Six Planning Opportunities with Life Insurance in 2013 and Beyond

By Lee Slavutin, MD, CLU

With passage of the American Taxpayer Relief Act of 2012 (P.L. 112-240) (ATRA) we enter a period of relative certainty for the estate planning community, something we have not experienced since passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) (EGTRRA).The transfer tax system remains intact, but with a relatively large estate and gift tax exclusion, which also operates as the exemption amount for purposes of the generation-skipping transfer (GST) tax. The large exclusion amount, coupled with historically low interest rates, and higher income tax rates, creates an atmosphere that is conducive to several beneficial planning opportunities relating to life insurance. In the following, Lee Slavutin, MD, CLU, provides a synopsis of six of these opportunities. Dr. Slavutin is a principal of Stern Slavutin-2 Inc., an insurance and estate planning firm in New York City, and a member of the CCH Financial and Estate Planning Advisory Board.

1. Use the available large gift tax exclusion amount to purchase life insurance. As adjusted for inflation, the basic estate and gift tax exclusion is $5,250,000 in 2013—double that amount for a married couple. This presents a huge opportunity to use part, or all, of the exclusion amount for a gift to a life insurance trust in order to purchase life insurance.

Example 1: A male, in his 70s, decided to use his lifetime exclusion to buy life insurance. He placed $5 million into an irrevocable life insurance trust (ILIT) with the money to be used to pay premiums over a three-year period, so approximately $1.7 million annually is used to pay the premium.

When contemplating such a strategy there are some caveats regarding policy design that need to be considered. First, it is important to review the rules governing modified endowment contract (MEC) status. If the insurance is deemed to be a MEC, a distribution from the policy in the future, such as a cash distribution before the insured dies, could be taxable if there is a gain to be recognized.

Second, should the policy have a relatively high death benefit today that will remain level for the life of the policy (guaranteed universal life)? Alternatively, should the death benefit start at a lower level, but grow over time and eventually exceed the death benefit of the first product? Applying these considerations to the individual in our example, let us assume it is possible to obtain an $8.5 million death benefit using a guaranteed universal life policy. On the other hand, if we used a whole life policy, the initial death benefit would be approximately $4 million and would grow to about $8 million in four to five years, and to around $11 million at life expectancy (caveat: growth of the death benefit in a whole life policy is based on the dividends paid by the insurer and is not guaranteed). Because this particular individual had a relatively optimistic family history—his parents had lived well into their 90s—it was more important to have a policy where the death benefit would grow over time rather than one that had a high initial death benefit that did not grow.

2. Make gifts of other policies. For someone who owns life insurance policies that are performing well, but wishes to get them out of his or her estate, gifting the policies to a trust should be considered.

Example 2: A male, in his 60s, has a $5 million universal life policy that he owns individually. He wants to make a gift of the policy to a trust.

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How do you value the policy for gift tax purposes? If the policy being transferred is a term policy, in order to determine the value you must consider the specific type of term policy. In the case of annual renewable term insurance, the value of the policy is generally the unearned premium. So, if the annual premium is $10,000 and the gift is made half way through the year, the value of the gift is $5,000. But, the more common type of term policy purchased today is a level-premium term policy. With this type of policy there is a reserve value and you must obtain a Form 712 from the insurance company—something that I recommend doing as a matter of course when making a gift of a life insurance policy, regardless of the type of policy.

With a permanent, whole life policy, the value is the unearned premium, plus the interpolated terminal reserve. One exception to that rule is if the policy was just recently purchased, then the value is equal to the premiums paid. Another exception is an insured whose health has deteriorated to the point that his or her life expectancy is shortened. In such a case, it may be necessary to go to the life settlement market and obtain a value based on what an investor would pay for the policy.

Finally, for universal life insurance we do not have clear guidance, because the regulations governing the valuation of life insurance for gift tax purposes were last amended in 1974 and there was no universal life at that time.

In Example 2, above, the client had recently purchased the policy with a single premium payment of $1.5 million. The value of the policy for gift tax purposes was the purchase price of $1.5 million.

Example 3: An individual has a universal life policy in a life insurance trust and wants to make a late allocation of the GST tax exemption. In response to a Form 712 request, the insurance company came back with four different valuations—the account value, the surrender value, the interpolated terminal reserve value, and the PERC value (premiums, plus earnings, minus reasonable charges). After speaking with an attorney at the insurance company, the decision was made to use the interpolated terminal reserve value. Cash surrender value should definitely not be relied upon in this case. The IRS has repeatedly litigated this issue and stated that cash surrender value is not an acceptable measure of gift value, because the surrender charge artificially depresses the value. This case illustrates the importance of going beyond making a request for valuation via a Form 712, and seeking actuarial or legal advice to bolster the valuation.

3. Make a gift to an ILIT, but use it to purchase life insurance from a retirement plan. It is not unusual to be presented with a client who has a life insurance policy held within a retirement plan. If the client dies with the policy still in the retirement account, this could present a problem because the policy will be part of his or her gross estate for estate tax purposes. Consequently, we may want to remove the policy from the retirement account. As an aside, I would note that in the 1980s and 1990s, some advisers advocated a technique using a "subtrust" to hold life insurance in a retirement plan. There was some controversy about this technique and I would describe it as a "gray area" of the law. Consequently, we would generally not recommend use of a subtrust. The safest, cleanest way to remove a life insurance policy from a retirement plan is to either (1) distribute the policy directly to the participant, if that is allowed under the plan; or even better, (2) make a gift to an ILIT and have the ILIT purchase the policy from the retirement plan. In the latter case, because the participant never holds the policy directly you avoid the three-year rule that could cause inclusion of the policy if the insured dies within that time period.

When a policy is distributed or sold from a retirement plan, it is important to look at the safe-harbor valuation methods described in Rev. Proc. 2005-25, 2005-1 CB 962. The two methods are described in Section 3.02 (for non-variable contracts) and 3.03 (for variable contracts) of the revenue procedure.

> …the fair market value of an insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection may be measured as the **greater of** [emphasis added]: A) the sum of the interpolated terminal reserve and any unearned premiums plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience, and B) the product of the PERC amount (the amount described in the following sentence based on premiums, earnings, and reasonable charges) and the applicable Average Surrender Factor described in section 3.04 of this revenue procedure. The PERC amount is the aggregate of: (1) the premiums paid from the date of issue through the valuation date without reduction for dividends that offset those premiums, plus (2) dividends applied to purchase paid-up insurance prior to the valuation date, plus (3) any amounts credited (or otherwise made available) to the policyholder with respect to premiums, including interest and similar income items (whether credited or made available under the contract or to some other account), but not including dividends used to offset premiums and dividends used to purchase paid up insurance, minus (4) explicit or implicit reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the valuation date and those charges are not expected to be refunded, rebated, or otherwise reversed at a later date, minus (5) any distributions (including distributions of dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date. [Rev. Proc. 2005-25, Section 3.02]

It should be noted that in Rev. Proc. 2005-25, the IRS also stated that "at no time are these rules to be interpreted in a manner that allows the use of these formulas to understate the fair market value of the life insurance contracts and associated distributions or transfers. For example, if the insurance contract has not been in force for some time, the value of the contract is best established through the sale of the particular insurance contract by the insurance company (i.e., as the premiums paid for that contract)."

Another factor to consider when buying a policy from a retirement plan is that the purchasing ILIT must be a defective grantor trust in order to avoid the transfer-for-value rule. With respect to this issue, see the IRS guidance in Rev. Rul. 2007-13, 2007-1 CB 684. In Rev. Rul. 2007-13, the IRS ruled that a grantor who is treated as the owner of a trust, that owns a life insurance contract on the grantor's life, is treated as the owner of the contract for purposes of applying the transfer-for-value limitations of Code Sec. 101(a)(2). Therefore, the transfer of a life insurance contract between two grantor trusts that are treated as wholly owned by the same grantor is not a transfer for valuable consideration. And, the transfer of a life insurance contract to a grantor trust that is treated as wholly owned by the insured is a transfer to the insured and is exempt from the transfer-for-value rule. In this regard, some advisers suggest being particularly cautious and include a provision in the trust, such as one that permits the substitution of assets of equal value (see Code Sec. 675(4)), to ensure that the trust be treated as a grantor trust.

Finally, one must be aware of the prohibited transaction rules. Generally, a qualified retirement plan is prohibited from selling plan assets to a "disqualified person," the definition of which includes a participant in the plan and the participant's relatives. However, under Prohibited Transaction Exemption 92-6, a qualified retirement plan can sell life insurance contracts and annuities owned by the plan to a plan participant, a relative of the participant, or to a trust for the benefit of the participant or his or her relatives, if certain conditions are met. One of these conditions is that the policy be sold for its fair market value.

4. Convert split-dollar arrangement to a loan. This particular strategy provides some exciting possibilities for tax savings.

Example 4: A female age 86 had a $1.5 million policy under a collateral assignment split-dollar arrangement established in the early 1990s. The arrangement was grandfathered because it was created prior to the IRS issuing Notice 2002-8, 2002-1 CB 398. The policy was held in a trust and she was reporting the economic benefit stemming from the insurance as income and the gift to the trust beneficiaries each year. The insurance company that issued the policy had a term insurance table that could be used instead of the IRS table [Table 2001] for computing the amount of the economic benefit. However, the insurance company table ended at age 85 and, under IRS Table 2001, the economic benefit for someone age 86 amounted to $99.16 per $1,000 of insurance benefit. As in a typical split-dollar arrangement, part of the death benefit belonged to the corporation and part to the insurance trust. In this case, the portion belonging to the trust would result in the insured having to report an economic benefit amount of approximately $85,000 this year.

Significantly, in Notice 2002-8, Section IV 3, the IRS allows for the possibility of treating an existing split-dollar arrangement as a loan. All of the premium payments up until the time of the conversion election have to be accumulated and they are treated as the initial loan amount. Every subsequent premium payment is a new loan. In this case, the loan was established as a demand loan at the then current interest rate of 0.22 percent. The cumulative premiums paid amounted to roughly $800,000. Accordingly, the resulting economic benefit for the first year of the loan arrangement would be 0.22 × $800,000 = $1,760 in interest, as opposed to the $85,000 taxable income cited above. The interest would be paid from the trust to the corporation, which in this case was a family business. Practically speaking, the insured makes a gift to the trust in an amount sufficient to pay the interest and the trust in turn remits this payment to the corporation. The $1,760 is reportable as interest income, but still this presents a dramatically more favorable result to the insured than paying tax on $85,000 of income.

One major caveat to be concerned with generally is how high interest rates may go in the future. However, with the insured in her 80s, the concern would not be so much about what could happen in 20 or 30 years, but what would happen in the next few years. In this case, the consensus was that there was little risk of interest rates climbing dramatically enough to adversely impact the strategy.

In this particular case, there was no "equity" involved because the cash value in the policy did not exceed the premiums paid. However, if there had been equity present it is arguable that the IRS would consider the conversion of an equity split-dollar arrangement to a loan as a taxable event resulting in income tax and gift tax ramifications. Thus, a point to remember is that if there is a significant amount of equity that has been built up, this particular strategy may not be advisable.

5. Premium financing. The concept of premium financing was very important when the lifetime gift tax exclusion was only $1 million. But, even now it can provide an interesting alternative under certain circumstances.

Example 5: A married couple in their 60s who are heavily invested in real estate and who have exhausted their lifetime exclusions from gift tax are seeking a way to finance the purchase of life insurance, by borrowing premiums from a bank.

The recommended strategy here is to "overfund" the insurance policy with more premiums than would be needed to cover the basic cost of the insurance. Accordingly, the policy will accumulate a large amount of cash value. The policy was structured so that premiums would be paid for nine or 10 years and after 16 years, a loan would be taken from the policy's cash value to repay the bank. At that point there is no more loan owed the bank and the policy has enough cash value to maintain the amount of insurance needed in the future.

Again, future interest rates could be detrimental to this strategy. The questions remain as to when will interest rates go up and how high will they go? If they remain low for a number of years, this may be a very attractive proposition. But, as they go up the strategy becomes more expensive.

And, as with any insurance product, what if the policy does not perform as projected? If it is a whole life policy and the dividend interest rate goes down, how will the death benefit hold up? Accordingly, it is imperative to review with the client various scenarios in which the variables change, such as the loan interest rate goes up or the policy dividend rate goes down, and to be prepared to deal with those contingencies. The client has to go into any life insurance strategy with a clear picture of what could happen—good or bad.

6. Combine insurance planning with GRATs. The American Taxpayer Relief Act of 2012 left grantor retained annuity trusts (GRATs) unchanged. However, they have been the subject of past legislative proposals that, if enacted, would adversely impact the tax benefits of the technique. GRATs could certainly be a target of future tax legislation. In addition, we still have an incredibly low Code Sec. 7520 rate. For example, it is 1.2 percent for February, 2013. With the right kind of assets, GRATs present the possibility to transfer a lot of money to beneficiaries. Consequently, I think it is important to examine ways in which GRATs can be beneficial to our clients in connection with life insurance now before any changes in their tax treatment may occur.

Example 6: In 2003, a female in her 70s purchased a large amount of life insurance. The purchase was funded by a series of loans between the insurance trust and the family business. The business would lend money to the trust each year to pay the premiums and the trust would pay interest back to the family business, with the interest payments being funded by way of gifts from the insured to the trust. At the same time, the insured created a five-year GRAT, the assets of which were to pour over into the insurance trust at the termination of the GRAT. The insured survived the GRAT term and the performance of the GRAT overall turned out to be very successful. Thus, at the end of the five-year period, the ILIT had more than enough money to repay the family business and pay future premiums.

Interestingly, approximately two years prior to the end of the GRAT term, the insured's advisors became concerned that if she died before the five-year period ended there was a risk that a large amount of assets would be includible in her gross estate. Consequently, a strategy was developed to buy short-term insurance coverage to deal with that risk and provide liquidity to the estate to pay the estate tax.

This illustrates that a GRAT ties in with life insurance in two ways. First, it becomes a way of funding an exit strategy from a loan arrangement by putting a lot of money into the ILIT and thereby giving the ILIT the ability to pay back loans. Second, term insurance can be used to cover the mortality risk inherent in a GRAT.