SO, YOU THINK YOU KNOW EVERYTHING ABOUT INCOME TAXATION OF LIFE INSURANCE? THINK AGAIN!

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I. INTRODUCTION

For many years, life insurance has been the "favored child" of the Internal Revenue Code receiving many tax benefits, particularly in the income tax arena. For a policy with cash reserves, the income build-up of the reserve remains income tax-free, unless the policy is totally or partially surrendered. If the insured should die prior to the surrender of the policy, the proceeds (including the income build-up or the cash value) is received income tax-free unless there has been a transfer for value. However, special death benefit rules apply to employer owned life insurance (EOLI). This outline will discuss the general income tax rules in relation to the receipt of insurance proceeds, the cash value growth within the life insurance contract, the deductibility of premium payments by an employer with the question of income taxation to the employee for those premiums and an analysis of the deductibility of interest on loans against the cash surrender value of the policy. There will be an analysis of the rules for tax-free exchange of insurance policies as older policies are being replaced.

II. PROCEEDS OF LIFE INSURANCE CONTRACTS UNDER SECTION 101(A)

A. PROCEEDS PAYABLE BY REASON OF DEATH OF INSURED.

1. General Rule. Generally, gross income of a beneficiary does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of death of the insured. IRC Section 101(a).

2. Other Death Benefits. The exclusion extends to proceeds from additions to the original insurance in the form of paid up additions or term insurance riders. PLR 8111054.

B. CERTAIN ACCELERATED DEATH BENEFITS EXCLUDED FROM GROSS INCOME.

1. Acceleration Under Life Insurance Contract. Amounts received by the owner of a life insurance contract during the lifetime of the insured shall be treated as an amount paid by reason of the death of the insured (and therefore excluded from gross income) if the payment is made by the insurer under either (a) a life insurance contract on the life of an insured who is a terminally ill individual or (b) under a life insurance contact on

the life of an individual who is a chronically ill individual. IRC Section 101(g)(1).

2. <u>Viatical Settlements</u>. Amounts paid by a viatical settlement provider to the owner of a life insurance contract for the sale or assignment of a portion of the death benefit shall be treated as an amount paid under the life insurance contract by reason of the death of the insured (and therefore excluded from gross income) if the life insurance contract is on the life of an insured who is either (a) a terminally ill individual or (b) a chronically ill individual. IRC Section 101(g)(2)(A).

   a. A "viatical settlement provider" means any person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts on the lives of terminally ill or chronically ill insureds.

   b. Such person must be licensed for such purposes in the state in which the insured resides.

   c. In the case of an insured who resides in a state not requiring the licensing of viatical providers, such viatical provider meets the requirements set by Sections 8 and 9 of the Viatical Settlements Model Act of the National Association of Insurance Commissioners and (i) with regard to terminally ill insureds, meet the requirements of the Model Regulation of the National Association of Insurance Commissioners (relating to standards for evaluation of reasonable payments) in determining amounts paid by such person in connection with such purchases or assignments and (ii) with regard to chronically ill insureds, meets the standards (if any) of the National Association of Insurance Commissioners for evaluation of the reasonableness of amounts paid by such person in connection with such purchases or assignments. IRC Section 101(g)(2)(B).

3. "<u>Terminally Ill Individual</u>." An individual who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of certification. IRC Section 101(g)(4)(A).

4. "<u>Chronically Ill Individual</u>." An individual who has been certified within the preceding 12-month period by a licensed health care practitioner as meeting one of the following three criteria (IRC Section 101(g)(4)(B) and 7702B(c)(2)):

   a. Being unable to perform (without substantial assistance from another individual) at least two activities of daily living (*e.g.*, eating, toileting, transferring, bathing, dressing and continence) for a period of at least 90 days due to a loss of functional capacity.

b. Having a level of disability (as determined under regulations prescribed by the Secretary of Treasury in consultation with the Secretary of Health Human Services) to the level of disability described in subsection a. above.

c. Requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment.

5. Special Rules for Chronically Ill Insured. The following restrictions apply to both accelerated benefits under the life insurance contract and payments under a viatical settlement;

a. Such payment is for costs incurred by the payee (not compensated for by insurance or otherwise) for qualified long-term care services provided for the insured for such period. IRC Section 101(g)(3)(A)(i).

b. The terms of the contract giving rise to such payment do not pay or reimburse expenses incurred for services that are reimbursable under Medicare. IRC Sections 101(g)(3)(A)(ii) and 7702B(1)(B). The contract must also meet the standards adopted by the National Association of Insurance Commissioners and the state in which the policyholder resides with regard to chronically ill individuals. IRC Section 101(g)(3)(B).

c. The amount excludable from income is limited to the greater of the cost incurred by the insured for qualified long-term care services or a per diem or other periodic payment received without regard to expenses incurred ($320 per day in 2013) indexed by the cost of living reduced by the aggregate amounts received in reimbursement (through insurance or otherwise) for qualified long-term care services. IRC Sections 101(g)(3)(C) and (D) and 7702B(d)(2).

6. Exception for Business-Related Policies. Normally, the exclusion applies to the owner of the insurance policy even though the owner is not the insured who is chronically ill or terminally ill. However, the exclusion does not apply if the owner has an insurable interest with respect to the life of the insured by reason of the insured being a director, officer, or employee of the owner, or by reason of the insured being financially interested in any trade or business carried on by the owner. IRC Section 101(g)(5).

C. EXCEPTION TO EXCLUSION – POLICY DOES NOT MEET DEFINITION OF LIFE INSURANCE CONTRACT.

1. Not Life Insurance Contract Under Applicable Law. A life insurance contract must be considered a life insurance contract under applicable state or foreign law. IRC Section 7702(a). If the entire contract does not qualify as life insurance under state or foreign law, (*e.g.*, lack of insurable interest), the death proceeds will be included in the gross income of the beneficiary. *Atlantic Oil Co. v. Patterson*, 331 F.2d. 516 (5th Cir. 1964) (Policy was wagering contract rather than an insurance contract under Alabama law because of lack of insurable interest).

2. Failure to Meet Alternative Tests or Variable Diversification.

a. If a contract which is life insurance contract under applicable law does not meet one of the alternative tests below, or the variable diversification requirement of IRC Section 817(h), the excess of the amount paid by reason of the death of the insured over the net surrender value of the contract shall be excludable from gross income. IRC Section 7702(g)(2). In other words, the pure death benefit is excluded as term insurance but the cash value was income during the life of the policy to extent it exceeds basis in the policy.

b. One of the two alternative tests must be met for a life insurance contract under applicable state law to be treated as a life insurance contract under federal law:

(1) The cash value accumulation test (primarily for whole life policies). IRS Section 7702(b).

(2) The guideline premium requirements (IRC Section 7702(c)) and the cash value corridor (IRC Section 7702(d)) (primarily for flexible premium policies).

c. If a variable contract is involved, it must meet the diversification requirements for its cash value investment to be considered a life insurance contract. IRC Section 817(h). It must also meet one of the two alternative tests.

D. EXCEPTION FROM EXCLUSION – TRANSFER FOR VALUABLE CONSIDERATION.

1. Tax Results. If the life insurance contract is transferred for valuable consideration, the beneficiary will include the proceeds in gross income less the consideration paid for the transfer and the premiums or other amounts subsequently paid by the transferee. IRC Section 101(a)(2).

2. <u>What Is a Transfer for Value</u>? It is an assignment or otherwise of a life insurance contract or any interest therein for a valuable consideration. IRC Section 101(a)(2).

   a. It is an absolute transfer for value of a right to receive all or part of the proceeds of a life insurance policy. Thus, the creation, for value, of an enforceable contractual right to receive all or a part of the proceeds of a policy may constitute a transfer for valuable consideration of a policy or an interest therein. Reg. Section 1.101-1(b)(4). A pledge or an assignment of a life insurance contract as collateral security is not a transfer for valuable consideration of such contract or an interest therein. Reg. Section 1.101-1(b)(4). The direct purchase of a policy on the life of its debtor by a creditor is not a transfer for value. *Durr Drug Co*. 99 F.2d 757 (1938).

   b. A transfer of an insurance policy to a non-insured shareholder by a corporation in liquidation was a transfer for value. *Lambeth v. Commissioner*, 38 B.T.A. 351 (1938).

   c. Transfers of policies to non-insured shareholders to finance a cross purchase agreement were transfers for value. *Monroe v. Patterson*, 197 F. Supp. 146 (N.D. Ala. 1961).

   d. Consequently, the purchase of a policy by a viatical settlement provider is a transfer for value resulting in part of the proceeds at death of the insured being taxable although the purchase price paid by the provider can be excluded from the income of the previous policy owner.

3. <u>Exceptions to Transfer for Value</u>.

   a. Transfer to the insured.

   b. Transfer to a partner of the insured or to a partnership in which the insured is a partner.

   c. Transfer to corporation in which the insured is a shareholder or officer.

   d. Transferor’s basis.

4. <u>Transfer to the Insured</u>. A sale of a policy directly to the insured definitely falls within the exception. What about a sale of a policy to a defective trust of which the insured is treated as the owner under IRC Sections 671-677?

a. A Court of Appeals has stated that the transfer is deemed to be to the insured for transfer for value purposes where the insured grantor had the power as trustee to broadly control the beneficial enjoyment of trust property under IRC Section 674. *Swanson v. Commissioner*, 518 F.2d 59 (8th Cir. 1975).

b. If the insured is the grantor of a grantor trust, a sale by a non-grantor trust of a policy on the insured's life to the grantor trust is the same as a sale to the insured and qualifies for the exemption from transfer for value. Rev. Rul. 2007-13, Situation 2, 2007–11 I.R.B. 684. PLR 201332004 (sale of second to die policy from non-grantor trust to husband's grantor trust was a sale to the insured husband for his insurance coverage and a sale to partner of the wife insured since husband and wife were partners).

c. One might think a sale of a policy by the insured's grantor trust or the insured himself to another grantor trust of the insured would also fall into the sale to the insured exception to the transfer for value rule. However, the IRS reached the same result by ruling that a sale of a policy on the life of the grantor from one grantor trust to another grantor trust of the insured was not a "transfer" for transfer for value purposes since the insured was, in effect, selling the policy to himself under the rationale of Rev. Rul. 85-13, 1985-1 C.B. 184. Rev. Rul. 2007-13, Situation 1, *supra*. Since there was no transfer, the purchasing grantor trust took the same basis as the selling grantor trust so that the transferor's basis exception discussed below applied. Presumably, a sale of a policy by the insured to his or her grantor trust would also not be a "transfer" for transfer for value purposes.

5. <u>Exception for Transfer to a Partner of the Insured or to a Partnership in Which the Insured is a Partner</u>. This is a very useful exception in connection with funding various partnership and corporate purchase arrangements.

a. For such a transfer to be exempt, a partnership must have a business purpose. The partners must intend to and actually operate the entity as a viable partnership. *Swanson v. Commissioner*, 518 F.2d 59 (8th Cir. 1975). The partnership must have partners and an objective to carry on business and divide gains therefrom. PLR 9042023.

b. However, the IRS will not rule whether an unincorporated organization is a partnership and whether the transfer of a life insurance policy to such organization is exempt from the transfer for value rule when substantially all of the organization's assets consist or will consist of life insurance policies on the lives of the members. Rev. Proc. 2013-3, 2013-1 I.R.B. 113, Section 3.01(11). Apparently, the IRS position is that 50% or more of partnership assets constituting life insurance is "substantially." *See* PLR 20017051 and PLR 200111038.

c. The following insurance contract transfers fell within this exception to the transfer for value rule:

(1) Transfer of policies on lives of limited partners to the limited partnership. PLR 200111038.

(2) Sale of corporate owned insurance policies on lives of its shareholders to a partnership in which the shareholders were partners to finance a partnership entity purchase or a corporate stock cross-purchase. PLR 7935127. PLR 9309021.

(3) Sale of corporate owned policies on the lives of its shareholders to non-insured shareholders who are also partners of the insured to facilitate a cross-purchase agreement. PLR 9045004. PLR 9239033. PLR 970102.6.

(4) Transfer by a partnership of policies owned on the lives of its partners to the non-insured partner to finance a stock purchase agreement among the partners who own stock in the corporation. PLR 9012063.

(5) Corporate sale of policy to trust which was a partner of the insurer. PLR 9235029 (avoids the three year rule which would have applied had the corporation sold the policy to the insured who would gift it to the trust).

(6) In order to finance a cross purchase agreement for corporation stock and partnership interests, a separate grantor trust owning an insurance policy on one shareholder/partner's life was created by the non-insured shareholders/partners to which the existing insurance policies were transferred and upon the death of the partner, his interest in the grantor trusts would lapse. The transfer of the pre-existing policy to the grantor trust and the transfer of a deceased partner's beneficial interest in such grantor trust were deemed to be transfers to the other partners exempt from transfer for value. PLR 9328010. PLR 9328012. PLR 9328017. PLR 9328019. PLR 9328020. This arrangement avoided multiplicity of insurance policies with each grantor trust owning one policy on one partner's life.

d. A limited liability company, which is taxable as a partnership under the entity classification rules of Reg. Section 301.7701-3, is considered a partnership for transfer for value purposes. *See* PLR 9625013. PLR 9843024. PLR 200111038.

e. The business of a partnership does not have to be related to the policy transfer. PLR 9045004 (corporation which sold musical instruments transferred policies to its non-insured shareholders who are also partners of the insured in an unrelated rental real estate and oil and gas business partnership).

f. A partnership is not a partnership under Section 101 if it checks the box to elect to be treated as any other entity. *See* PLR 20017051.

6. <u>Transfer to Corporation in Which the Insured Is a Shareholder or Officer</u>.

a. If the policy is transferred to a corporation of which the insured is an officer or shareholder, the transfer for value rule does not apply. Reg. Section 1.101-1(b)(5), (Ex. 5).

b. A transfer from the corporation to an officer or shareholder who is not the insured does not fall within this transfer for value exception. *Monroe v. Patterson*, 197 F. Supp. 146 (N.D. Ala. 1961). *Estate of Rath v. United States*, 608 F.2d 254 (6th Cir. 1979). NOTE: This does not go as far as the partner/partnership exception.

c. Also a transfer of a policy to a co-shareholder of the insured for valuable consideration (*e.g.*, to fund a buy sell agreement) does not fall within this exception.

7. <u>Transferor's Basis</u>. If the contract has a basis for determining gain or loss in the hands of the transferee determined in whole or in part by reference to the basis of such contract in the hands of the transferor, this is an exception to the transfer for value rule. IRC Section 101 (a)(2)(A).

a. <u>Tax-Free Reorganization</u>. The transfer of a policy from one corporation to another corporation in a tax free reorganization results in no transfer for value. The basis of the policy owned by the transferee corporation is the same as the basis of the policy to the transferor corporation. Reg. Section 1.101 (b)(5), (Ex. 2).

(1) However, if the policy involved in the tax-free reorganization was already tainted by valuable consideration in a prior transfer, the transfer for value taint carries over to the transferee corporation despite the subsequent tax free exchange. Reg. Section 1.101-1(b)(5), (Ex. 4).

(2) A tax-free reorganization could be a merger, consolidation, or transfer of substantially all of a corporation's property in exchange for voting stock of another corporation. IRC Section 368. Another tax-free transfer involves transfer of property to a corporation controlled by the transferor immediately after the transfer. IRC Section 351.

(3) Note that a purchase of assets from one corporation by another corporation is not a tax free exchange.

b. Interspousal Transfers. The transfer of property to a spouse or former spouse incident to a divorce is deemed to be a gift. Thus, such a valuable transfer is a carryover basis transaction with the basis remaining the same for both spouses or former spouses. IRC Section 1041(b).

(1) The IRS ruled in PLR 20012007 that when the insured husband's grantor trust sold the policy to his wife's grantor trust there was no change in basis. Citing IRC Section 1041(b), the IRS ruled that the acquisition was a gift to the wife and that the transfer for value rule did not apply. However, a transfer by the insured for value to a trust for the spouse of the insured which is not a grantor trust for the spouse would not be protected by IRC Section 1041.

(2) However, the regulation gives an example of a sale of $1,000 policy by a husband to his wife for $600 constituting a transfer for value. Reg. Section 1.101-(b)(5), ex. 6. Note that IRC Section 1041 was effective July 19, 1984 after the above regulation was finalized (1957 amended in 1964 and 1982). Presumably, the statute trumps the regulation.

(3) Note that IRC Section 1041 does not apply to policy transfers to nonresident alien spouses or ex-spouses. IRC Section 1041(d).

(4) Sale of a policy to a trust can be used to avoid the three year estate tax inclusion rule. The insured sells the policy to his or her spouse for full value, the spouse then gives the policy to an irrevocable trust for their children. No transfer for value for insured's sale to spouse. No three year rule for sale to spouse since there is an exception for transfers of a bona fide sale for adequate and full consideration in money or money's worth. The three year rule would not apply to spouse's gift to the trust since IRC Section 2035

only applies to transfers by the insured. However, the spouse cannot be a beneficiary of the irrevocable trust to avoid inclusion in the spouse's gross estate for estate tax purposes.

c. Sale to a Grantor Trust. If the grantor sells an insurance policy to a grantor trust of which he is an income tax owner under IRC Section 671-678, there is no transfer for value since the grantor in selling the policy to himself for income tax purposes and the trust will have the same basis in the policy as the grantor. PLR 200636086. *See*, Rev. Rul. 85-13, 1985-1 C.B. 184. Furthermore, the IRS has privately ruled that there is no "transfer" when the insured's grantor trust sells a policy to another grantor trust of the insured. PLR 20012007. PLR 200228019. PLR 200247006. PLR 200514001. PLR 200514002. PLR 200518061. PLR 200606027.

d. Part Sale/Part Gift. Be careful if a policy subject to a non-recourse loan is transferred to a life insurance trust or a third person.

(1) Loan assumption is consideration. The transfer of a policy subject to a loan to a trust is partly for valuable consideration and partly by gift. Rev. Rul. 69-187, 1969-1 C.B. 45. PLR 8027113. The assumption of the non-recourse loan by the transferee is the valuable consideration.

(2) When a transfer of property is in part a sale and in part a gift, the adjusted basis of the property in the hands of the transferee is the sum of (a) the greater of (i) the amount paid by the transferee for the property or (ii) the transferor's basis for the property at the time of the transfer and (b) the amount of increase, if any, in basis because of the gift tax paid. Reg. Section 1.1015-4.

(3) Thus, when the transferor's basis exceeds the amount of the loan, the transferee's basis is determined by the transferor's basis and the transfer falls within the exception to the transfer for value rule. PLR 8951056. *See also*, Rev. Rul. 69-187, 1969-1 C.B. 45. PLR 8027113. PLR 8628007. Be alert to the IRS position that basis in the sale of an insurance policy is reduced by the mortality changes up to date of sale. Rev. Rul. 2009-13, 2009-21 I.R.B. 1029.

(4) On the other hand, when the amount of the loan exceeds the transferor's basis in the policy, there would be a transfer for value. The loan should be reduced below the transferor's

basis before the policy is given away. Of course, if the insured transfers the policy subject to the loan to the insured's grantor trust, there will be no taxable transfer and thus no transfer for value. Rev. Rul. 85-13, 1985 – 1 C.B. 184.

8. Series of Transfers.

a. If a policy already tainted by transfer for value is sold to another, the policy remains tainted and the transferee may only exclude death proceeds equal to consideration plus subsequent premiums paid by transferee. Reg. Section 1.101-1(b)(3)(i) and (5), Ex. (1).

b. If such a tainted policy is given or transferred in a tax-free reorganization, the transferee may only exclude death proceeds equal to the consideration paid by the transferor and the subsequent premium paid by both the transferee and transferor. Reg. Section 1.101-1(b)(3)(iii) and (5), Ex. (4).

c. However, if such a tainted policy is transferred by gift or valuable consideration to the insured, a partner or partnership of the insured or a corporation of which the insured is an officer or shareholder, the taint is removed and all of the death proceeds are excluded from income. Reg. Section 1.101-1(b)(3)(ii) and (5). Exs. (5) and (7).

E. EXCEPTION — GENERAL RULE THAT EMPLOYER-OWNED LIFE INSURANCE PROCEEDS ARE TAXABLE.

1. Concept. Effective for life insurance contracts issued after August 17, 2006, Congress enacted IRC Section 101(j) to counter the practice of some employers purchasing insurance policies on the lives of a large segment of their employees, in many cases without notice to the employees. These arrangements were derogatorily referred to as janitor insurance or dead peasant insurance. Employers were taking advantage of the tax deferred buildup of cash value and tax free death benefits of life insurance contracts on employees which would be used to provide medical or other benefits to the employees or perhaps to serve as a tax favored investment by the employer. Congress was particularly concerned when such policies were purchased without notice to the insured employee. The new statute would include in the employer's income death proceeds in excess of premium payments, except for a restricted class of employees but only, in such cases, if the insured was notified of, and consented to, the purchase.

2. General Rule. If the employer purchases an insurance policy on the life of a person who is an employee at the time of issue, the general rule is that the death proceeds will be included in the employer's income to the extent

they exceed the amount of premiums and other amounts paid on such contract. IRC Section 101(j)(1) and (3)(A).

a. An "employer" is a person engaged in a trade or business under which such person (or related person) is directly or indirectly a beneficiary under the contract. A "related person" includes any person who bears a relationship to the employer which is specified in IRC Sections 267(b) or 707(b)(1) or is engaged in trades or businesses with such employer which are under common control (within the meaning of subsection (a) or (b) of IRC Section 52). IRC Section 101(j)(3)(A)(i) and (B)(ii). For a discussion of issues raised by the "related person" language, *see* Adney, Keene and Brunt, "COLI in Congress: New Tax Rules Address Concerns and the Product's Future," J. of Financial Service Professionals, Vol 61 (March 2007) 37.

(1) Insurance owned by a qualified pension plan or a VEBA sponsored by the employer is not subject to IRC Section 101(j). Notice 2009-48, 2009-24 I.R.B. 1085, Q/A 1.

(2) Insurance owned by a rabbi trust created by the employer is subject to IRC Section 101(j). Notice 2009-48, Q/A 1.

(3) Insurance owned by a partnership or sole proprietorship on an employee is covered by IRC Section 101(j). But a policy owned by a sole proprietor on his or her life is not covered. Notice 2009-48, Q/A 3.

b. An "insured" under EOLI/COLI is an employee with respect to the trade or business of the employer or related person on the date the life insurance contract is issued. Employee includes an officer, director and highly compensated employee (within the meaning of IRC Section 414(q)). IRC Section 101(j)(3)(A)(ii) and (5)(A). However, the term "insured" is limited to an individual who is a United States citizen or resident and, in the case of a contract covering the joint lives of two individuals, includes both of the individuals. IRC Section 101(j)(5)(B).

3. Exceptions to the General Rule. There are two exceptions to the general rule that death proceeds in excess of premiums and other amounts paid is included in the employer's gross income. If either exception applies, the death proceeds may be excluded from employer income under IRC Section 101(a). Neither exception applies unless certain notice and consent requirements discussed below are met.

a. <u>Exceptions based on employee status</u>.

(1) <u>Rank and file employee</u>. The first exception to death proceeds being included in the employer's income relates to the death of any insured who was either an employee at the date of his or her death or was employee at any time during the twelve-month period before his or her death. IRC Section 101(j)(2)(A)(i). Thus, this exception applies to any employee (even though not a director or highly-compensated employee) but the exception applies only if the employee dies during employment or within twelve months after termination of employment.

(2) <u>Director and highly-compensated</u>. The second exception applies only if the insured at the time the contract was issued is (i) a director, (ii) a highly compensated employee within the meaning of IRC Section 414(q) (2013 compensation in excess of $115,000 or a 5% owner) or (iii) a highly compensated individual pursuant to IRC Section 105(h)(5) (one of five highest paid officers, a shareholder owning more than 10% of the value of employer's stock or among the highest paid 35% of all employees, excluding certain employees who are not participants). Thus if the insured was a director or highly-compensated at the time the policy was issued, the death proceeds are excluded from the employer's income regardless of when employment terminates

b. <u>Exception for amounts paid to insured's heirs</u>. Insurance proceeds received because of the death of the insured employee are not subject to IRC Section 101(j) if payable to:

(1) A family member (within the meaning of IRC Section 267(c)(4)) of the insured, any individual who is the designated beneficiary of the insured under the contract other than the employer, a trust established for the benefit of any such member of the family or designated beneficiary, or the estate of the insured, or

(2) The amount is used to purchase an equity (or capital or profits) interest in the employer from such family member, designated beneficiary, trust or the estate of the insured.

(a) This exception applies to any insurance owned by the employer to finance a stock redemption or business purchase agreement.

(b) Notice 2009-48, Q/A 6 requires that such proceeds be paid or used by the due date of the tax return for the taxable year of the employer in which they are received as a death benefit under the insurance contract.

4. Notice and Consent. For any exception to apply, before the issuance of the contract, the employee (i) must be notified in writing that the employer intends to insure his or her life and the maximum face amount for which the employee could be insured at the time the contract was issued, (ii) provides written consent to being insured under the contract and that such coverage may continue after the employee terminates employment, and (iii) is informed in writing that the employer will be a beneficiary of any proceeds payable upon the death of the employee. IRC Section 101(j)(4).

a. The policy is deemed issued at the latest of date of application, the effective date of coverage or formal issuance of the contract. Notice 2009-48, Q/A 4.

b. A policy owned by a wholly owned corporation on the life of its sole owner/employee must comply with the written notice and consent requirement. Notice 2009-48, Q/A 7.

c. Notice and consent is not needed if the employee transfers a policy to the employer. But notice and consent is required if the employer subsequently increases the insurance coverage. Notice 2009-48, Q/A 8.

d. The policy must be issued before the earlier of one year after consent or termination of employee’s employment. Notice 2009-48, Q/A 9.

e. Notice and consent can be electronic if certain requirements are met. Notice 2009-48, Q/A 11.

f. Notice and consent of “maximum face amount” must be either in dollars or a multiple of salary. Notice 2009-48, Q/A 12.

g. An inadvertent failure to satisfy the notice and consent requirements may be corrected under the following circumstances: (i) the employer made a good faith effort to satisfy those requirements such as maintaining a formal system for providing notice and securing consents from new employees, (ii) failure was inadvertent, and (iii) failure was discovered and corrected no later than the due date of the tax return for the taxable year of the employer in which the policy was issued. Notice 2009-48, Q/A 13.

h. The IRS issued a very favorable ruling that notice and consent were present when, before the policy was issued, the employer and employee signed a buy-sell agreement requiring the employer to buy the insurance and the employee signed the insurance application. PLR 201212017. It is dangerous to follow this ruling since the IRS was bending over backwards to assist a good faith employer who inadvertently failed to give a formal notice and receive a formal consent and the correction period had expired.

5. EOLI/COLI Reporting Requirements. Every employer owning one or more EOLI/COLI contracts issued after the date of enactment shall file a return at such time and in such manner as the Secretary of Treasury shall by regulations prescribe, showing for each year such contracts are owned (1) the number of employees, (2) number of employees insured under EOLI/COLI contracts, (3) the total amount of life insurance in force under EOLI/COLI contracts, (4) the name, address, taxpayer identification number and type of business of the employer, and (5) that the employer has a valid consent for each insured employee (or, if all such consents are not obtained, the number of insured employees for whom such consent was not obtained). The employer is required to keep such records to show that the requirements of IRC Section 101(j) are met. IRC Section 6039(I).

a. A temporary regulation was issued for taxable years ending after November 13, 2007, authorizing the Treasury Secretary to prescribe the form of satisfying the reporting requirements. Reg. Section 1.6039I-1T.

b. Form 8925 “Report of Employer Owned Life Insurance Contracts” was issued January 2008.

c. A final regulation has replaced the temporary regulation setting reporting requirements on Form 8925 for tax years ending after November 6, 2008. Reg. Section 1.6039I-1.

6. Effective Date. The new EOLI/COLI rules apply to insurance contracts issued after August 17, 2006. Section 863(a) of the Pension Protection Act of 2006.

a. A grandfathered insurance policy which is subject to a tax-free exchange under IRC Section 1035 after August 17, 2006, will remain grandfathered from the statute. However, if the new policy obtained in the exchange itself contains material changes, such as increase of death benefit, grandfather status will be lost. Notice 2009-48, Q/A 15 and 16. PLR 200715006.

b. Grandfather status will be lost if there is any material increase in the death benefit or other material change and the policy will be treated as a new contract, forfeiting grandfather status, except that, in the case of a master contract, the addition of covered lives shall be treated as a new contract only with respect to the additional covered lives. Notice 2009-48, Q/A 14.

c. The following are not material changes forfeiting grandfather status: death benefit increase required by IRC Section 7702 definition of life insurance contract or a death benefit increase according to the terms of the existing contract, provided that the insured's consent to the increase is not required. In addition, administrative changes, changes from general to separate account, changes as a result of the exercise of an option or right granted under the contract as originally issued will not be material changes. Examples of nonmaterial changes are an increase in death benefit to preserve the corridor test or cash value accumulation test under IRC Section 7702, and paid up additions from dividends and resulting from market performance or contract design for variable contracts and universal life contracts. Notice 2009-48, Q/A 14.

d. Modification of a split-dollar life insurance arrangement with no change to the underlying life insurance contract is not a material change under EOLI. Notice 2008-42, 2008-15 I.R.B. 747.

7. <u>Application of IRC Section 101(j) to Economic Benefit Regime (Endorsement) Split Dollar</u>.

a. Loan regime split dollar policies would not be covered by IRC Section 101(j) since the policy is owned by the employee or his life insurance trust. The employer is merely a creditor.

b. The statue would apply to economic benefit regime policies owned by the employer.

(1) However, it doesn't apply to the extent the death benefits are paid to a family member of the insured, the insured's designated beneficiary or a trust established for the benefit of the family member or designated beneficiary. Notice 2009-48, Q/A 2.

(2) Nevertheless, IRC Section 101(j) would apply to the equity death proceeds paid to the employer to the extent equity exceeds premiums paid. *See* Richey, Baier and Brody, "Protecting the Income Tax Exemption for Death Proceeds on Employer-Owned Life Insurance: The New Rules Under IRC Sections 101(j) and 6039I." 37 Tax Management Compensation Planning Journal 47 (2009).

c. What about non-equity split dollar arrangements owned by a life insurance trust?

(1) Under a special exception, such non-equity arrangements are treated as owned by the employer so that the economic benefit regime applies rather than the loan regime. Reg. Section 1.61-22(c)(1)(ii)(A)(1-2).

(2) Such a non-equity split dollar arrangement may be used between a life insurance trust and a corporation controlled by the employee/insured. This will allow the use of a term premium to measure economic benefit (rather than the AFR of the loan regime) without potential incidents of ownership under the controlling shareholder regulation. Reg. Section 20.2042-1(c)(6). The controlled corporation is treated as the "owner" under the split-dollar rules, but the trust is the actual owner for estate tax purposes.

(3) Since the employer is treated as owner under IRC Section 61, is the employer also the owner under Section 101(j)? Probably not, although there is no authority. The split dollar regulation containing this special rule for the definition of "owner" states that the definitions "apply for purposes of this section." Reg. Section 1.61-22(c).

F. PARTIAL EXCEPTION TO EXCLUSION — POLICIES OWNED BY QUALIFIED EMPLOYEE BENEFIT PLANS

1. If an insurance contract is purchased by an employee benefit trust described in IRC Section 401(a) which is exempt from tax under IRC Section 501(a), if the employee paid or was taxed on the cost of the insurance while living and the proceeds from such contract are payable directly or indirectly to the beneficiary of the insured participant, at the death of the insured, the proceeds at the death of the insured in excess of the cash surrender value of the policy are not includable in gross income of the beneficiary and the amount equal to the cash surrender value of the policy immediately before the death of the insured will be treated as a distribution from the plan. IRC Section 72(m)(3)(C). Reg. Section 1.72-16(c).

2. The portion of the proceeds in excess of cash value are excludable from the beneficiary's income only if they are paid directly to the beneficiary or indirectly to the beneficiary. Where the proceeds are payable to the trustee but, under the terms of the plan, the trustee is required to pay over all of such proceeds to the beneficiary, the proceeds are indirectly paid to the beneficiary. Reg. Section 1.72-16(b)(1).

3. If the insurance policy was a key person policy which was owned by, and payable to, the plan and the employee neither paid the cost of life insurance protection nor realized taxable income for such protection, the entire distribution of assets from the plan (including insurance proceeds) will be considered a taxable distribution to the beneficiaries. Reg. Section 1.72-16(c)(4).

G. EXCEPTION TO EXCLUSION -- PROCEEDS COMPENSATION OR DIVIDENDS

1. <u>Employer/Corporation Is Policy Owner and Beneficiary</u>. If the policy on the life of the insured employee/shareholder is owned by and payable to the employer/corporation, the proceeds are not taxable to either the employer/corporation or the employee/shareholder when paid to the employer/corporation (assuming the EOLI rules of IRC Section 101(j) are met).

    a. However, if the employer/corporation distributes the proceeds to a shareholder, the proceeds are dividends since the tax free status ends after receipt of the proceeds. Rev. Rul. 71-79, 1971-1 C.B. 12.

    b. Likewise, if the employer distributes the proceeds to the employee's widow in discharge of a death benefit deferred compensation agreement, the proceeds are income to the widow. *Essenfield v. Commissioner*, 311 F.2d 208 (2d Cir. 1962).

2. <u>Employer/Corporation is Policy Owner but Not Beneficiary</u>. Income tax consequences are not clear.

    a. If the corporation is the owner but someone else is the irrevocable beneficiary, the death proceeds would not be dividends since the corporation does not possess all incidents of ownership in the policy. *See* Rev. Rul. 61-134, 1961-1 C.B. 250. But the premiums might be dividends to the shareholder if there is such an irrevocable beneficiary. *Commissioner v. Bonwit*, 87 F.2d 764 (2d Cir. 1937).

    b. Where the corporation has all incidents of ownership including the right to change beneficiaries, if the beneficiaries are shareholders of the corporation, as a general rule the IRS will treat the death proceeds as dividends (as if the corporation had collected the proceeds and paid them to the shareholders). Rev. Rul. 61-134, 1961-2 C.B. 250.

        (1) However, the IRS has ruled that the death proceeds payable to the insured shareholder's widow, who is not herself a shareholder, are not dividends or income with respect to a

decedent under IRC Section 691 even though the corporation was the sole owner and premium payor of the policy. TAM 8144001.

(2) Where the corporation owned and paid premiums on a policy on the life of its controlling shareholder, the proceeds paid directly to the widow of the insured were not dividends although the widow was herself a minority shareholder. *Estate of Horne v. Commissioner*, 64 T.C. 1020 (1975), *acq. in results*, 1980-1 C.B. 1. The court's rationale was that the corporation had no incidents of ownership since they were attributed to the insured under the controlling shareholder Regulation Section 20.2042-1 (c)(6). The court applied the estate tax rule to avoid a constructive dividend and a possible double tax-estate and income.

c. The Third Circuit also concluded that death proceeds were a dividend from a policy owned by the corporation payable to a trust for the benefit of shareholders. *Golden v. Commissioner*, 113 F.2d 590 (3rd Cir. 1940).

d. However, the Sixth Circuit has taken the opposite position that corporate owned policy death proceeds payable directly to shareholders did not constitute dividends. *Ducros v. Commissioner*, 272 F.2d 49 (6th Cir. 1959), *nonacq*, Rev. Rul. 61-134, 1961-2 C.B. 250.

e. Presumably, if the insured is an employee and the beneficiaries are not shareholders, the death proceeds would not be compensation to the beneficiaries by analogy with the above authority concerning shareholders.

f. It may be possible to exclude death proceeds from income if the employer/corporate premium payments are taxable to the employee/shareholder.

(1) The theory is that the insured shareholder/employee would own the insurance death coverage produced by premiums which were included in the insured's income.

(2) The Tax Court has held that the premiums paid by the employer/corporation on a policy on the life of its president/shareholder are not taxable to the insured even though the insured's family is the beneficiary when the employer/corporation can change the beneficiaries.

Rodebaugh v. Commissioner, 33 T.C.M. 169 (1974), *aff'd on another issue*, 518 F.2d 73 (6th Cir. 1975).

(3) However, in dicta, the *Rodebaugh* court suggested that the term premium of the insurance coverage enjoyed by the insured's family might be income to the insured citing split dollar authority. If so, then the death benefit would be paid for and the death proceeds would be owned by the employee/shareholder and tax exempt under IRC Section 101(a).

(4) To eliminate any possibility that all or part of the insurance proceeds would be subject to income tax, the employer/corporation should enter into a formal economic benefit split dollar arrangement with the insured or his life insurance trust.

III. CASH VALUE GROWTH OF LIFE INSURANCE CONTRACT

A. GENERAL RULE – NOT CURRENTLY TAXED.

The inside build-up of the cash value of a life insurance contract is not subject to income taxation before distributions in the form of surrenders, withdrawals or dividends. IRC Section 72(e). IRC Section 7702(g). Of course, if the cash value is held in the contract until the death of the insured, the entire death proceeds, including the cash value immediately before death, will be excluded from gross income under IRC Section 101(a).

Cash value increases are not taxed to the policy owner under constructive receipt rules since access would be subject to substantial restrictions and limitations involving a surrender or partial surrender of the policy. *Cohen v. Commission*, 39 T.C. 1055 (1965), *acq.*, 1964-1 C.B. 4. *Nesbitt v. Commissioner*, 43 T.C. 629 (1965).

B. FAILURE TO MEET DEFINITION OF LIFE INSURANCE CONTRACT EXCEPTION

1. <u>Applicability</u>. The general rule does not apply to any life insurance policy under applicable law which does not meet the alternative tests for a life insurance contract under IRC Section 7702(a). IRC Section 7702(g)(1)(A). Also any life insurance policy which fails the diversification requirements for variable contracts is excepted from the general rule. IRC Section 817(h).

2. <u>Results</u>.

a. When a life insurance contract is disqualified, the income on the contract for any taxable year shall be treated as ordinary income received or accrued by the policyholder during such year. IRC Section 7702(g)(1)(A).

b. If, during any taxable year, the contract which is a life insurance contract under applicable law ceases to meet one of the alternative tests under IRC Section 7702(a), the income on the contract for all prior years shall be treated as received or accrued by the policyholder during the taxable year in which such cessation occurs. IRC Section 7702(g)(1)(C).

3. Once Disqualified, Always Disqualified. Once a policy fails to meet the test, it will remain disqualified even though it might meet the test requirements in a future year.

4. "Income on the Contract". With respect to any taxable year of a policyholder, the taxable "income on the contract" includes the sum of (i) the increase in the net surrender value of the contract during the taxable year and (ii) the cost of life insurance protection provided under the contract during the taxable year reduced by premiums paid during the taxable year. IRC Section 7702(g)(1)(B)(A).

a. The "net surrender value" of the contract shall be determined with regard to surrender charges but without regard to any policy loan.

b. The "cost of insurance protection" during the taxable year is based upon the lesser of the (i) the uniform premium tables (computed on the basis of 5-year age brackets) to be prescribed by regulations or (ii) the mortality charge, if any, stated in the contract. IRC Section 7702(g)(1)(D).

5. Reporting Requirements. If the life insurance contract is disqualified, then the income on such contract is a non-periodic designated distribution subjecting the insurance company to the record keeping, recording, withholding, and deposit requirements of the Code. Rev. Rul. 91-17, 1991-1 C.B. 190.

C. DIVIDENDS, WITHDRAWS, SURRENDERS, AND SALES OF POLICY EXCEPTION.

1. General Rule. Except with regard to modified endowment contracts, as a general rule, dividends, withdraws and proceeds from the surrender or sale of a policy that are not received as an annuity are considered a return of basis (the investment in the contract). IRC Section 72(e)(5)(A)(C). In other words, such distributions reduce basis first with the excess being included in gross income.

2. "Investment in the Contract." Investment in the contract or basis as of any date is the aggregate amount of premiums or other considerations paid for

the contract before such date, less the aggregate amount received under the contract before such date to the extent that such amount was excludable from gross income. IRC Section 72(e)(6).

a. “Premiums Paid.” The starting point in determining basis is the aggregate premiums paid by the taxpayer.

(1) Premium payments for the following benefits are not includable as part of the premium in determining investment in the contract: disability income, double indemnity provisions, disability waiver premiums. Rev. Rul. 55-349, 1951-1 C.B. 232. *Estate of Wong Wing Non v. Commissioner*, 18 T.C. 205 (1952).

(2) Interest payments on policy loans are not included in determining investment in contract. *Chapin v. McGowan*, 271 F.2d 856 (2nd Cir. 1959).

(3) For insurance policies with long term care riders, charges against cash value will reduce basis but the charge will not be includable in gross income. IRC Section 72(e)(11).

b. Other Consideration Paid. If there has been a transfer of the insurance policy for valuable consideration, then the new owner’s investment in the contract would be the amount of consideration paid at the time of transfer plus any subsequent premiums paid, reduced by any dividends, withdraws or funds received from the policy to the extent not included in gross income. In some situations, the transferee will maintain the basis of the transferor despite the payment of consideration — transfer from one corporation to another corporation in a tax-free reorganization; transfer of a policy partially as a gift and partially for consideration when the transferor’s basis exceeds the consideration paid; transfer of policies between spouses or between former spouses incident to a divorce; tax-free exchange of policies under IRC Section 1035.

3. Dividends. With regard to participating insurance policies, dividends benefiting or directly paid to the policyholder will reduce the investment in the contract. IRC Section 72(e)(1)(B). If the dividend distribution plus all previous non-taxable distribution withdraws exceed the investment in the contract, the excess would be ordinary income. IRC Section 72(e)(5)(A).

a. Dividends received in cash will reduce basis. Reg. Section 1.72(b)(2). Presumably, dividends left with the insurance carrier without restriction to accumulate interest would reduce basis under constructive receipt. Interest earned on the retained dividends does not reduce basis but is currently taxable to the policyholder under constructive receipt rules. *Cohen v. Commissioner*, 39 T.C. 1055 (1963,), *acq.*, 1964-1 C.B. 4.

b. Presumably, dividends used to purchase policy riders and other benefits not integral to the insurance policy would reduce basis — disability income, waiver of premium upon disability, accidental death insurance, term insurance riders. *See Estate of Wong Wing Non v. Commissioner*, 18 T.C. 205 (1952).

c. However, dividends used to purchase paid up additions do not reduce basis since the reduction in basis under the original policy will be offset by the premium paid on the additions.

d. Dividends used to pay principal or interest on policy loans reduce basis. Reg. Section 1.72-6(a)(1). *Brown v. Commissioner*, 693 F.3d 765 (7th Cir. 2012).

e. Dividends used to pay policy premiums also reduce the basis. *Brown v. Commissioner, supra*.

4. Withdrawals.

a. General Rule. As a general rule, with regard to a policy which is not a modified endowment contract, cash distributions from withdraws or partial surrenders will not be included in the policy owner's gross income if they do not exceed the investment in the contract. IRC Section 72(e)(5)(A). Withdrawals first come from basis and only then from income build-up within the policy.

b. Fifteen Year Exception. There is an exception for withdraws from the policy within the first fifteen years after issuance of the policy if there is a reduction in the death benefit under the contract. IRC Section 7702(f)(7).

(1) In such a case, the order is reversed so that income comes out first and basis second up to a recapture ceiling. IRC Section 7702(f)(7)(B).

(2) If the withdraw occurs during the first five years, there are two recapture ceilings depending on the type of policy involved.

(a) in the case of a traditional contract qualifying under the cash value accumulation test, the recapture ceiling is the excess of the cash surrender value of the contract, immediately before the reduction, over the net single premium immediately after the reduction.

(b) in the case of a universal life contract qualifying under the guideline premium/cash value corridor test, the recapture ceiling is the greater of the excess of the aggregate premiums paid under the contract, immediately before the reduction, over the guideline premium limitation for the contract taking into account the reduction in benefits or the excess of the cash surrender value of the policy, immediately before the reduction, over the cash value corridor, determine immediately after the reduction.

(3) If the withdraw occurs after the fifth year and before the sixteenth year, the recapture ceiling is the excess surrender value of the contract, immediately before the reduction, over the cash value corridor, determined immediately after the reduction.

(4) The distribution rules of IRC Section 7702(f)(7) also apply to any distribution which reduces the cash surrender value of the contract which is made within two years before reduction in death benefits under the contract.

(5) Except for modified endowment contracts, since loans against the cash value of insurance policies are not treated as distributions and do not reduce the death benefits, loans are not subject to this special fifteen year rule.

5. Redemptions, Surrenders or Maturities.

a. General Rule. Any amount received under a contract upon its complete surrender, redemption, or maturity shall be included in gross income but only to the extent it exceeds the investment in the contract. IRC Section 72(e)(5)(A)(E). Rev. Rul. 2009-13, Situation1, 2009-21 I.R.B. 1029. Such amount is taxed as ordinary income and not as capital gain. *Blum v. Higgins*, 150 F.2d 471 (2nd Cir. 1945). Proceeds received from surrender of paid up additions also reduce basis first. *Brown v. Commissioner, supra.*

b. Settlement Option Prior to Maturity or Surrender. There is an exception when there is a postponed receipt of the proceeds under a settlement option and payment is received in another format (*e.g.*, an annuity or deposit of proceeds with payment of interest only). In such a case, income will be taxed to the beneficiary upon receipt rather than at the date of surrender. *Frackelton v. Commissioner*, 46 B.T.A. 883 (1942).

c. The Sixty Day Rule. There is another exception relating to certain annuity options elected after maturity or surrender. Although the surrender proceeds in excess of the investment in the contract would normally be included in the gross income of the policyholder if he is entitled to a lump sum distribution after the policy has matured or been surrendered, income is not recognized if the policyholder before receipt of the lump sum and within sixty days after the surrender or maturity exercises an option or irrevocably agrees with the insurance carrier to take the payments in the form of an annuity. IRC Section 72(h). Reg. Section 1.72-12. In such a case, future distributions would be taxed to the policyholder under the annuity rules of IRC Section 72.

d. Does IRC Section 1234A change the results of the gain from the surrender of a policy from ordinary income to capital gain? That section states in part that "gain or loss attributable to the cancellation, lapse, expiration or other termination of … a right or obligation … with respect to property which is … a capital asset in the hands of the taxpayer … shall be treated as gain or loss from the sale of a capital asset." The IRS position is that, although the insurance policy may itself be a capital asset, the internal buildup of cash value is ordinary income to which IRC Section 1234A does not apply. Rev. Rul. 2009-13, Situation 2, 2009-21 I.R.B. 1029. TAM 200452033.

6. Sale of Life Insurance Contract. If a policy is sold, the seller will realize ordinary income (not capital gain) on the amount of sale proceeds in excess of the investment in the contract up to the amount of the inside build up. *Gallun v. Commissioner*, 327 F.2d 809 (7th Cir. 1964). Rev. Rul. 2009-13, Situation 2, 2009-21 I.R.B. 1029. *Commissioner v. Phillips*, 275 F.2d 33 (4th Cir. 1960). IRC Section 72(e)(5)(A).

a. The internal build up in excess of cost basis represents accumulation of interest income rather than appreciation of capital and is therefore ordinary income. *Neese, Jr. v. Commissioner*, 23 TCM 1748 (1964) ruled that the ordinary income accretion to cash value of an insurance policy is not a capital asset.

b. If the insurance policy is subject to a non-recourse loan, the sale price is determined by the sum of the property received by the seller plus the amount of the loan. PLR 8951056.

c. As noted earlier, there is an exception for policies sold to a viatical settlement provider pursuant to IRC Section 101(g)(2)(A).

d. What if a life settlement policy not eligible for viatical treatment is sold. In Revenue Ruling 2009-13, Situations 2 and 3, 2009-21 I.R.B. 1029, the IRS ruled that the excess sales proceeds over the greater of basis and cash value is capital gain.

e. Reduced by Mortality Charges.

(1) IRC Section 72 does not reduce basis by mortality charges when determining the taxability of withdrawals and distributions from a life insurance policy. *See* Rev. Rul. 2009-13, Situation 1, 2009-21 I.R.B. 1029. IRC Section 72 covers amounts received under the insurance contract and does not address the basis of a life insurance policy when the policy is sold or transferred. Many practitioners thought that the basis for distribution and withdrawal under IRC Section 72 also applies to sales or transfers of insurance policies. The IRS disagrees.

(2) When a policy is sold, the IRS looks to IRC Section 1001 for the determination of gain or loss on the sale of property. The basis for determining gain or loss is the cost of acquiring such property adjusted "for expenditures, receipts, losses or other items, properly chargeable to the capital account." IRC Sections 1012 and 1016. The IRS has ruled that, with regard to the sale of a policy by the insured, the basis or investment in the contract is reduced by the cost-of-insurance (mortality) charges over the term of the policy. Rev. Rul. 2009-13, Situations 2 and 3, s*upra*. Rev. Rul. 2009-14, Situation 2, 2009-21 I.R.B. 1031. PLR 9443020. ILM 200501004. The cost-of-insurance is presumed to equal the premium on a term policy. In so ruling, the IRS position is that insurance premiums pay for two items – the investment in the cash value and the insurance protection. For the basis in the cash value investment in the policy, the cost-of-insurance protection premium is ignored. Strangely, in a situation where the owner of the policy bought the policy solely with a view to profit (such as a life settlement purchase), when the owner for profit later sells the policy, such owner's basis is not reduced by cost-of-insurance protection and his basis is consideration paid plus subsequent premiums. Rev. Rul. 2009-14, Situation 2, *supra*. Thus the reduction in basis for mortality charges appears to apply only to policies owned by the insured or someone who purchased the policy for protection against any loss upon the insured's death.

(3) The IRS position is that premiums are reduced by the cost-of-insurance protection or mortality charges before the date of the sale. Rev. Rul. 2009-13, Situations 2 and 3, *supra*. Rev. Rul. 2009-14, Situation 2, 2009-21 I.R.B. 1031. PLR 9443020. ILM 200501004.

(4) The IRS position is controversial. The private letter ruling cited three court cases. *Century Wood Preserving Co. v. Commissioner*, 69 F.2d 967 (3rd Cir. 1934). *Keystone Consolidated Publishing Co. v. Commissioner*, 26 BTA 1210 (1932). *London Shoe Co. v. Commissioner*, 80 F.2d 230 (2nd Cir. 1935), *cert. denied*, 238 U.S. 663 (1936). The facts of those cases involve sales or surrenders of insurance policies where the premiums exceeded the sales proceeds or cash surrender value. Thus, the courts determined that basis to measure a loss is based upon premiums reduced by cost-of-insurance protection.

(5) However, in *Forbes Lithograph Manufacturing v. White*, 42 F.2d 287 (N.D. Ma. 1930), the court allowed the taxpayer to recognize a loss when the surrender proceeds for the insurance policy were less than the premiums paid. There are no court decisions involving basis in a sale of a policy for gain.

(6) In *Lucas v. Alexander*, 279 U.S. 573 (1929), the U.S. Supreme Court determined that the realized gain on the surrender proceeds of an insurance policy was the amount in excess of the total premiums paid. Technically, the Supreme Court did not consider the cost basis in the policy but merely the realized gain which was exempt from income taxation because it preceded the Federal income tax.

(7) Thus it is not clear whether the IRS position is correct that the cost of insurance policy is always reduced by the mortality charges. There are two alternative arguments. One is that the premium is basis without any reduction for mortality charge. The other position is that the full premium is the measure of basis for determining gain but the premium less mortality charge is used to determine loss.

(8) Consider this analogy. The basis in your home is not reduced by the fair rental value of your use of the home. Why should the basis in your life insurance policy be reduced by the cost-of-insurance coverage you receive? The IRS answer is that the policy is two items of property –

an investment in cash value and death coverage. Some of the investment is taken to continue the death coverage.

D. MODIFIED ENDOWMENT CONTRACT EXCEPTION.

1. Purpose. The Modified Endowment Contract ("MEC") rules were adopted by Congress to discourage the sale of insurance policies as tax shelter investment vehicles (rather than for family, creditor and business investment purposes) through the payment of large single premiums for policies with the minimum amount of pure insurance coverage under the definition of life insurance contract. These policies could generate significant internal income which could be accessed without income taxation by the owner through withdrawals or loans at minimum interest rates.

2. Definition of MEC. A MEC means any contract meeting the requirements of IRC Section 7702 which is entered into on or after June 21, 1988 and fails to meet the 7-pay test. IRC Section 7702A(a)(1). A new contract received in exchange for a MEC is also a MEC. IRC Section 7702A(a)(2).

a. "7-Pay Test." A contract fails to meet the 7-pay test if the accumulated amount paid under the contract at any time during the first seven contract years exceeds the sum of the net level premiums which would have been paid on or before such time if the contract provided for paid up future benefits after the payment of 7 level annual premiums. IRC Section 7702A(b). "Amount paid" means the premiums paid under the contract reduced by any amount received in a distribution not includable in gross income. IRC Section 7702A(e)(1)(A).

(1) The 7-pay test will be determined at the time the contract is issued by applying the cash value accumulation test of IRC Section 7702(b)(2) subject to the computational rules of IRC Section 7702(e) except that the death benefit provided for the first contract year shall be deemed to be provided until the maturity date without regard to any scheduled reduction after the first seven contract years. IRC Section 7702A(c)(1). Charges for qualified additional benefits are taken into account in determining if the 7-pay test is met. Rev. Rul. 2005-6, 2005-6 I.R.B. 471.

(2) If there is a reduction in death benefits under the contract within the first seven contract years, the 7-pay test will be applied as if the contract had originally been issued at the reduced benefit level. Any reduction in benefits attributable to non-payment of premiums due under the

contract shall not be taken into account if the benefits are reinstated within 90 days after reduction in such benefits. IRC Section 7702A(c)(2).

(3) If the contract is a second-to-die policy, and there is a reduction in death benefit below the lowest level of death benefit provided under the contract during the first seven contract years, the 7-pay test will be applied as if the contract had originally been issued at the reduced benefit level. IRC Section 7702A(c)(6).

b. Material Changes. If there is a material change in the benefits under (or in other terms of) the life insurance contract which was not reflected in any previous determination, such contract shall be treated as a new contract entered into on the day on which such material change takes effect and the 7-pay test shall be applied again. IRC Section 7702(A)(c)(3).

(1) A "material change" includes any increase in the death benefit under the contract or any increase in, or addition of, a qualified additional benefit under the contract. IRC Section 7702A(c)(3)(B).

(2) "Material Change" shall not include (a) any increase which is attributable to the payment of premiums necessary to fund the lowest level of the death benefit and qualified additional benefits payable in the first seven contract years or to crediting of interest or other earnings (including policyholder dividends) in respect of such premium and (b) to the extent provided in regulations not yet issued, any cost of living increased based on an established broad-based index if such increase is funded ratably over the remaining period during which premiums are required to be paid under the contract. IRC Section 7702A(c)(3)(B)(i)(ii).

(3) In applying the 7-pay test to a policy after a material change, appropriate adjustments are made to the cash surrender value. IRC Section 7702A(c)(3)(A)(ii). However, if cash surrender value is artificially repressed, fair market value of the contract will be used instead. A series of material changes is not intended to circumvent the limitations in IRC Section 7702A. "Technical Explanation of the Job Creation and Worker Assistance Act of 2002," Staff of Joint Committee on Taxation, p. 45. The 7-pay premium for each of the first seven contract years after the change is to be reduced by the product of (a) the cash surrender value of the contract as of the date that the

material change takes effect (determined without regard to any increase in the cash surrender value that is attributable to the amount of premium payment that is not necessary), and (b) a fraction the numerator of which equals the 7-pay premium for the future benefits under the contract, and the denominator of which equals the net single premium for such benefits computed using the same assumptions used in determining the 7-pay premium. HR Conf. Rep. No. 100-1104 at p. 105. "Technical Explanation of Job Creation and Worker Assistance Act of 2002," *supra* p. 45.

3. Taxation of Distributions from MEC.

a. Income First Rule. The tax consequences of distributions from a MEC are the exact opposite of the distributions from a non-MEC. Distributions will be deemed to come from the income build-up in the cash value of the policy first with distribution of investment in the contract coming second. Furthermore, any loans against the policy or assignment or pledge of the policy will be treated as a distribution. IRC Section 72(e)(10). In other words, distributions from a MEC are taxed in the same manner as distributions from a tax deferred annuity.

(1) In determining the amount includable in gross income, all MECs issued by the same insurance company to the same policyholder during any calendar year shall be treated as one MEC. IRC Section 72(e)(11)(A)(i). See Rev. Rul. 2007-38, 2007-1 C.B. 1420 and PLR 200801001 regarding impact on tax-free exchange of less than all aggregated MECs.

(2) A MEC loan will be treated as a distribution even though the policy owner is a person other than an individual. IRC Section 72(e)(10)(A)(ii).

b. Dividends. With regard to a participating policy, dividends received in cash or used to pay the principal or interest on a policy loan are distributions taxable to the extent of income build-up in the cash value. On the other hand, a dividend under a MEC retained by the insurer to purchase additional paid-up insurance or a qualified additional benefit or to pay a premium is not a taxable distribution. HR Conf. Rep. No. 100-1104, page 102. As noted earlier, presumably, dividends used to purchase riders which are not integral to the policy would be treated as distributions – waiver of premium upon disability, term insurance rider, disability income, *etc.*

c. Loans. As noted above, a loan against a MEC is considered to be a taxable distribution to the extent of income build-up of the cash value. IRC section 72(e)(4). Amounts borrowed under the MEC retained by the insurer as premium under the contract is a distribution. If the amount of loan is includable in gross income, the policyholder's investment in the contract is increased by the amount of the loan. HR Conf. Rep. No. 100-1104 at pp. 592/593.

d. Distributions Affected. If a contract is a MEC, distributions are affected during the contract year in which the MEC fails the 7-pay test and during any subsequent contract year. IRC Section 7702A(d).

e. Anticipatory Distributions. Any distribution from an insurance contract which is made within two years before the failure to meet the 7-pay test shall be treated as made in anticipation of such failure. IRC Section 7702A(d).

4. Ten Percent Additional Tax on MEC Distributions.

a. If a taxpayer includes a MEC distribution in his or her gross income, his tax will be increased by an amount equal to 10 percent of the distribution so included. IRC Section 72(v)(1).

b. The 10 percent additional penalty tax will not apply in the following situations (IRC section 72(v)(2)):

(1) Distributions after taxpayer attains age 59½

(2) Distributions attributable to the taxpayer's becoming disabled (within the meaning of IRC section 72(m)(7)).

(3) Distributions which are a part of a series of equal periodic distributions made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of the taxpayer and his beneficiary.

5. Effective Date. Generally, the MEC rules apply to life insurance contracts entered into on or after June 21, 1988. TAMRA Section 5012(e)(1).

6. Grandfathering Rules. As a general rule, life insurance contracts issued before June 21, 1988, are grandfathered from the MEC rules.

a. Grandfathering is lost if the death benefit under the contract increases by more than $150,000.00 over the death benefit under the contract in effect on October 20, 1988. The 7-pay rules would apply as if this were a material change in testing whether this is a MEC.

b. The grandfathering status is not lost if the policy as of June 21, 1988, required at least seven level annual premium payments and under which the policyholder continues to make level annual premium payments over the life of the contract (the typical whole life contract). TAMRA Section 5012(e)(2).

c. Grandfathering is lost if, on or after June 21, 1988, the death benefit under the contract is increased (or a qualified additional benefit is increased or added) and before June 21, 1988, the owner of the contract did not have a unilateral right under the contract to obtain such increase or addition without providing additional evidence of insurability. TAMRA Section 5012(e)(3)(A).

d. Grandfathering is lost if the contract is converted after June 20, 1988, from a term life insurance contract to a life insurance contract providing coverage other than term life insurance coverage without regard to any right of the owner of the contract to such conversion. TAMRA Section 5012(e)(3)(B).

e. The IRS has privately ruled that grandfather status will not apply to a new insurance contract issued in exchange for a grandfathered policy under IRC Section 1035. PLR 9044022.

E. SECTION 1035 TAX-FREE EXCHANGE OF LIFE INSURANCE CONTRACT.

1. Purpose. Normally, the surrender of a life insurance contract with the purchase of a new life insurance contract with the surrender proceeds would result in the inclusion in the gross income of the policy owner that portion of the surrender proceeds in excess of his or her investment in the contract. However, if the requirements of IRC Section 1035 are met, the old insurance policy can be exchanged for a new insurance policy without triggering income.

2. Code Section 1035. No gain or loss shall be recognized on the exchange of a contract of life insurance (which is not ordinarily payable in full during the life of the insured) for another contract of life insurance or for an endowment, an annuity contract or a qualified long-term care insurance contract. IRC Section 1035(a)(1) and (b)(3).

a. However, the reverse is not true. There is no tax free exchange of an endowment, an annuity contract or a qualified long term care contract for a life insurance policy. IRC Section 1035(a)(2)-(4). Reg. Section 1.1035-1(c).

b. Many of the citations in this section apply to annuity exchanges but the rules should be the same for life insurance policy exchanges.

c. The owner of the contract which is exchanged does not have to be the insured. However, presumably, the owner of both the surrendered and the new contracts have to be the same. Some argue that the exchange of a policy owned by the insured for a new policy owned by the insured's irrevocable grantor life insurance trust is the same owner. This is based by analogy to the transfer for value ruling that the purchase of a policy by a grantor trust is equivalent to a purchase by the grantor insured. Rev. Rul. 2007-13, 2007-11 I.R.B. 684. However, this is risky since the trust is a separate legal entity and the IRS might treat it as a separate owner for IRC Section 1035 purposes. Proponents of this analogy seek to avoid the three-year rule of IRC Section 2035 by having the trust own all incidents of ownership of the new policy at all times. The IRS has not ruled on whether this technique would avoid the three-year rule.

3. <u>The Same Insured Requirement. The reg</u>ulation states that IRC Section 1035 does not apply if the policies exchanged do not relate to the same insured. Reg. Section 1.1035-1.

a. As long as the same insured is involved, exchanges involving multiple policies are tax free. PLR 9708016 (two policies for one annuity). PLR 90177062 (two policies for two participating interests in group policy).

b. The substitution of one insured for another under an option contained in a corporate-owned life insurance policy did not qualify as a tax-free exchange of insurance contracts under IRC Section 1035. Rev. Rul. 90-109, 1990-2 C.B. 191.

c. The exchange of a second-to-die policy after the death of the first insured to die for a new life insurance policy on the surviving insured's life qualified as a tax-free exchange. PLR 9248013. PLR 933040. PLR 201304003.

d. In PLR 9542087, the IRS determined that the following exchanges to acquire a second-to-die policy do not qualify for tax-free treatment:

(1) Married policyholder exchanges life insurance contract insuring his own life for a second-to-die insurance contract on the lives of both the owner and his spouse.

(2) Married policyholder exchanges two life insurance contracts, one of which insures the life of the owner and one of which insures solely the life of his spouse), for a

second-to-die insurance contract on the lives of both spouses.

(3) Married owners jointly exchange separate life insurance contracts each of which insures solely the life of one spouse for a jointly owned second-to-die life insurance contract which covers the lives of both spouses.

(4) Trust exchanges life insurance contract on life of one spouse for a second-to-die life insurance contract on the lives of both spouses.

(5) Trust exchanges two life insurance contracts, one of which insures the life of one spouse and one of which insures the life of each spouse, for a second-to-die insurance contract on the lives of both spouses.

(6) Presumably, an exchange of a second-to-die policy for another second-to-die policy on the lives of the same insureds would qualify. The 1995 private letter ruling casts doubts on the tax-free nature of a division of a second-to-die policy into separate policies insuring a single life of the formerly joint insureds.

4. What Is An Appropriate Exchange?

a. The only safe approach is for the policyholder to assign the existing life insurance contract to the insurance company which surrenders the old policy and issues a new policy purchased from the surrender proceeds. Rev. Rul. 72-358, 1972-2 C.B. 473. This is called inside procedure.

b. Can there be a tax-free exchange if the surrender proceeds from the old policy are made available to the insured even if the insured immediately purchased the second policy with the proceeds (the outside procedure)?

(1) There are no rulings on point involving exchanges of life insurance contracts but the rulings discussed below on annuity exchanges would indicate a negative IRS position.

(2) Exchange of one annuity for another annuity is not tax-free unless the inside procedure is followed by assigning the annuity contract to the new insurance carrier for surrender. Rev. Rul. 2007-24, 2007-21 I.R.B. 1282. PLR 200622020.

(3) However, the IRS made an exception for nontransferable annuity from an IRC Section 403(b) or a qualified plan. In

such a case, the old insurance company may issue a check to the policyholder if the policyholder endorses the check to the new insurance company pursuant to an irrevocable pre-existing binding agreement. PLR 8741052. In other words, the outside procedure may be used for annuity exchange only if there is a nontransferable annuity and there is a binding agreement. *See* Rev. Rul. 73-124, 1973-1 C.B. 200. This would not apply to life insurance since there is no similar nontransferable life insurance contract.

(4) The Tax Court disagreed with the IRS position with regard to the necessity for a pre-existing binding agreement and found a tax-free exchange when the taxpayer surrendered a IRC Section 403(b) annuity for cash and then purchased an new annuity without such a pre-existing agreement. *Greene v. Commissioner*, 85 T.C. 1024 (1985), *acq. in result only*, 1986-2 C.B. 1. Note that, since the exchange involved a nontransferable IRC Section 403(b) annuity, this decision does not necessarily mean the Tax Court will support the outside procedure for a transferable annuity.

(5) Note that the IRS does not appear to agree with the *Greene* case since it acquiesced in result only and since it ruled that a pre-existing binding agreement was necessary in its subsequently issued PLR 8741052.

5. Exchange Involving Boot. If an exchange would otherwise be tax-free if it were not for the fact other property or money is received in addition to the insurance contract, then gain, if any, to the recipient shall be recognized, but in an amount not in excess of such money and fair market value of such other property. IRC Section 1031(A). However, loss is not recognized even with the presence of boot. IRC Section 1031(c).

a. The assumption of liability (or a transfer subject to liability) is to be treated as other property or money. Reg. Section 1. 1031(a). Consequently, if a policy subject to a loan is exchanged for a new policy without a loan, the extinguished loan will be considered boot. If the new life insurance contract is also subject to a loan, that loan will offset dollar for dollar the amount of the loan against the exchanged policy reducing boot. PLR 604033. PLR 8806058. PLR 8816015. Reg. Sec. 1.1031(b)-1(c). To avoid boot on exchange of a policy subject to a loan, pay off the loan before the exchange and create a new loan against the new policy after the exchange.

b. Partial exchanges of insurance contracts may involve boot or non-tax-free exchange. The IRS recently issued a revenue procedure governing when a transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract can be tax-free under IRC Section 2035. Rev. Proc. 2011-38, 2011-30 I.R.B. 66. The annuity transfer will be tax-free if no amount, other than an amount received as an annuity for a period of ten years or more or during one or more lives, is received under either the original annuity contract or the new contract during the 180 days beginning on the date of transfer (in the case of the new contract, the date the annuity contract is placed in-force). If the transfer is within the 180 days, it will be characterized by the IRS in a manner consistent with its substance, based upon general tax principles and all the facts and circumstances – a distribution under IRC Section 72(e) or boot under IRC Section 1035. A subsequent transfer of all or a portion of either annuity contract outside the 180 day window pursuant to IRC Section 1035 will not be affected by the previous transfer. Do these rules apply to a partial transfer of life insurance contracts under IRC Section 1035? Some commentators think so. In a ruling predating the annuity revenue procedure, a loan against an endowment policy was paid off by a partial surrender of the same policy. Subsequently the endowment policy was exchanged for another endowment policy. The IRS treated the surrender of the old endowment policy as an exchange for new endowment policy with the extinguishment of the loan as boot. PLR 9141025.

c. If there is an exchange involving cash boot, the basis of the new policy will be equal to the original policy's basis, less the cash boot, plus the amount of gain recognized. If the boot is property other than cash, the basis of the new policy calculated above will be divided between the new policy and the property boot with the boot receiving basis equal to its fair market value. IRC Section 1031(d).

6. Impact of Tax-Free Exchange on Grandfathering Provisions. There are many statutes applicable to life insurance policies but which contain grandfathering provisions for policies issued before the statute's effective date. In most cases, a tax-free exchange loses grandfathering protection for the new policy received in the exchange--but occasionally not.

a. Loss of grandfathering status if tax-free exchange after grandfathered effective date.

(1) Definition of life insurance contract (IRC Section 7702) for policies issued after December 31, 1983. PLR 8816015.

(2) Modified endowment contract (IRC Section 7702A) issued after June 21, 1988. PLR 9044022 (subject to 7-pay test on issue of new contract). Grandfathering not lost in tax-free

reorganization of mutual carrier into a stock insurance carrier. PLR 985039.

(3) Denial of interest deduction for insurance contracts (IRC Section 264(a)) issued after August 6, 1963 pursuant to systematic direct or indirect borrowing of all or part of cash value increases. PLR 8816015.

(4) Fifteen year withdrawal exception to basis first rule for contracts (IRC Section 7702(f)(7)) issued after December 31, 1983. PLR 8816015.

(5) Disallowance of employer general interest deduction allocable to unborrowed employer owned policy cash value (IRC Section 264(f)) for policies issued after June 8, 1997. PLR 200627021.

(6) It is unclear that a tax-free exchange of a grandfathered split dollar policy after September 17, 2003 loses grandfathered status.

b. But some tax free exchanges do not lose grandfathered status.

(1) EOLI/COLI rules (IRC Section 101(j)) for policies issued after August 17, 2008, do not lose grandfathered status after a subsequent tax free exchange unless the new policy contains material changes, such an increase in death benefit. Notice 2009-48, Q/A 15 and 16, 2009-24 I.R.B. 1085.

(2) Modification or restructuring of a policy pursuant to an insurance company's rehabilitation, conservatorship, insolvency or similar state proceedings (if certain conditions are met) does not lose grandfathering under IRC Sections 72, 101(f), 264, 7702 or 7702A. Rev. Proc. 92-57, 1992-2 C.B. 410.

IV. PREMIUM PAYMENTS.

A. PREMIUMS INCLUDED IN INCOME.

1. <u>Employment Related</u>.

a. <u>Policy Owned by Employee</u>. If the employee owns the policy and he designates the beneficiary, premium payments by the employer will be included in the employee's gross income. Reg. Section 1.61-2(d)(2)(ii)(A). Also income to employee if policy owned by employee family member. *Brock v. Commissioner*, T.C. Memo 1982-335.

b. Policy Owned by Employer.

(1) If the employer is the owner and the beneficiary of the policy (key person insurance), premiums will not be included in the employee's gross income. *Casale v. Commissioner*, 247 F.2d 440 (2nd Cir. 1957).

(2) If the employer is the owner of the policy but the employee's estate or family members are the beneficiaries, the employer premium payments may be taxable to the employee but there is a risk that the entire insurance proceeds payable at death may be income to the beneficiary.

(a) The regulation cited above implies that the entire premium may be taxable to the employee even though the employer is the owner of the policy. The Tax Court held there was no premium income to the employee where the employer retained the right to change the beneficiary designation although the case contains dicta that the amount equal to the value of one year term insurance protection might have been includable in the employee's income. *Rodebaugh v. Commissioner*, 33 T.C.M. 169 (1974). The entire premium was taxable to the employee when the employee's wife and sons were designated the irrevocable beneficiaries. *Commissioner v. Bonwith*, 87 F.2d 764 (2d Cir. 1937).

(b) The ownership and beneficiary designation should be coordinated to avoid the risk that the IRS may argue that the insurance proceeds are compensation when the employer is the owner of the policy and the employee's estate or family member is beneficiary. As indicated above, the IRS has made such an argument that insurance proceeds are dividends when a corporation owned the policy on the life of a shareholder but was not the beneficiary.

c. Split Dollar Life Insurance. Employer payment of premiums under a split-dollar life insurance contract can result in income to the employee or shareholder.

(1) Under a split dollar arrangement, the employer assists the executive in obtaining life insurance coverage by paying all or part of the insurance premiums. However, the employer will obtain out of the death proceeds or the cash value of the policy after the termination of the split dollar arrangement at least its premium payments and perhaps the entire cash surrender value of the policy, if greater. Under the split dollar regulations, there are two split dollar arrangements. Under the loan regime, the employer loans the premium payments to the executive while the executive owns the insurance policy, perhaps with a collateral assignment to the employer to secure the loan. Under the economic benefit regime, usually the employer owns the insurance policy and endorses to the executive all or part of the pure death benefit.

(2) Income Tax Consequences of Economic Benefit Regime.

(a) General Rule. Any economic benefit from a split dollar arrangement will be treated as provided from the owner to the non-owner. Reg. Section 1.61-22(d)(1).

(i) The value of the economic benefit will be reduced by any consideration paid by the non-owner.

(ii) The tax treatment of the economic benefit will depend upon the relationship between the owner and the non-owner -- employer/employee (compensation), corporation/shareholder (dividend) or private split dollar (gift).

(iii) If a third party is involved such as a life insurance trust, there could be two tax consequences. With regard to an economic benefit regime between the employer and a life insurance trust, there will be compensation to the employee and a gift by the employee to the trust.

(b) Valuing Economic Benefits. There are three possible elements of economic benefit to the non-owner under the economic benefit regime pursuant to Reg. Section 1.61-22(d)(2):

(i) The cost of current life insurance protection.

(ii) The amount of policy cash value to which the non-owner has current access. Thus, if the employee/life insurance trust has access to any of the cash value of the policy, that cash value will be taxed as income to the employee and a gift to the trust. Thus, economic benefit regime split dollar gives all of the cash value to the employer/donor.

(iii) The value of any other economic benefit received by the non-owner, such as dividends, withdrawals, partial surrenders and specified policy loans. Reg. Section 1.61-22(e)(1). Thus, economic benefit regime split dollar normally restricts the employee/life insurance trust to a death benefit only and prohibits any right to benefit from dividends, withdrawals, surrenders or specified loans.

(c) Cost of Current Life Insurance Protection Benefit. The value of the current life insurance protection enjoyed by the employee/life insurance trust is an economic benefit provided by the owner of the life insurance contract. Reg. Section 1.61-22(d)(3).

(i) The cost of the current life insurance protection will be based upon a term premium factor published by the IRS in the Internal Revenue Bulletin. Until future guidance, Notice 2002-8, 2002-1 C.B. 398 applies.

(ii) The amount of current life insurance protection is the excess of the death benefit over the total amount payable to the owner employer (including any policy loans) reduced by any cash value previously taken into account by the non-owner employee. This will normally be the death benefit in excess of the cash value of the policy.

(d) Death Proceeds. Insurance proceeds are not normally income to the beneficiary, but there is a potential trap in the economic benefit regime regulation.

(i) The regulation states that the death proceeds are excluded from the gross income of the beneficiary under IRC Section 101(a) "to the extent such amount is allocable to current life insurance protection provided to the non-owner pursuant to the split dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account." Reg. Section 1.61-22(f)(3)(i).

(ii) In the preamble to the regulation, the IRS rejected comments that the inclusion of current death benefits in the gross income of the beneficiary runs counter to the exclusion of death benefits from gross income under IRC Section 101(a).

(iii) The preamble further states that, in situations where the non-owner neither pays for nor takes into account the current life insurance protection, the proceeds are treated as if they were payable to the owner *(e.g.*, employer), excluded from the owner's income by IRC Section 101(a) and distributed by the owner to the beneficiary outside of IRC Section 101(a). The taxation of the deemed distribution depends upon the relationship of the parties -- employee (compensation), shareholder (dividend), or life insurance trust (gift). *See* Reg. Section 1.61-22(f)(3)(iii).

(iv) Consequently, once the economic benefit regime arrangement is in existence, it is important scrupulously to have the non-owner employee pay the term premium or include it in his income in order to avoid the IRS position that IRC Section 101(a) does not apply. This seems to be quite a penalty for lack of follow through and the regulation may be invalid as contrary to IRC Section 101(a).

(e) Tax Consequences to Employer.

(i) Any term premium paid by the employee or life insurance trust, directly or indirectly to the owner for current life insurance protection is included in the owner's gross income. Reg. Section 1.61-22(f)(2)(ii). This is a surprise and contrary to common opinion and practice under split dollar arrangements grandfathered from the regulation. Under the regulation, the term premium reimbursement by the employee will be income to the employer. The preamble to the regulation justifies its taxation on the grounds that the owner/employer is "renting" the current coverage to the non-owner/employee. Although not totally clear in the regulation, presumably there is no "indirect" reimbursement or income to the owner/employer if the non/owner employee does not pay the term premium but it is included in his W-2 by the owner/employer.

(ii) The owner's investment in the contract (basis) will be equal to the premiums paid by the owner/employer plus the amount of any term premium paid by the non-owner which was included in the owner's income (to the extent not otherwise so included by reason of having been paid as a premium by the owner). Reg. Section 1.61-22(f)(2)(ii). Thus, the value of current life insurance protection (the term premium) attributed to or paid by the employee/trust will not constitute basis in the policy to the employee/trust. Reg. Section 1.61-22(g)(4)(ii).

(iii) No term premium economic benefit realized by the non-owner/employee during the existence of the split dollar arrangement is deductible by the owner/employer.

(3) Loan Regime.

(a) If a loan is a below market loan, then IRC Section 7872 applies. If sufficient interest is paid, then IRC Section 7872 does not apply. Reg. Section 1.7872-15(a)(1). The executive or his trust is the borrower and the employer is the lender and each premium payment is a separate loan for Federal tax purposes. Reg. Section 1.7872-15(a)(1) and (2)(iv), Ex. 1. The preamble to the final regulation emphasizes that each premium payment is a separate loan and rejected requests that all premium payments in a single year or a single quarter be treated as a single loan.

(b) Thus, if the applicable Federal rate is paid on the loan, there are no income or gift tax consequences and the following will not apply.

(c) Types of Below Market Loans.

(i) Demand Loans: any split dollar loan that is payable in full at any time on the demand of the employer (or within a reasonable time after the employer's demand). Reg. Section 1.7872-15(b)(2).

(ii) Split Dollar Term Loans: any split dollar loan other than a demand loan. Reg. Section 1.7872-15(b)(3).

(iii) Certain Term Loans Treated as Demand: split dollar loans payable on the death of an individual or conditioned on the future performances of substantial services by an individual and gift term loans are treated as split dollar term loans to determine whether the loan provides for sufficient interest, but, if it is below market, then the forgone interest is determined annually for income tax purposes only, similar to a demand loan, but using the applicable Federal interest rate ("AFR") appropriate for the loan's term and that is determined when the loan is issued. Reg. Section 1.7872-15(e)(5). The demand loan treatment for these hybrid arrangements does not apply for gift tax purposes.

(d) Income Below Market Split Dollar Demand Loans.

(i) Testing for Sufficient Interest. Reg. Section 1.7872-15(e)(3)(ii). The stated loan rate is sufficient if the rate based on annual compounding on the amount of the loan during the year is no lower than the blended annual rate for the year published by the IRS in the July Internal Revenue Bulletin. The 2013 blended annual rate is 0.22%. Rev. Rul. 2013-54, 2013-28 I.R.B. 47. If the loan does not have sufficient interest, the loan is a below market split dollar demand loan for the whole calendar year.

(ii) Amount and Timing of Forgone Interest on Demand Split Dollar Loan. The forgone interest is the excess of: The amount of the interest which would have accrued by the end of the calendar year on the loan at the AFR which is the blended annual rate determined in July of that year over any interest that accrues on the loan during the year. Reg. Section 1.7872-15(e)(3)(iii)(A). The forgone interest for the calendar year is treated as transferred from the employer to the executive or his trust (and retransferred as interest by the executive or his trust to the employer) on the last day of the calendar year (*e.g.*, compensation, dividend or gift from lender to borrower following transfer of interest from borrower to lender in same amount). Reg. Section 1.7872-15(e)(3)(iii)(B).

(e) Income Below Market Split Dollar Term Loans.

(i) Testing for Sufficient Interest. Reg. Section 1.7872-15(e)(4)(ii). The stated loan rate is sufficient if the imputed loan amount equals or exceeds the amount loaned. The imputed amount is the present value of all payments due under the loan, determined as of the loan date, using a discount rate equal to the AFR in effect on such date. The AFR must be appropriate for the loan's term (short-term, mid-term or long-term) and for the compounding period used in computing the present value. If the loan does not have sufficient interest, the loan is a below market split dollar term loan under IRC Section 7872.

(ii) Timing and Amount of Imputed Transfer in Connection With Below Market Split Dollar Term Loans. Reg. Section 1.7872-15(e)(4)(iv). If the term loan is a below market loan, each premium payment will be characterized into two portions - an imputed loan amount (the discounted present value of the premium payment as determined in testing for sufficient interest) and the imputed transfer from the employer to the executive or his trust. The amount of transfer is the excess of the actual loan over the discounted imputed loan with such transfer being treated as compensation, dividend, or gift to the borrower depending upon the relationship between the lender and the borrower. The imputed transfer is calculated as of the date of the premium loan. Thus it results in single front end lump sum income and gift on the date of the loan.

(f) Special Income Rules for Certain Hybrid Split Dollar Term Loans.

(i) General Rule. Split dollar loans payable at the death of an employee or conditioned on the future performance of substantial services by an employee and gift term loans are treated as term loans in determining whether there is sufficient interest but, if it is a below market split dollar loan, then the forgone interest is determined annually like a demand loan but using an AFR that is appropriate for the loan's term and that is determined when the loan is issued. Reg. Section 1.7872-15(e)(5)(i). The effect of this regulation is to treat all or part of the income tax consequences of these types of term loans as occurring annually rather than in a lump sum at the date the loan is contracted. With regard to compensation loans between employer and employee, if the loan continues until the employee's death or until termination of employment, income for the foregone interest will be realized annually as in the case of a demand loan and not in a single lump sum on the date of the loan as in the case of other term loans. With regard to an indirect loan by the employer to a life insurance trust, the second imputed loan from the executive to the trust is a gift loan and, if the employer loan is payable at the executive's death or termination of employment, income to the executive for the foregone interest from the trust will be realized annually and not in a single lump sum on the date of the loan. However, this is for income tax purposes only. The taxable gift of the foregone interest from the executive to the trust will be a single sum on the date of the loan.

(ii) Careful of Contingent Payment Split Dollar Loans. If split dollar loan provides for contingent payments, then the value of the loan and determination of adequacy of interest will be subject to special calculations. Reg. Section 1.7872-15(j)(3). If the payment on a split dollar loan is nonrecourse (and most are), the payment is a contingent payment. Reg. Section 1.7872-15(d)(1). However, there is an exception to a nonrecourse loan being contingent if the employer and the executive represent in writing that a reasonable person would expect that all payments under the loan will be made. The representation must be signed by both parties before the first return is filed and must be attached to both tax returns for the taxable year in which the loan is made. Reg. Section 1.7872-15(d)(2). <u>Failure to do so could cause severe difficulties.</u>

d. <u>Group Term Life Insurance</u>. Special rules apply to employer provided group term insurance if the rules of IRC Section 79 are met.

(1) Generally, the cost of the group term insurance is included in the income of the employee or retired employee. IRC Section 79(a).

(2) The cost of the first $50,000.00 of insurance plus the amount of coverage paid by employee, if any, is excluded from the gross income of an employee or retired employee. Furthermore, the entire cost of the group term insurance (even the amount above $50,000.00) is excluded from the gross income of a disabled former employee. IRC Section 79(a)(1) and (b)(1).

(3) Group term premiums are excluded from employee income if an IRC Section 170(c) charity is the sole beneficiary. IRC Section 79(b)(2)(B). This is true even if the designation is revocable. However, there is no charitable deduction since the premiums are excluded from the employee's income. Reg. Section 179-2(c)(3).

(4) The cost of the group term insurance coverage in excess of $50,000.00 is determined monthly by reference to the government term rate Table I. Reg. Section 1.79-3(d)(2).

(5) The exclusion of IRC Section 79 does not apply to dependent coverage on the life of the spouse or other family member of the employee. Reg. Section 1.79-3(g)(2). Such group term premiums for dependent coverage are expressly included in the income of the employee. Reg. Section 1.61-2(d)(2)(ii)(b). However, the IRS policy is not to include in the employee's income as a de minimus fringe benefit the cost of group coverage which does not exceed $2,000 on a spouse or dependent. Notice 89-110, 1989-2 C.B. 447.

(6) If group term insurance plan discriminates by eligibility or benefit in favor of a key employee, the cost of all of the key employee's coverage (including the first $50,000) is included in such key employee's income. IRC Section 79(d).

  (a) The income inclusion is the greater of the actual cost or the Table I rates. IRC Section 79(d)(1)(B).

  (b) A plan discriminates as to eligibility unless if meets at least one of the following: IRC Section 79(d)(3)(A).

    (i) benefits 70% or more of all employees.

(ii) at least 85% of participating employees are not key employees.

(iii) if part of a cafeteria plan, meets the requirements of IRC Section 125.

(iv) benefits a class of employees which Secretary of Treasury determines is not discriminatory.

(c) A plan discriminates as to benefits if not all the benefits available to key employees are not also available to all other participants. IRC Section 79(d)(4). A plan is not discriminatory merely because the insurance coverage bears a uniform relationship to total compensation or the basic or regular compensation of such employees. IRC Section 79(d)(5).

(d) Definition of key employee--the same as for a top-heavy plan under IRC Section 416(i). Also includes a former employee if he was a key employee when he retired or separated from service. IRC Section 79(d)(6).

e. Qualified Plan Insurance. Although a qualified pension plan is primarily a plan for deferred compensation, the plan can provide incidental life insurance coverage. Reg. Section 1.401(b)(1).

(1) For a life insurance contract owned by a qualified plan, the life insurance protection under the contract is includable in the gross income of the participant for each taxable year. IRC Section 72(m)(3)(B).

(a) The proceeds of the life insurance contract must be payable directly or indirectly to the participant or his beneficiary. The proceeds will be considered payable indirectly to the participant or his beneficiary when they are payable to the trustee, but under the terms of the plan, the trustee is required to pay over all of such proceeds to the beneficiary. Reg. Section 1.72-16(b)(1).

(b) If the insurance policy is key person coverage, which is an investment by the plan, there is no income to the participant if the trust has a right to retain the proceeds. Reg. Section 1.72-16(b)(6). Rev. Rul. 66-138, 1966-1 C.B. 25.

(2) The cost of insurance coverage includable in the employee's income is based upon the amount of insurance coverage in excess of the cash surrender value. IRC Section 1.72-16(b)(5).

(a) In determining the cost of the insurance includable in the participant's income, the Table 2001 rates contained in Notice 2001-10, 2001-5 I.R.B. 459 are to be used. However, if the one-year term rate of the insurance carrier is less, it may be used, subject to the interim guidelines of Notice 2001-10, and final guidances to be issued by the IRS at a later date. Notice 2002-8, 2007-1 C.B. 398.

(b) If term insurance is in the qualified plan, all of the cost of protection will be included in the employee's income since there is no cash value.

(c) If group term policy is owned by the qualified plan, IRC Section 79 does not apply and there is no $50,000 exclusion of coverage. IRC Section 79(b)(3).

(3) Employee contributions to qualified plan owning life insurance:

(a) Life insurance premiums are deemed to be paid first from employer contributions unless the plan provides otherwise. Rev. Rul. 58-390, 1968-2 C.B. 175. To the extent premiums paid by the employer's contributions, employee includes cost of coverage in income.

(b) If premiums are paid by employee's tax deductible contributions, employee has income equal to the premium payment and not the lesser of Table 2001 or carrier term costs. IRC Section 72(o)(3)(B).

(c) If premiums are paid with employee's nondeductible plan contributions, no cost of coverage income to the employee.

(4) The cost of coverage is taxable to employee even if insurance is on the life of a third party. PLR 8108110. PLR 8426090.

(5) Cost of insurance coverage is taxed to employee even though cash value is subject to a risk of forfeiture. *Funkhouser v. Commissioner*, 58 T.C. 940 (1972).

2. Shareholder Related.

a. Shareholder Owned Policy. If a corporation pays premiums on a policy owned by the shareholder for his personal use, the premium payments are dividends. *Schwartz v. Commissioner*, 22 T.C.M. 1786 (1963). Likewise, if the corporation pays premiums under a split dollar contract for a policy owned by the shareholder, the economic benefit is a dividend to the shareholder. Rev. Rul. 79-50, 1979-1 C.B. 138.

b. Corporation Owner and Beneficiary. The shareholder would have no taxable income for premiums paid by the corporation. *Casale v. Commissioner*, 247 F.2d 440 (2d Cir. 1957). Rev. Rul. 59-184, 1959-1 C.B. 65.

c. Corporation Owner But Not Beneficiary. Such a divided ownership can create confusion as to whether the shareholder has no dividend income, has dividend income equal to the premiums paid or has dividend income equal to the proceeds payable at death.

(1) There are no dividends to shareholder when the policy owner corporation is the equitable beneficiary. This is a result where a corporation pays premiums for life insurance on the lives of its stockholders owned by the stockholders, the proceeds of which are to be used in payment of stock even though the stockholder has a right to designate a beneficiary, if such right of the beneficiary to receive the proceeds is conditioned upon the transfer of the corporate stock to the corporation. *Prunier v. Commissioner*, 248 F.2d 818 (1st Cir. 1957). Rev. Rul. 59-184, 1959-1 C.B. 65. Rev. Rul. 70-117, 1970-1 C.B. 30.

(2) If the corporation owns the policy and the proceeds are payable to family members of the shareholder, the entire premium might be treated as dividend income.

(a) The premium was income when corporation was owner and insured's family were irrevocable beneficiaries. *Commission v. Bonwit*, 87 F.2d 764 (2nd Cir. 1937).

(b) However, if the corporation owns the policy with the insured's family as beneficiary, the premium is not income to the insured since the corporation retained the right to change the beneficiary. However, in dicta, the court suggested that the term premium of the insurance coverage enjoyed by the insured's family might be dividend income to the insured. *Rodebaugh v. Commissioner*, 33 T.C.M. 169 (1974) *aff'd on another issue*, 518 F.2d (6th Cir. 1975).

(3) Obviously, it is better to avoid the confusion and to coordinate the ownership and beneficiary designation of the insurance policy to eliminate any argument that the death proceeds are dividends and to clarify whether the premium payments are dividends.

3. <u>Alimony Income</u>. The rules concerning the inclusion of alimony in the gross income of the recipient former spouse were changed dramatically for decrees of divorce and separate maintenance after 1984. IRC Section 71. The previous law continues to apply to decrees of divorce or separate maintenance entered prior to 1985 unless a post-1984 decree incorporates or adopts the new law. Reg. Section 1.71-1T(b), Q/A 6.

a. <u>Post-1984 Premium Rules</u>. Assuming that the divorce or separation instrument meets the requirements of IRC Section 71, "premiums paid by the payor spouse for term or whole life insurance on the payor's life made under the terms of the divorce or separation instrument will qualify as payments on behalf of the payee spouse to the extent that the payee spouse is the owner of the policy." Reg. Section 1.71-1T(b), Q/A 6. Consequently, assuming a proper divorce or maintenance agreement, premium payments are alimony income to the recipient spouse if:

(1) Premiums are paid by the other spouse.

(2) The policy is on the other spouse's life.

(3) The recipient spouse is the owner of the policy.

(4) The policy is term or whole life insurance.

b. <u>Post-1984 Requirements for Alimony or Separate Maintenance Payments</u>. IRC Section 71(a) states that gross income includes amounts received as alimony or separate maintenance payments. "Alimony or separate maintenance payments" must meet the following requirements. IRC Section 71(a)(b)(c). Reg. Section 1.71-1T(a), Q/A 2:

(1) The payment is in cash.

(2) The payment is not designated as a payment which is excludable from the gross income of the payee and non-deductible by the payor.

(3) The spouses are not members of the same household at the time the payments are made.

(4) The payor has no liability to continue to make any payment after the death of the payee (or to make any payment as a substitute for such payment).

(5) The payment is not treated as child support.

B. DEDUCTIBILITY OF PREMIUMS.

1. <u>Not Deductible -- Personally Owned Life Insurance</u>. No deduction is allowed for personal, living or family expenses. IRC Section 262(a). Personal, living and family expenses include "premiums paid for life insurance by the insured." Reg. Section 1.262-1(b)(1).

2. <u>Not Deductible -- Taxpayer Beneficiary Under Policy</u>. No deduction is allowed for premiums on any life insurance policy or endowment or annuity contract, if the taxpayer is directly or indirectly a beneficiary under the policy or contract. IRC Section 264(a)(1).

   a. This prohibition applies to any insurance policy where the premium payor is a beneficiary of the policy whether the beneficiary is an individual, an employer, or a business in a non-employment context.

   b. If the taxpayer is a beneficiary of the policy, the premiums are not deductible even though they would otherwise be deductible as trade or business expenses. Reg. Section 1.264-1(a).

   c. Where a business is both the owner and a beneficiary of a policy on the lives of its key personnel (key person policies), no deduction is allowed for the premiums as ordinary and necessary business expenses. Rev. Rul. 66-262, 1966-2 C.B. 105.

   d. The deduction is also disallowed for premium payments where the taxpayer is the indirect beneficiary of the policy. Reg. Section 1.264-1(b) (A partner owns policy on his life irrevocably designating another partner as sole beneficiary in order to induce his partner to retain his investment in the partnership). Rev. Rul. 70-148, 1970-1 C.B. 60 (Employee owned policy but employer could terminate policy at will and receive the cash surrender value). Rev. Rul. 66-203, 1962-2 C.B. 104 (Employer was entitled to portion of cash value during the first nine years of policy).

e. The entire premium payment is not deductible even though the taxpayer is only a partial beneficiary of the policy. Rev. Rul. 66-203, 1966-2 C.B. 104 ("The deduction cannot be divided; it must be allowed or disallowed in total"). With regard to a split dollar insurance policy, the employer cannot deduct his premium benefit or the economic benefit realized by the employee. Rev. Rul. 64-328, 1964-2 C.B. 11.

3. Employee Compensation Deduction.

a. Assuming that the employer is not the owner or beneficiary of the policy, premium payments on insurance policy on the life of an employee or someone in whom the employee has an insurable interest should be deductible if it is a reasonable allowance for salary or other compensation for personal services actually rendered in carrying on any trade or business. IRC Section 162(a)(1).

b. A deduction for premiums will not be disallowed merely because the taxpayer may derive a benefit of increased efficiency of the officer or the employee insured as long as the taxpayer is not the owner or beneficiary of the policy. Reg. Section 1.264-1(b).

c. Of course if premium is paid for the benefit of a shareholder not in an employment capacity, the premium will be a nondeductible dividend.

4. Alimony Deduction. If insured's premium payments are includable in the gross income of the recipient spouse under IRC Section 71, then such premium payments are also deductible by the payor spouse. IRC Section 215(a).

5. Charitable Premium Deduction.

a. Requirements for a charitable deduction for premium payments:

(1) The charity has an insurable interest under applicable state law. PLR 9110016.

(2) The charity has all incidents of ownership in the policy. PLR 8304068. If the charity only has a partial interest in the policy, no charitable deduction is allowed. IRC Section 170(f)(3). Rev. Rul. 76-1 C.B., 1976-157 and Rev. Rul. 76-143, 1976-1 C.B. 63 (Split dollar arrangements where charity owned only cash surrender value or annuity portion).

b. What are the adjusted gross income limits on deductibility of charitable premium?

(1) If the policy is owned by a charity other than those listed in IRC Section 170(b)(1)(A) (mostly private foundations), premium payments are treated as “30% deductions” and are aggregated with similar contributions which cannot be deducted in excess of 30% of adjusted gross income.

(2) If the policy is owned by a charity listed in IRC Section 170(b)(1)(A), premium payments “to” the charity will be considered “50% contributions” aggregated with other similar charitable contributions not to exceed 50% of adjusted gross income but payments “for the use of” such charity will be considered 30% charitable contributions. Reg. Section 1.170A-8(a)(2).

(3) Deductions denied because of the 50% or 30% limitation may be carried over and deducted over the next five years retaining their character as 50% or 30% deductions. IRC Sections 170(d)(1)(A) and 170(b)(1)(B).

c. When is a premium payment “to” or “for the use of” a charity listed in IRC Section 170(b)(1)(A)?

(1) If the premium is contributed directly to the charity which it uses to pay the insurance company, there should be no doubt that the gift is “to” the charity and qualifies as a 50% charitable contribution.

(2) If the premium is paid by the taxpayer directly to the insurance company for the policy owned by the listed charity, it is likely (although there are no authorities) that the premium gift will be considered “for the use of” the charity and thus qualify as a 30% charitable contribution.

(3) If the 50% limits are important, the safest approach is to pay the premium directly to the charity which then pays the insurance carrier.

d. There is no charitable deduction for premiums pay on personal benefit contracts (charitable reverse split dollar) and there is a 100% excise tax on premiums paid by charities on personal benefit contracts. IRC Section 170(b)(10).

V. INTEREST DEDUCTIONS IN LIFE INSURANCE.

A. PERSONALLY OWNED LIFE INSURANCE.

1. Policies Issued After June 8, 1997 — No Deduction. No deduction shall be allowed on any indebtedness with respect to one or more life insurance policies owned by the taxpayer covering the life of an individual. IRC Section 264(a)(4). This provision is effective for contracts issued after June 8, 1997 and taxable years ending after such date. Taxpayer Relief Act of 1997, Section 1084(d). This would prohibit deduction for interest on policy loans and for loans to pay insurance premiums.

2. Policies Issued On Or Before June 8, 1997. Loans against a personally owned (non-business) policy may be deductible if two additional hurdles are overcome.

a. IRC Section 264 Limitations. The prohibition against deductions of interest on indebtedness incurred or continued to purchase or carry a single premium life insurance policy or incurred or continued to purchase or carry a life insurance contract pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of a part or all of the increases in the cash value of such contract must be overcome. IRC Section 264(a)(2)(3). Since these limitations apply to both business and personally owned life insurance, they are discussed later.

b. IRC Section 163(h) Limitations. The section of the Code prohibits an interest deduction for a taxpayer other than a corporation for personal interest.

(1) The statute lists several exceptions from the definition of personal interest including trade or business interest, investment interest, qualified residence interest, educational loan interest, interest taken into account in computing income or loss from a passive activity and interest on estate tax installments. IRC Section 163(h)(2).

(2) The most likely source of deductible interest from a life insurance policy loan for an individual taxpayer is investment or passive activity interest. Allocation of interest to investment or passive activity is determined by tracing the disbursements from the insurance policy to the specific expenditures. Reg. Section 1.163-18(a)(3).

(3) Therefore, if money borrowed against the cash value of a policy or an individually owned policy is pledged for a loan and the proceeds are used for investment or passive activity

expenditures, the interest might be deductible for a pre-June 9, 1997 policy.

B. CORPORATE OR OTHER BUSINESS OWNED LIFE INSURANCE

1. Pre-June 20, 1986 Contract. An employer is allowed to deduct interest paid or accrued on any indebtedness on policies issued before this date covering an individual who is an officer, employee, or financially interested in the trade or business; provided that the applicable rate of interest cannot exceed the rate of interest described in Moody's Corporate Bond Yield Average - Monthly Average Corporate as published by Moody's Investors Service, Inc. (or any successor thereto) for the month in which the contract was purchased (fixed rate) or for the third month preceding an applicable 12-month period (variable rate). IRC Section 264(e)(2)(B)(ii).

2. General Non-Deduction Rule for Post-June 19, 1986 Contracts. Except as provided below, no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance policies owned by a taxpayer covering the life of an individual or any endowment or annuity contract owned by the taxpayer covering any individual. IRC Section 264(a)(4).

a. Timing of Non-Deduction Rule.

(1) The non-deduction rule applies to all post-June 19, 1986 contracts covering an individual who is an officer, employee, or financially interested in any trade or business carried on by the taxpayer.

(2) This non-deduction rule also applies to contracts issued after June 8, 1997 for policy owed by a business taxpayer covering individuals who are not officers, employees or financially interested in the taxpayer's trade or business. IRC Section 264(a)(4). Taxpayer Relief Act of 1997, Section 1084(d). Thus, a mortgage lender that a buys a life insurance policy on the life of a borrower after June 8, 1997, will no longer be able to deduct any interest incurred in obtaining the coverage.

b. Key Person Insurance Exception To Non-Deductibility Rule. The general non-deductibility rule does not apply to interest paid or accrued on indebtedness with respect to policies or contracts covering an individual who is a key employee to the extent that the aggregate amount of such indebtedness with respect to policies and contracts covering such individual does not exceed $50,000. IRC Section 264(e)(1).

c. Definition of Key Person. A key person means an officer or 20% owner, except that the number of individuals who may be treated as key persons with respect to any employer shall not exceed the greater of five individuals, or the lesser of 5% of the total officers and employees of the taxpayer or 20 individuals. IRC Section 264(e)(3).

d. Definition of 20% Owner. If the taxpayer is a corporation, a 20% owner means any person who owns directly 20% or more of the outstanding stock of the corporation or stock possessing 20% or more of the total combined voting power of all stock of the corporation. If the taxpayer is not a corporation, a 20% owner is any person who owns 20% or more of the capital or profits interest in the taxpayer. IRC Section 264(e)(4).

e. Applicable Rate of Interest Cap. The applicable rate of interest for deduction purposes cannot exceed the interest rate described in Moody's Corporate Bond Yield Average–Monthly Average Corporate as published Moody's Investors Service, Inc. for such month. IRC Section 264(e)(2)(D)(i).

f. Control Group Aggregation. In applying the $50,000 limitation, all members of a control group shall be treated as one taxpayer. IRC Section 264(e)(5) incorporating definitions found in IRC Section 52(a) and (b) and IRC Section 414(m) and (o).

3. Disallowance of Prorated Allocation of General Interest Expense to Policy Cash Values.

a. Purpose and Effective Date. Effective for life insurance policies, annuities and endowment contracts issued after June 8, 1997, IRC Section 264(f) would automatically allocate a portion of the interest on all corporate (or any other non-natural taxpayer) indebtedness with respect to unborrowed cash value of insurance policies owned by such taxpayer even though there is no tracing of the indebtedness to the payment of premiums on such insurance policy. The IRS has ruled that an IRC Section 1035 exchange after June 8, 1997 for a policy issued before the date was a material change, losing the grandfather status for the new policy. PLR 200627021.

b. Calculation of General Interest Deduction Disallowance. The amount of general interest deduction which will be disallowed under IRC Section 264(f) as allocable to the unborrowed cash value to the insurance policy is determined by a ratio, the numerator of which is the unborrowed cash values of life insurances policies, annuities, and endowment contracts issued after June 8, 1997, and the denominator of which is the sum of the averaged unborrowed cash values of such policies and contracts and the average adjusted basis of all other assets of the taxpayer. IRC Section 264(f)(2).

(1) "Unborrowed policy cash value" is the excess of the cash surrender value of the policy determine without regard to any surrender charge over the amount of the loan with respect to the policy.

(2) If the cash surrender value does not reasonably approximate the actual value of the policy, the amount taken into account in the fraction shall be the greater of the amount of the insurance company liability or the insurance company reserve with respect to such policy or contract as determined for purposes of the annual statement approved by the National Association Insurance Commissioners or such other amounts as determined by the Secretary of Treasury.

c. Exception for Policies on Lives of 20% Owners, Officers, Directors and Employees. The disallowance of part of the general interest deduction does not apply to certain insurance policies owned in the employment context. IRC Section 264(f)(4)(A) expressly excepts from the prorata disallowance of general interest deduction any policies owned by a business if the policies cover one individual who is a 20% or more owner, officer, director or employee of the trade or business. IRC Section 264(f) was invoked by the IRS when the policy was on the life of a former employee. PLR 200627201. The Obama Administration revenue proposals for fiscal years 2011, 2012 and 2013 recommend narrowing the exception to only 20% owners. 2013 Greenbook, pp. 109-110.

(1) Relationship with Key Person Exception. If the policy is on the life a key person as defined in IRC Section 264(e)(3), not only is a prorata portion of the general interest expense of the employer not disallowed by allocation of these insurance policies, any indebtedness indirectly or directly related to such policy is deductible under IRC Section 264(e) up to the first $50,000 of indebtedness. Note that the IRC Section 264(f) exclusion for 20% owners, officers, directors and employees is broader than the definition of key person.

(2) Second-to-Die Insurance. There is an exception from the disallowance of a prorata portion of the general interest

expense for an insurance policy covering the joint lives of a 20% owner and such owner's spouse. IRC Section 264(f)(4)(A).

(a) However, a second-to-die policy on the joint lives of a spouse and an officer, director, or employee (who is not a 20% owner) is not excepted, and the prorata share of the interest expense of the employer applicable to the unborrowed cash value of these policies would be disallowed.

(b) The most common situation in which the employer would own an interest in a second-to-die policy is in the split dollar arrangement with an officer, director or employee.

(c) If the trade or business is the owner of the split dollar policy under an endorsement or joint ownership arrangement, there is no doubt that the cash surrender value of that second-to-die policy will be added to the fraction in disallowing some of the general interest expense of the employer (unless a 20% owner and spouse are insureds).

(d) With regard to policies issued prior to September 18, 2003, and not otherwise subject to the final split dollar regulations and if the policy was issued after June 8, 1997, it is uncertain whether IRC Section 264(f) would apply to a collateral assignment second-to-die policy. It could be argued that IRC Section 264(f) does not apply since the trade or business does not own the policy and it only has a security interest therein. Although not entirely clear, the section would seem to require the trade or business to own the policy or its cash values. On the other hand, IRC Section 264(f) might apply since the IRS has ruled that the split dollar insurance is an investment by an employer in a life insurance contract whether an endorsement or collateral assignment is used. Rev. Rul. 64-328, 1964-2 C.B. 11. Although the ruling involved determining income for an employee under IRC Section 61 of the Code, there is always the possibility that the IRS would extend the same rational to the denial of interest deduction under Section 264(f).

(e) Perhaps a "bare bones" collateral assignment of a second-to-die split dollar contract would not be subject to IRC Section 264(f). Under the "bare bones" collateral assignment, all incidents of ownership and rights in the policy are given to the employee and the only right that the trade or business has in the policy is to be paid its premium from the cash value or death proceeds. The IRS has approved bare bones collateral assignment for no estate tax inclusion under the controlling shareholder rule. PLR 9511046. PLR 9651030. PLR 9709027. PLR 9808024. PLR 9848011. Also, the IRS used the bare bones collateral assignment to prevent estate tax inclusion for a private split dollar agreement between insureds and their life insurance trust. PLR 9745019.

(f) With regard to policies issued after September 17, 2003, or otherwise subject to the final split dollar regulation, a collateral assignment second-to-die policy would normally be a split dollar loan regime subject to IRC Section 7872. Presumably, IRC Section 264(f) would not apply to such policy since the employer is not an owner but merely a secured creditor. However, a non-equity collateral assignment policy is not part of the loan regime but is subject to the economic benefit regime as if the employer were the owner. Reg. Section 1.61-22(c)(1)(ii)(1). The unanswered question is whether the employer is treated as owner just for split dollar purposes under Reg. Section 1.61-22 or the employer is also treated as owner for IRC Section 264(f) purposes. Presumably the statutory requirement of IRC Section 264(f) that the employer actually own the policy trumps the regulation under a different statute since the non-equity arrangement is structured as a loan by the employer.

C. LIMITATIONS ON SINGLE PREMIUM INSURANCE INTEREST DEDUCTION.

1. <u>Denial of Deduction for Loans to Purchase or Carry Single Premium Policy</u>. Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract is not deductible. IRC Section 264(a)(2).

2. <u>Applicability</u>. This non-deduction rule applies to any single premium policy whether owned by an individual or a trade or business even though all of the other restrictions under IRC Section 264 or IRC Section 163 have been met.

3. <u>Definition of Single Premium Contract</u>. IRC Section 264(c) states that two types of contracts will be treated as single premium:

    a. Substantially all of the premiums on the contract are paid within a period of four years from the date on which the contract is purchased.

    b. An amount is deposited with the insurer for payment of substantial number of future premiums on the contract.

4. <u>What is “Substantially All?”</u>

    a. The Tax Court has held that 73% of the premiums paid within four years was not “substantially all.” *Dudderar v. Commissioner,* 44 T.C. 632 (1965), *acq.*, 1966-2 C.B. 4.

    b. The *Dudderar* case has been favorably cited by other courts in determining that substantially all the premiums were not paid under Section 264(a)(2). *Campbell v. Cen-Tex, Inc.*, 377 F.2d 688 at 693 (5th Cir. 1967). *Golden v. United States,* 403 F.2d 776 at 778 (10th Cir. 1968).

    c. The Tenth Circuit has held that 62.7% of the total anticipated premium payments was not “substantially all” and it also cited favorably the *Dudderar* case. *Shirar v. Commissioner*, 916 F.2d 1414 at 1420-21 (9th Cir. 1990). The *Shirar* case also emphasized that the substantially all test is determined by measuring the premium payments in the first four years with the anticipated premium payments even though the actual premium payments were less because of the surrender of the insurance policy caused by the change in federal estate tax laws.

    d. Although the cited cases give some guidance as to how much of the premium payment is substantially all, the question is essentially a fact and circumstances issue to be determined on a case by case basis. *See Campbell v. Cen-Tex, Inc., supra*.

5. <u>Is a Universal Life Contract a Single Premium Policy?</u> Technically, no premiums are ever due on a universal life policy as long as there is sufficient cash value to pay the monthly mortality and expense charges. Since no premiums are due, are all premium payments on a universal life policy treated as single premium?

a. There is a statement in the Ways and Means Committee report on TRA 1986 which reaffirms the non-deductibility of interest on loans against single premium policies but which implies that universal life insurance policies are single premium policies. HR Rept. 99-426, 99th Cong., First Session, page 660.

b. The Conference Committee on TRA 1986 accepted the above-referenced language in the House Report on the single premium policies but the Conference Report includes language that "no inference is intended that universal life insurance policies are always treated as single premium contracts." Conf. Rep. 99-841, 99th Cong., Second Session, II-341.

c. It would seem that universal life policy is not per se a single premium policy and that the issue would depend upon the amount of premiums paid.

6. Single Premium Policy as Collateral. If a single premium policy is used as collateral for a loan of the taxpayer, the IRS has disallowed the part of the interest deduction on the loan attributable to the collateral of the single premium policy. Rev. Rul. 79-41, 1979-1 C.B. 124. Rev. Rul. 95-53, 1995-2 C.B. 30. GCM 39534. The IRS theory is that the loan proceeds were indirectly used to "carry" the single premium contract since the taxpayer, rather than liquidating the contract for its cash surrender value, maintained the policy investment by borrowing, using the policy as collateral and then using the loan proceeds for other purposes.

D. LIMITATION UPON INTEREST INCURRED FROM SYSTEMATIC BORROWING OF CASH VALUE.

1. Nondeductibility of Interest. Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance contract pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in cash value of the contract (either from the insurer or otherwise) are nondeductible. IRC Section 264(a)(3).

2. Applicability. This nondeductibility rule applies to all insurance policies other than single premium policies whether owned by an individual or by a trade or business even though the other limitations of IRC Section 264 and IRC Section 163 have been met.

3. Plan Which Contemplates Systematic Borrowing. Such a determination shall be made on the basis of all facts and circumstances. Unless shown otherwise, in the case of borrowing in connection with premiums for more than three years, the existence of a plan is presumed. The failure to borrow in a particular year does not in and of itself preclude the existence

of a plan. The plan need not exist at the time the contract is entered into, but may come into existence at any time during the seven-year period following the taxpayer's purchase of the contract or following a substantial increase in the premiums of the contract. Reg. Section 1.264-4(c)(1)(i).

4. Direct or Indirect Borrowing. Direct borrowing of cash value increases to pay premiums is not necessary but can also include borrowing from an insurance carrier, from a bank or from any other person pursuant to a plan. The plan need not involve a pledge of the contract but may contemplate unsecured borrowing or the use of other property. Reg. Section 1.264-4(c)(2). Rev. Rul. 74-500, 1974-2 C.B. 91.

5. Exceptions to Denial of Interest Deduction. There are four exceptions to the general rule that interest deduction is disallowed if premiums are paid pursuant to a plan of purchase which contemplates the systematic borrowing of cash value. IRC Section 264(d). Thus, even if there is a plan of systematic borrowing, interest deductions may be available if any of the following four exceptions apply.

a. The Four Out of Seven Exception. This is the most commonly used exception.

(1) No part of four of the first seven premiums from the date of the issuance of the policy is paid under such plan by means of indebtedness. IRC Section 264(d)(1). If there is a substantial increase in any annual premium, a new seven-year period begins on the date the increased premium is paid. If there are multiple premium payments during the year, the annual premium is the aggregate of the premiums due for the year. Reg. Section 1.264-4(d)(1)(i).

(2) If during the first seven years, a loan in excess of an annual premium is made, the loan is applied against the year of the loan and applied to prior policy years which have not been disqualified by previous borrowing. If the borrowing exceeds the premiums paid for the current and all prior policy years, the excess borrowing will be carried forward to future policy years. Reg. Section 1.264-4(d)(1)(ii). Reg. Section 1.264-4(d)(1)(iv), (Ex. 1).

(3) If any part of a premium is paid by borrowing, the entire policy year is tainted. IRC Section 264(d)(1) ("no part of four of the annual premiums").

(4) Once a policy is tainted by failing to meet the four out of seven exception, interest will be disallowed on policy loans

even though the policy owner might repay the loans before the end of the seven-year period. Rev. Rul. 72-609, 1972-2 C.B. 199.

(5) Once the four out of seven rule is met, interest is deductible for loans against the policy even though there is a plan for systematic borrowing against the cash value of the policy, assuming that the other restrictions of IRC Section 264 and IRC Section 163 have been met.

(6) There are questions concerning universal life policies. Since there are technically no premiums due, there is the issue of whether the four out of seven exception applies. There is no authority as to whether the exception will apply if a level premium payment is made on the universal life policy. The flexibility in premium payments on universal life policies can cause problems. If a premium in one year is substantially higher than the others, a new seven-year period might be started. If the premiums vary during the first seven years (but not substantially) and a loan is made against the policy, presumably, in determining the number of years tainted by the loan, the lowest premium paid may be the standard (which might be zero if a year was skipped). *See* Reg. Section 1.264-4(c)(1)(ii).

b. <u>The $100 Exception</u>. If the total amount of interest on all insurance policy loans during the taxable year does not exceed $100, a deduction is allowed. IRC Section 264(d)(2). However, if the interest exceeds $100, none of the interest is deductible. Reg. Section 1.264-4(d)(2).

c. <u>The Unforeseen Events Exception</u>.

(1) If the interest on policy loans is incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in financial obligations, the deduction is allowed. IRC Section 264(d)(3).

(2) The event which caused the loss of income or increase in financial obligation must not have been foreseen at the time of the purchase of the contract. College education expenses are foreseeable, but, if college expenses substantially increase, then to the extent that such increases are unforeseen, this exception will apply. If a taxpayer incurs substantial unexpected medical expenses or is laid off his job and he borrows against the cash value of the policy to

pay premiums, the deduction for the interest paid on the loan will not be denied. Reg. Section 1.264-4(d)(3).

d. The Trade or Business Exception.

(1) A deduction is allowed for interest on indebtedness incurred with trade or business. IRC Section 264(d)(4).

(2) The indebtedness must be incurred to finance business obligations rather than finance cash value life insurance. Thus, the deduction is allowed on interest on a loan to finance the expansion of inventory or capital improvements for a business even though the taxpayer pledges a life insurance contract as collateral. However, borrowing by a business to finance business life insurance such as key person, split dollar or stock retirement plans is not considered to be incurred in connection with a trade or business. The determination of whether an indebtedness is so incurred is based upon all of the facts and circumstances. Reg. Section 1.264-4(d)(4).

(3) Loans against insurance policies used to finance an employee's retirement plan do not fall within the trade or business exception. Rev. Rul. 81-255, 1981-2 C.B. 79. However, if a corporation borrows substantial sums to carry on its business while at the same time maintaining a retirement plan that purchases level premium life insurance to fund its retirement obligation, the corporation will not lose its deduction for interest paid on its normal indebtedness even though the policy is later used as part of the collateral for its normal indebtedness. Reg. Section 1.264-4(d)(4) (Ex. 1).

(4) If the corporation has outstanding business debt and at the same time has a key person insurance policy, and the amount of indebtedness is increased each year by the amount of insurance premiums, the deduction will be lost on such interest. Reg. Section 1.264-4(d)(4) (Ex. 2).

(5) Even if the trade or business exception applies, do not forget the impact of § 264(e) which limits the interest deduction on policy loans not to exceed $50,000 of indebtedness for policies on the lives of key persons.

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