charity, if in connection with such transfer, the charity directly or indirectly pays any premium on any personal benefit contract with respect to the donor or there is an understanding or expectation that any person will directly or indirectly pay any premium on any personal benefit contract with respect to the donor.

a. There is also imposed a 100% excise tax on the charity if Section 170(f)(1) applies.

b. Personal benefit contract is defined in the section to include any life insurance contract if any direct or indirect beneficiary under such contract is the donor, any member of the donor's family or any person designated by the donor.

(1) This definition would except any gifts of a policy to a charity or money to pay premiums on a policy owned by the charity, to a charity, since there is no benefit retained by the donor.

(2) However, gifts to split interest trusts, where the donor, a member of the donor's family or any person designated by the donor, is a beneficiary is a particular concern.

c. The Section provides that in the case of a Charitable Remainder Trust, however, a person shall not be treated for purposes of this section as an indirect beneficiary of a life insurance contract held by the CRT solely by reason of receiving annuity payments from the CRT, so long as the CRT possesses all of the incidents of ownership under the policy and the CRT is entitled to all the payments from the policy.

d. There is no mention of Charitable Lead Trusts in Section 170(f)(10). Some commentators have stated that if a "paid up" policy is contributed to a CLT, then even if Section 170(f)(10) did apply, the CLT is not paying any premiums. However, the nature of a "paid up" policy is that premiums are still due but the cash value is large enough to cover the premium payment. Query, is this an indirect payment of premiums?

2. Charitable Remainder Trusts ("CRT")

a. Donor creates a charitable remainder trust with a net income and make-up features ("NIMCRUT") in which the annuity payment (a set percentage of the fair market value of the trust determined each year) is limited to the lesser of the stated amount or net income, with a provision for paying the balance of the annuity payments at such time as the trust receives sufficient income.

(1) Donor is an income beneficiary followed by the Donor's spouse.

b. The donor transfers sufficient amounts to the NIMCRUT to enable the trust to purchase a life insurance on his or her life[43] or transfers a policy to the CRT[44]. (Since the trust is a unitrust, additional contributions could be made to the trust, enabling the donor to make contributions each year to meet the annual premium cost.)

(1) The trust cannot be a grantor trust or it will not qualify as a Charitable Remainder Trust.

(2) See discussion of avoiding grantor trust status under Section 677(a)(3) above.

(3) See Ltr. Ruling 9227017 which addressed a CRT holding life insurance and avoiding Section 677(a)(3).[45]

c. At donor's death, when spouse becomes the income beneficiary, the CRT is increased by the death benefit under the policy and the make up provision is activated, plus the future income distributions to the donor's spouse is increased due to the increased value in the CRT. The charity will also benefit from the increased value in the CRT.

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[43] See Ltr. Ruling 8745013.

[44] See Ltr. Ruling 7928014, Ltr. Ruling 199915045.

[45] See also Ltr. Ruling 9915045.

d. Alternatively, upon the donor's retirement, if there is cash value in the policy, the policy could be sold or surrendered, thereby triggering the make up provision and future unitrust payments during the donor's retirement.

(1) The IRS is concerned about the use of charitable trusts for retirement plan purposes.

(2) See Ltr. Ruling 9825001 approving the purchase of a deferred annuity by a CRT.

e. The donor receives an income and gift tax charitable deduction upon creating the CRT for the actuarial value of the remainder interest and a marital gift tax (or estate tax) deduction for the amount passing to the spouse.

f. Issues with a CRT holding a life insurance policy

(1) UBIT issue.

(a) Section 514(b)(1) provides that income from debt-financed property (property in which debt was incurred in order to acquire the property) which is held to produce income is unrelated business income.

(b) Under prior law, if a CRT had one dollar of net unrelated business income, it caused the CRT to lose its exempt status in that year. Under current law, however, if the CRT receives any net unrelated business income, the income is subject to a 100% excise tax but there is no loss of the CRT's exempt status.

(c) A policy loan to pay premiums could be considered acquisition indebtedness where the debt was reasonably foreseeable at the time the policy was acquired.[46]

(d) But this presupposes that a policy is property held to produce income. Unless there is a transfer for value, under Section 101(a), the death benefit of a policy is income tax free as is the inside build up of the cash value and the borrowing of such value. Therefore, there is no unfair advantage gained by a charity or CRT, as a tax-exempt entity, to invest in insurance over any taxable entity or person. Addressing the unfair advantages a tax-exempt entity had over taxable entities and persons when engaged in a business was the reason for the UBIT rules.

(2) Other Tax Issues

(a) Jeopardy investment under Section 4944: Even if an insurance policy were considered a jeopardy investment, which is doubtful, a CRT is not subject to Section 4944 under Section 4947(b)(3)(B) if all of the remainder interest is owned by the charity and all of the income interests are owned by persons who are not charities.

(b) Treas. Reg. Section 1.664-1(a)(3) prohibits a CRT from restricting the trustee's ability to invest for a reasonable amount of income.

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[46] See Ltr. Ruling 8745013, however, this was a case where the CRT borrowed against a policy it owned in order to purchase income producing assets. There are no rulings addressing the situation where a CRT borrows against a policy to pay premiums.

(i) A life insurance policy produces no income.

(ii) So long as the trustee has wide investment discretion, is not required to purchase a policy, can sell the policy and the CRT explicitly states that the Trustee is not restricted from investing to produce reasonable income, there should be no problem with the purchase of a life insurance policy by a CRT.[47]

(3) Insurable Interest of a CRT

(a) Under the applicable state law, does a CRT have an insurable interest in its donor that will enable it to purchase the policy?

(b) This is not an issue if the donor is transferring a policy to the CRT.

(c) All states have an insurable interest statute that provide that charities have insurable interests in their donors.

(i) Under state law, is a CRT considered the same as a charity?

(ii) It is not as clear in all states if trusts have an insurable interest in their settlors.

g. The traditional plan using an irrevocable life insurance trust coupled with a CRT.

(1) In this plan, the assets transferred to the CRT are replaced (with respect to the family) with life insurance held in an irrevocable life insurance trust.

(2) The family is actually better off, since if the donor had done nothing, the assets when sold would have produced taxable income that would have depleted the donor’s estate and the assets would have been included in the donor’s taxable estate at the donor’s death.

(a) The CRT is a tax-exempt entity and therefore no gain is recognized when the assets are sold (although the taxable income will be passed out as part of the annuity under the “tier rules”).

(b) The policy proceeds escape estate taxation at the donor’s death due to being held in an irrevocable life insurance trust.

(c) Since the annuity is based on the fair market value of the CRT undiminished by income tax, the annuity amount that is paid out is higher (than if the after-tax sale proceeds had been invested for income distributions) and the higher annuity amounts can be used to gift funds to the irrevocable insurance trust to pay premiums on the policy.

[47] Id.

VI. SELLING A POLICY

A. Viatical and life settlements.

1. Viatical settlements, for terminally/chronically ill insureds, who may need the proceeds to live on. These transactions are non-taxable, under a relatively recent amendment to Section 101, adding Section 101(g).

2. Life settlements, for non-terminally ill insureds, who may want to sell an existing unneeded policy (even a term policy) for more (sometimes much more) than the surrender value in the secondary market.

3. The only choice a policyholder had before the development of the settlement market was to surrender the policy to the insurer for its cash surrender value.

a. Since there was only one buyer and one price, regardless of the then state of the insured's health, the market was inefficient. The settlement industry developed as a result of that inefficiency. Because the carrier can't get updated medical information, and the life settlement buyer can, and will, it can make a more informed decision about the policy's real value.

4. When a policy is sold, the gain on the sale is measured by the difference between the amount realized and the seller's basis in the policy. The amount realized on such deemed sale is the amount of proceeds received by the seller plus any liability from which the seller is relieved when the policy (with any policy outstanding policy loans) is transferred to the buyer, who then assumes the liability at the same time the policy is transferred.

a. The seller's basis in the policy isn't completely settled, nor is the character of the gain on the deemed sale, each of which was most recently addressed by the Service in Rev. Ruling 2009-13.[48]

(1) Basis in the Policy

(a) Courts have generally found that the adjusted cost basis of a life insurance contract equals the total premiums paid for the life insurance policy, less amounts actually received and properly excluded from gross income (such as dividends received in a participating, whole life policy).

(b) In Priv. Ltr. Rul. 9443020, however, the IRS ruled that the adjusted basis of the life insurance contract also must be reduced for the "cost" of the insurance protection provided through the date of sale of the contract.

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[48] At the same time, the Service issued Rev. Ruling 2009-14, 2009-21 I.R.B. 1031 which dealt with the sale of a policy by an investor, the tax consequences of which were more favorable than the tax consequences that arise when the insured or a trust or party related to the insured sells a policy on the insured's life. The difference is that when the insured sells a policy on his or her life, the insured's basis must be reduced by the cost of insurance (thereby realizing more gain on the sale), whereas the investor does not reduce his basis in the policy by the cost of insurance. The investor is treated differently because he did not receive any insurance protection (the cost of insurance) while he held the policy, the policy itself was the investment.

(i) In Priv. Ltr. Rul. 9443020, an insured who held a participating whole life insurance contract was diagnosed as being HIV-positive and terminally ill. The insured irrevocably assigned the contract to a viatical settlement company for 63 percent of the contract's face value. The IRS concluded an assignment of a life insurance contract for consideration constitutes a sale of property under Section 1001. Under Section 1001(b) the amount realized is the amount of money and the fair market value of any property (other than money) received upon the sale. In this case, the amount realized by Taxpayer upon the sale of his life insurance contract is the consideration received from the viatical settlement company. To determine the gain on the sale, the amount realized is reduced by the adjusted basis of the contract.

(ii) The IRS concluded the adjusted basis of the taxpayer's contract is equal to the premiums paid less the sum of (i) the cost of insurance protection provided through the date of sale and (ii) any amounts (e.g., dividends) received under the contract that have not been included in gross income.

(iii) The IRS concluded, on the facts of this ruling, and in the absence of proof to the contrary, that the cost of insurance protection may be approximated using the difference between (i) the aggregate amount of premiums paid and (ii) the cash value of the contract with regard to surrender charges. This formulation tends to overstate the basis reduction since it ignores the effect of commissions and carrier expenses on cash values.

(c) In IRS Chief Counsel Advice 200504001, the Chief Counsel concluded the adjusted basis of a life insurance policy should be reduced for the cost of insurance protection provided through the date of sale. There, a taxpayer converted an existing policy and subsequently recovered damages in connection with a lawsuit against the insurer regarding the policy conversion. The issue was whether the amount of the damages constituted a return of the taxpayer's basis in the policy. Chief Counsel concluded

> "[u]nder section 1001 and Century Wood, the basis of the Taxpayer's former … policy is equal to the amount of premiums paid by the Taxpayer less the sum of (i) the cost of insurance protection provided through the date of sale (such as loading charges, expense charges, mortality charges and administrative fees) and (ii) any amounts received under the contract that have not been included in gross income."

(d) In a series of cases, the courts found that the adjusted cost basis of a life insurance contract equals the total premiums paid for the life insurance policy, less only amounts actually received and properly excluded from gross income, thus including in adjusted basis the cost (generally not deductible) of insurance protection.[49] It is also worth noting the IRS does not discuss a reduction in basis for the cost of insurance protection in Rev. Rul. 70-38,[50] where the IRS concludes a corporation does not recognize income on the sale of a policy based on the cash surrender value of the policy which was less than the total premiums paid by the corporation on the policy.

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[49] Gallun v. CIR, 327 F.2d 809 (7th Cir. 1956), In re Est. of Crocker, 37 TC 605 (1962), CIR v. Phillips, 275 F.2d. 33 (4th Cir. 1960).

[50] 1970-1 C.B. 11.

(2) Character of Gain on the Deemed Sale

(a) Although the gain realized in connection with the sale or other transfer of a life insurance policy is arguably a capital gain (see discussion above about gifts of policies to charity) there is a component of ordinary income that may be realized on the sale.

(b) For example, in *Gallun v. Commissioner*, the taxpayer transferred several policies, having an aggregate $250,000 of life insurance coverage, with a total accumulated premium cost of $121,648.36 and a cash surrender value of $159,848.81 for the cash surrender value. The taxpayer claimed capital gain treatment for the resulting $38,200.45 gain since he had sold a capital asset. Both the Tax Court and the appeals court focused on the assignment of income doctrine as controlling the taxability of the gain on sale of the policies. The appeals court quoted the Tax Court to the effect that

> "Congress did not intend to permit, even through medium of a bona fide sale, the conversion of what is the equivalent of ordinary income into a capital gain . . . . [T]he increments realized upon the assignments were primarily attributable to accumulated interest, taxable to petitioners as ordinary income upon receipt under Section 61(a)(4). We therefore hold that the entire gain realized on the assignments was ordinary income."

(c) The Court in *Gallun* went on to state that the question presented has been considered by other courts, which uniformly have held that the assignment of income doctrine developed in *Comm'r v. P. G. Lake, Inc.*[51], should be applied and that the profits realized from the sale of the cash surrender value of an annuity or life insurance contract should be treated as ordinary income rather than capital gain.

(d) Based on the case law and secondary sources, therefore, gain on the sale of a life insurance policy is generally taxed as ordinary income, at least to the same extent that it would be so taxed under a policy surrender and the court in *Gallun* also seemed to apply the rules of Section 72(e), applicable to surrenders of unencumbered policies to the insurer.

(e) The IRS has accepted the potential for capital gain treatment.

(i) In Priv. Ltr. Rul. 8943014, in which the IRS stated "[t]he cases holding that the proceeds of the disposition of life insurance policies are ordinary income rely principally on the theory that the redemption is not a sale or exchange, or on the conversion theory of *Campbell v. P.G. Lake* …"

(ii) In TAM 200452033, the IRS concluded although since whole life insurance contract is not described in the exceptions to the definition of "capital asset" set forth in Section 1221(a), it falls under the Section as a capital asset; however, to the extent amounts received by a taxpayer upon sale of the insurance contract are attributable to ordinary income accretions to the contract's value, the IRS concluded that the ordinary accretion component of the payment does not constitute property that is a capital asset.

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[51] 356 U. S. 260 (1958).

(iii) Rev. Rul. 2009-13.

a) The ruling states that the gain in excess of cash value is capital gain – it is a capital asset (because it isn't excluded under Section 1221) and there is a supporting sale transaction (which is missing in a surrender).

b) The Ruling also held that gain over investment in the contract up to cash value was ordinary (on the substitution of income doctrine of cases like *Comm'r v. P. G. Lake, Inc.*[52]) and gain above cash value was capital.

c) Policy basis is premiums paid, minus any non-taxable dividends received (in whole life policies), and minus the "cost of insurance".

d) Investment in the contract, under Section 72 (which is a basis like concept that determines the ordinary income realized under a policy surrender and now a the policy sale) is premiums paid minus any non-taxable dividends received and does not subtract for "cost of insurance".

e) Rev. Rul. 2009-13 held that basis was reduced by the cost of insurance in a sale, without discussing how to determine that cost.

i) In universal or universal variable policies, that cost is disclosed; in traditional whole life it isn't (and would have to be obtained from the carrier).

ii) In prior private rulings, the Service held that, in the absence of other proof, it would be considered the difference between premiums and cash value – obviously including more than just insurance charges.

iii) See Section 7702(g), for a statutory definition of cost of insurance – the greater of the Table I (Section 79) costs or the actual policy charges.

[52] 356 U.S. 260 (1958).