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SETTING THE STAGE

Let's be clear about the ambiguity

- The economic (read 'low interest') and tax (read 'whatever is happening at the moment') environment that affects why life insurance is purchased, owned, paid for and managed has created uncertainty among policyholders and their advisors about:
 - Whether policies are needed or wanted for their original purpose
 - Whether policies should be supported and, if so, to what extent
 - How policies should be managed economically going forward
 - How policies should be supported and managed from a wealth transfer tax perspective going forward
 - How the arrangements under which the policies are financed as well as the arrangements themselves should be managed

What we'll cover

- Understanding the situation
- Getting the facts and figures
- Identifying the issues and opportunities
- Exploring the options
- Dealing with ILITs and split-dollar at the intersection of complexity and uncertainty

Understanding the situation

- Where does it hurt?
 - Is it the principle of the thing or the principal of the thing?
- The client's objectives, priorities and constraints
 - And insurability, of course
- The vintage, type and construct of the policy
 - No, they don't get better with age
- The terms and tax characteristics of the ILIT
 - And you told me it was a 'no-brainer'!
- The type and vintage of any split-dollar or other financing arrangement to which the policy is subject
 - We told you to fund that trust!

Range of potential outcomes

- Depending on the context and many other factors, the outcome of the discussions might be to:
 - Grin and bear an increased premium
 - Surrender the policy
 - Manage it to reduce the outlay, stabilize performance, etc.
 - Redeploy it for investment purposes
 - Replace it with another policy or an annuity
 - Sell it in a life settlement
 - Donate it to charity
 - Leave the policy alone but fix the ILIT by modification or decanting
 - Leave the ILIT alone but fix the split-dollar arrangement
 - Fix both
 - OK, how much more time you got?

GETTING THE FACTS AND FIGURES

The 'as-sold' illustration (if available)

- What the client originally bought
- Shows underwriting classification, policy construct, the then current assumptions, premium and planned duration, pattern of projected cash value and death benefit at 'relevant' ages, age policy matures, etc.
- Is there an accelerated death benefit provision to fund long-term care cost?

The inforce illustration

- Similar to as-sold illustration, but starts with current year
 - Be sure it includes (when available) a report detailing annual policy charges for costs of insurance and other policy expenses
- Some things to look for:
 - Any changes in policy structure, death benefit option, etc.?
 - How long will the current premium support the death benefit?
 - Is the policy underfunded? Overfunded?
 - When will the policy be self-sufficient?
 - Are there any loans against the cash value? If so, is the loan “problematic”?
 - If the policy is EIUL or VUL, what is the index or how is the cash value invested?
- Also get the current policy statement from the carrier
 - By the way, confirm the policy owner and beneficiary!

Almost done...

- If the policy is owned by an ILIT get a copy of the trust (and gift tax returns).
 - How have the premium gifts been treated and how much gift tax/GST tax exemption does the client/grantor (and his or her spouse) have left?
 - Is the ILIT a grantor trust? If so, how and as to whom?
 - Grantor trust status could be a critical part of “fixing” the problem, e.g., maybe the next premium gift wants to be a loan.
- Is the policy subject to a split-dollar (or other financing) arrangement? If so:
 - Get a copy of the agreement
 - If the arrangement is an economic benefit arrangement of any vintage, get an in-force illustration that shows the annual economic benefit through policy maturity and if it is based on carrier term costs or Table 2001.

Ah, now we see...

- Does the client still need (or want) all of the insurance?
 - If so, to what age?
 - If not, need (or want) a lesser amount? If so, to what age?
- Is it about cash flow or the policy itself?
 - If it's cash flow, let's see what we can do (and what the client is willing to give up).
 - If it's about the policy, is it a matter of basic construct, which can't be fixed or a matter of policy management, which can?
- Is it about the carrier, e.g., ratings have dropped, doesn't answer the phone, etc.? Has the carrier changed?
- Is it about the gift/GST tax implications of paying premiums?
- Is it about the arrangement or plan, e.g., a split-dollar arrangement with no end in sight except death?
- Maybe it's about the ILIT (and not the policy)
- Maybe it's about all three

EXPLORING THE OPTIONS

If it's about cash flow

- Determining the cause of the crunch will help determine a solution
 - The client just doesn't have the cash flow or has too many competing needs for the cash and (or),
 - Dividend or crediting rates dropped, thereby requiring increased premiums to support the death benefit or the same premium to be paid (far) longer than ever anticipated
- If the policy is whole life
 - Get an illustration that shows a change of dividend option from buying paid-up additions to reducing premium. Client will pay the net premium.
 - Can the client change the option back without evidence?
 - Be sure client understands the long-term impact of this change
 - If the policy is a whole life/term blend, see if payments for cash building riders can be reduced (and then resumed, if and when).
 - Don't be surprised if the premium cannot be reduced for the foreseeable future!

Cash flow (cont.)

- If the policy is current assumption universal life (CAUL)
 - See how much the premium can be reduced and still support the death benefit to a targeted age.
 - See whether a change from an increasing death benefit option to a level death benefit option will make a significant difference in the premium.
- If the policy is guaranteed universal life (GUL)
 - Revisit the duration of the no-lapse guarantee. Does client still need to support the death benefit to that age?
 - Ask the agent to illustrate a cutback in the premium followed by a “catch-up” premium in the future that will restore the guarantee
 - Maybe get a letter from the carrier supporting the illustration

Cash flow (cont.)

- If the policy is variable universal life (VUL)
 - Assume client is still comfortable with VUL as a concept but wants to manage the policy differently (better?) (for the first time?) in the future to reduce some of the volatility in performance.
 - Revisit the asset allocation of the cash value. Then, depending on the policy's features:
 - Reallocate a growth portfolio to either a more balanced fund/portfolio offered by the carrier or constructed by the client.
 - Explore automatic rebalancing feature, if available.
 - Allocate a portion of the cash value to a fixed account from which the carrier will take monthly costs-of-insurance and expenses, rather than taking those charges pro-rata from all of the funds.

A mid-course correction, perhaps

- A policy originally purchased for traditional use can be ‘redeployed’ as an investment/retirement vehicle
 - Depending upon the type of policy and how it’s constructed, it might be an attractive investment vehicle under current tax law.
 - Cash value grows tax-deferred
 - Client can access cash value for income via partial surrenders, withdrawals (up to basis) or loans (even in excess of basis) on a tax-free basis.
 - Ask the agent to show how the policy can be used for retirement savings/income
 - But this involves more than just picking an age and showing a series of partial surrenders/withdrawals and then loans.
 - Might involve, inter alia, an increase in the premium, decrease in the death benefit and a carefully calibrated approach to tapping the policy for income.
 - If the policy is owned by an ILIT, consider how (and at what tax cost) it can be owned by the insured.

Exploring the redeployment

- If the policy is whole life, there will be little flexibility with regard to the premium or other aspects of policy design.
 - Redeployment will be more a function of the client's thinking about the policy than actually tinkering with it.
- If the policy is a whole life/term blend, the client might be able to increase the premium (to build more cash value) without evidence of insurability.
- If the policy is GUL, the client can likely increase the premium (now viewed as an investment contribution) without evidence.
 - However, depending on its vintage, the policy may not generate robust cash values on a current assumption basis.
 - Exchange?

Exploring the redeployment (cont.)

- If the policy is CAUL or VUL, then more fundamental design changes could be feasible. For example:
 - Consider some combination of increasing the premium for a certain number of years and, within carrier and tax guidelines, reduce the death benefit to reduce the “drag” of the costs-of-insurance on cash value accumulation.
 - Of course, also determine any requirements for underwriting, imposition of surrender charges, etc.
 - Illustrate the maximum tax-free cash flow that the policy can generate at retirement
 - For a given number of years, without requiring more premium to support the death benefit well beyond client’s life expectancy
 - And be sure the illustrations show how that loan works!

Sweet surrender?

- Ask the carrier for a “surrender quote”
- Cash surrender value in excess of investment in the contract (generally, premiums paid less non-taxable distributions) is ordinary income, not capital gain.
- If the policy is a modified endowment contract, there is also a 10% penalty tax on the amount of income realized, if the “taxpayer” is under 59½.
- If there is an outstanding policy loan at time of surrender, then the policyholder will be taxed on the excess of the gross cash value (which includes the loan amount) over the investment in the contract.
 - Which can mean a little cash but a lot of income!

Exchange the policy

- Assume client still wants the insurance but is unhappy with, inter alia, the carrier, the type of policy or the required (and immutable) outlay. The client wants to explore an exchange.
 - One rationale for an exchange is that the client wants coverage for potential long-term care costs but doesn't want to take the “gamble” of buying an individual policy that he or she may never need.
- First, some caveats:
 - Presume that the existing policy should be retained, i.e., proposed replacement must show that it can legitimately meet the needs more effectively than the existing policy.
 - Never cancel a policy until its replacement is in force!
 - Be sure to identify and address any ancillary implications of an exchange, e.g., exchange as a material modification of a pre-final regulations collateral assignment split-dollar plan, etc.

Applicable tax law

- If the transaction qualifies under Section 1035, no gain or loss is recognized in an exchange of one life insurance contract for another on the same insured or for an annuity so long as there is no “boot” received in the exchange.
 - Different insurance carriers and types of policies can be involved in the exchange.
- In order to qualify under Section 1035, the policy received in the exchange must be on the same insured or insureds.
 - Basis in the old policy is carried over to the new policy.
 - Therefore, an exchange under Section 1035 may be helpful to preserve basis even if there is no gain in the policy.
 - Be careful! If there is a loan on the current policy that is extinguished in the exchange, that is “boot” and will be taxed as ordinary income.
 - If the loan is carried over to the new policy, there is no boot.

Internal vs. external exchanges

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

Trust but verify

- When all of the illustrations and supporting material about the products and carriers have been received:
 - Does an exchange make sense? It depends...
 - Does everyone really understand all of the working parts of the policies?
 - Have the usual “what ifs” been covered?
 - All premiums, cash values and death benefits considered, do they clearly understand what they might be gaining vs. losing?

Exchange for an annuity

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

Sell the policy

- A life settlement is the sale of a life insurance policy issued on the life of a person (who does not have a condition that is likely to result in death within 24 months), for an amount that is less than the policy's face value but more than the cash surrender value.
- Based on various criteria for the client/insured, the policy and other factors, the agent can advise:
 - How the marketability of the policy is determined
 - The steps involved in (and after) a life settlement
- Meanwhile, client should see all bids for the policy, the compensation that the agent (and others) will receive, etc.

Some inside baseball

- Some very specific generalities (meaning there will be exceptions) used to determine marketability:
 - Can sell term, universal, variable, single life or second-to-die
 - Life insurance company is sound
 - Policy has been in force for at least two years (beyond the contestability period)
 - Face amount of \$250,000+
 - Premium should not be more than 5% of the death benefit and cash value not more than 15-20% of the death benefit
 - The less cash value vis a vis the death benefit, the better

Some inside baseball

- Insured should be at least 65-70, life expectancy of up to 12-14 years, smoker is better than non-smoker
- Policy issued on a more favorable underwriting basis than warranted and insured's health has since turned for the worse
 - The worse the better

Taxation of life settlements

- Rev. Rul. 2009-13
 - Section 72(e), which applies in context of a surrender, does not apply in the context of a sale of a policy – here it is income tax basis.
 - Policyholder must reduce basis by the cost of insurance charges.
 - Tell me again where we get those figures...
 - And whether this basis reduction rule applies outside the life settlement sale context
 - Gain above (reduced) basis is ordinary to the extent of the amount of ‘inside build-up’ that would have been ordinary income upon surrender and capital gain thereafter.
 - Based on the “substitution of income” theory.

Does the life settlement make sense?

- It depends...
- If there's a settlement offer on the table, it means that somebody doesn't think the insured will live too long.
 - Will the sale and reinvestment of the after-tax proceeds of sale leave a larger amount of money to the survivors than if the insured had kept (and, if necessary, supported) the policy?
 - Ask the agent to determine the lowest premium outlay projected to support the death benefit to just beyond life expectancy. Then compare on an annual basis, the “premium-cost-adjusted” death benefit from the policy to the after-tax result of investing the (after-tax) proceeds of the life settlement to see the “crossover” year.
 - And then ask the insured again, “What if...?”

Donate the policy to charity

- Can be a low cost means of making a potentially significant gift to charity.
- But will the charity accept the gift?
 - Need to check the charity's policy (no pun intended) on acceptance of policies – they vary widely
- Might find that the charity is generally willing to accept policies that meet certain criteria regarding:
 - Age or life expectancy of the insured(s)
 - Amount and number of remaining premiums
 - Type of policy
 - Ratings of the insurer
- Will this insured/policy meet the criteria?
 - Charities will generally not use their funds to pay premiums

Basic tax implications of the gift

- The donor may be entitled to a current income tax deduction for the gift.
- The transfer must include all of the donor's incidents of ownership in the policy.
- But the amount of the deduction is not necessarily clear, *infra*

Determining the amount of the deduction

- Section 170(e)(1)(A)
 - If a life insurance policy is “ordinary income property”, then the donor would only be entitled to an immediate income tax deduction equal to the lesser of the insured's income tax basis in the policy or the fair market value of the policy (however determined).
 - But query as to the impact of Rev. Rul. 2009-13 on the character of a life policy and determination of basis – it is a capital asset with some aspect of ordinary income; the deduction should be FMV minus the ordinary income portion.
 - And the impact of the life settlement market
 - In any event, must observe applicable reporting requirements, that is, Form 8283, formal qualified appraisal if the value exceeds \$5,000, etc.

DEALING WITH ILITS AND SPLIT-DOLLAR

Well, we are here, or maybe here, or maybe...

- Possible combinations of changes to the transfer taxes and basis at death as affecting life insurance
 - Estate tax, gift tax and GST tax are repealed permanently, and there is full basis step up at death.
 - All three taxes are repealed permanently, and there is carry-over basis at death (with or without some exemption).
 - All three taxes are repealed and there is capital gain at death (with or without some exemption).
 - The estate and GST taxes are repealed permanently, but the gift tax is retained, with any of the basis possibilities.
 - Any of the above, but with repeal of the repeal (sunset) at the end of the tenth year in the budget cycle (as in the Bush tax cuts), if done under reconciliation as is now contemplated.
 - The exemptions are doubled in 2018, the estate and GST taxes are repealed in 2024, the gift tax remains, and there is full basis step-up at death (presumably excluding IRD), even after 2023.
 - Stay tuned.

What if the real problem is the ILIT?

- Many clients established ILITs when the estate tax exemption was a fraction of what it is today. Now, with a \$5 million indexed exemption, (perhaps doubled in 2018) many who have ILITs regard them as albatrosses around the necks of their financial and tax lives.
 - Of course, if the ILITs could talk, many would say the same thing about the products they own!
- Even if the estate tax is repealed, the gift tax implications of funding those ILITs can still be problematic, if the gift tax remains.
 - And it's "problematic-squared" if the ILIT's terms make addressing the client/grantor's concerns more difficult, e.g., ILIT is not a grantor trust, it was created in an unfriendly jurisdiction, it has an uncooperative trustee, etc.

Overview of options for the undoing

- Court reformation/non-judicial modification
- Decanting
- Distribute policy to adult beneficiaries
- Distribute the policy to a new ILIT
- Sell the policy to a new ILIT (if a grantor trust)
- Sell the policy to the grantor
- Forget the above and go back the product and cash flow issues

Split-dollar

- Identifying and addressing issues with existing plans
 - Economic issues
 - Tax issues
- Identifying opportunities to use split-dollar in a continuing gift tax sensitive environment

Existing plans

- Many collateral assignment equity split-dollar plans established prior to the issuance of the regulations in 2003 were not recast as loans nor terminated under the safe-harbor of Notice 2002-8 and are still in force today.
 - Many of these plans are still years away from ‘rollout’ and the annual economic benefit has become a significant income (and gift) tax problem, which will only seem worse if the estate tax is repealed but the gift tax isn’t.
 - Briefly, why these plans were used, how they were supposed to work and why they now present the issues they do, and what (if anything) can be done with them.
 - Most of these older plans were not managed well (or at all).

The backstory

- Plans were widely used to fund substantial amounts of life insurance in a gift and GST tax-efficient manner
- Typical plan
 - ILIT owns the policy, company pays the premium.
 - Company is secured by a collateral assignment of the policy.
 - Upon termination of the arrangement during the insured's lifetime, the company is repaid the lesser of the premiums it advanced or policy's cash value. Any cash value in excess of the company's share, commonly referred to as the "equity", remains in the ILIT.
 - If the arrangement is terminated at the insured's death, the company's share would be the same, but the ILIT would retain the excess death benefit.

From a tax perspective

- Insured has imputed economic benefit because of the insurance protection from the plan.
 - The annual economic benefit is also an imputed gift (GST transfer) by the insured to the ILIT.
- Because the economic benefit rises as the insured ages, plan designs usually called for the company to pay premiums for 10 to 15 years, with a 'roll out' in the 16th year from the policy's cash value.
- Back when (meaning before 'guidance'), the only tax issue with the plan might have involved Section 2042, but that was easily addressed.

And then came the “guidance”

- TAM 9604001 says the equity is taxable as it accrued, but then, radio silence
- Notice 2001-10 introduces Table 2001 and new split-dollar regimes, but stay tuned
- Notice 2002-8 restates Notice 2001-10 but offers some grandfathering, some safe harbors and some interesting language about “no inference”
- Sarbanes-Oxley Act (SOX) negatively impacts collateral assignment plans for executives of public companies
- Proposed regulations issued in 2002 establish new playing field for split-dollar plans:
 - Economic benefit regime with traditional annual taxation of that economic benefit
 - Loan regime
- Final regulations issued in September 2003 that apply to arrangements implemented after September 17, 2003 or to pre-existing arrangements that are thereafter “materially modified” (an undefined term).
- Notice 2007-34 – Section 409A can apply to certain compensatory split-dollar arrangements but not others, with grandfathering for cash value attributable to pre-2005 premiums, and a requirement for amending the plan by 2008 to comply with Section 409A.
 - Many were not amended and pose substantial income and transfer tax risks, as well as penalties and punitive interest charges.

Fast forward to today

- Many, if not most business owners who had these collateral assignment split-dollar arrangements did nothing about them in reaction to Notice 2002-8.
 - Inertia, waiting for grandfathering, etc.
 - Now, roughly 15 years after Notice 2002-8 was issued, many of these plans are still in place...and they are in trouble.
- Largely due to the downdraft in interest rates in recent years, many of the policies are years away from having enough cash value to finance the rollout.
 - Meanwhile, the economic benefit continues to increase for income and gift (and GST) tax purposes.
 - Even if the estate tax is repealed and the insured is no longer needed, as long as there is an income and gift tax, these plans will only become more onerous as the insured ages.

Fast forward to today

- Does the insurer still support the term rates?
- Check to see if the agreement is subject to Section 409A and, if it is, whether the agreement complies. If it does not, find out if it was amended to comply pursuant to Notice 2007-34 and subsequent guidance; if not, what then? Also, get a copy of the ILIT and determine if it is a grantor trust for income tax purposes.
- Second, get an inforce illustration for the policy from the agent. Ideally, the illustration can be run in a split-dollar mode so that you can see the increasing economic benefit, the position of the policy relative to the company's outlay and how many more years it will take before the policy can fund the rollout without collapsing.
- Third, present and explain the illustration/exhibit to the insured. Show the numbers, meaning the economic benefit and (once there) the equity and describe the income and gift tax implications.
 - Especially if Notice 2007-34 and Section 409A apply.

The options, as it were

- Assuming, of course, the client still wants the insurance:
- Stay the course – Maybe because the policy will never build enough cash value to roll out of the plan within the insured's life expectancy. There will be ongoing (and ever-increasing) taxable economic benefit for both income and gift tax, but (presumably) there will never be an issue of equity taxation if the plan continues until the insured dies.
- Roll out and terminate the plan – The company releases the collateral assignment for full, partial or no consideration.
 - Insured includes in income any shortfall between what the company is due and the amount paid for the release of the assignment. The shortfall is also a gift (GST transfer) to the ILIT.
 - If the policy is in equity when the plan is terminated, the company will have to determine if it will report the equity as compensation to the insured who will, in any case, have to report the equity as a gift (GST transfer) to the ILIT.
 - Ongoing premiums can be paid by the company as additional compensation to the insured or from the insured's own funds (or by the ILIT if it has been funded).
 - Perhaps explore an exchange
 - Recast the split-dollar arrangement as a loan - If there is little or no equity in the policy, it might make sense to recast the arrangement as a loan.

Constructing new purchases

- Private non-equity split dollar
- Private premium financing

Non-equity collateral assignment

- Used where tax economics of the economic benefit regime will be better than the loan regime at the outset.
 - Can be particularly attractive with a survivorship policy
- ILIT owns policy
- Insured advances premiums
- Insured entitled to all cash value
- Insured is secured by 'bare-bones' collateral assignment
- If ILIT is not a grantor trust, insured reports imputed economic benefit.
 - Table 2001 or insurer's one-year term cost

Non-equity collateral assignment

- At earlier of when policy is on cusp of equity or economic benefit will exceed interest cost, change to loan regime
- Initial loan will be for aggregate premiums advanced
- Subsequent premium payments will be loans
 - Discussed infra
- Unless insured will die in the split-dollar saddle, as it were
 - Need exit strategy because ILIT has no equity
 - Must fund ILIT, so consider current or deferred gifts and sales

Collateral assignment split-dollar

- Loan regime governs
 - Insured is lending the premiums to the policyholder.
 - No economic benefit determined by term costs
 - Each premium is a new loan, governed by terms and AFR rate(s) at time of each loan.
 - Loan must provide for sufficient interest, either paid currently or accrued, so the Section 7872 below-market loan rules will not apply – if they do, it would be a gift term loan, with unfavorable transfer tax consequences.

Collateral assignment split-dollar

- Key planning issues
 - What type of loan, i.e., demand, term or term treated for income tax purposes as demand?
 - Charge AFR to avoid imputed interest under Section 7872
 - Pay interest currently or accrue it until roll out?
 - Should loan be secured?
 - What's the exit strategy?
 - What's the right policy?

Collateral assignment split-dollar

- What's the exit strategy?
 - Will loan be repaid during insured's lifetime or will plan and insured be rolled out at same time?
- The policy
 - Does insured want ILIT to have a level death benefit net of the loan?
 - Will interest be paid or accrued? If accrued, will policy generate enough death benefit to handle the loan?
 - Will policy finance its own roll out from cash value, fund the ILIT so policy can be left intact or maybe some of both? Flexible premium product might give flexibility to adjust premiums to achieve targeted objective or to adapt to changing circumstances.