UNWINDING AN UNWORKABLE TRANSACTION WITH A WORKABLE POLICY

DEALING WITH EXISTING ILITS,
DEALING WITH EXISTING SPLIT-DOLLAR ARRANGEMENTS
AND
A CLOSELY HELD BUSINESS OR A BUSINESS OWNER OWNS A POLICY

53RD ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING
ORLANDO, FL
JANUARY 17, 2019
2:00 PM – 3:30 PM

LAWRENCE BRODY
MARY ANN MANCINI
TODD STEINBERG

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UNWINDING AN UNWORKABLE TRANSACTION WITH A WORKABLE POLICY

DEALING WITH EXISTING ILITS

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Dealing with Existing ILITs

• Many clients established ILITs when the estate tax exemption was a fraction of what it is today.
Dealing with Existing ILITs (cont.)

- Now, with a $11,118,000 per person exemption, doubled for married couples, less prior use (indexed and, barring future legislative changes, in effect through 2025), many who have ILITs regard them as albatrosses around the necks of their financial and tax lives.
Dealing with Existing ILITs (cont.)

• Consider “undoing” the ILIT
  – Remembering it is an otherwise irrevocable trust
    • Which generally means what it says
Dealing with Existing ILITs (cont.)

• Also consider “fixing” an existing ILIT, using the increased exemption(s)
  – Additional gifts now could mean no more premium payments
    • The gifts could go into the policy or could be held in the trust to pay premiums as they come due
  – Or they could be used to terminate old split-dollar or other financing arrangements
Dealing with Existing ILITs (cont.)

• Or “fixing” it by changing its terms
  – Remembering, again, it is irrevocable
    • And that it generally means what it says
Overview of options for the “undoing” or the “fixing”

- Decanting to another “better” ILIT (if and as permitted under local law)
  - Generally requires the trustee have broad discretionary distribution powers
  - May require notices to the beneficiaries of the old or the new trust (or both), may require both trusts have the same beneficiaries, etc.
    - It cannot be generalized – the power to decant depends exclusively on local law
    - Consider moving the trust situs, if necessary
Overview of options for the “undoing” or the “fixing” (cont.)

- Termination or amendment by a non-fiduciary trust protector (if the trust provides for one with this power)
  - Termination would result in a distribution of the policy(ies) to the beneficiaries
    - Taking the policy(ies) out of a creditor and spouse protected entity
    - And putting the policy(ies) in the hands of a group of beneficiaries, all of whom would have to act together to exercise incidents of ownership
Overview of options for the “undoing” or the “fixing” (cont.)

• Court reformation/non-judicial modification (as and to the extent permitted under local law)
  – Generally requires settlor and beneficiary (and sometimes trustee) consent
    • Again, it depends exclusively on local law
Overview of options for the “undoing” or the “fixing” (cont.)

• Distribute the policy to adult beneficiaries (if possible under the trust)
  – Raises fiduciary duty issues for the trustee, without the consent of all beneficiaries
    • Raises the same beneficiary-owned issues described above
Overview of options for the “undoing” or the “fixing” (cont.)

- Distribute the policy to a new ILIT (if possible under the trust)
  - Raises fiduciary duty issues for the trustee, without the consent of all beneficiaries, unless the new trust has identical beneficiaries
Overview of options for the “undoing” or the “fixing” (cont.)

• Sell the policy to a new ILIT (if a grantor trust, to avoid gain on the sale and be exempt from the transfer for value rule), based on FMV
  – Raises fiduciary duty issues for both trustees, with a similar exception
  – How does the trustee determine FMV?
    • Can the trustee use gift tax value?
    • Does it require an appraisal?
      – If so, who pays the appraiser?
Overview of options for the “undoing” or the “fixing” (cont.)

• Sell the policy to the grantor, based on FMV
  – Raises fiduciary duty issues for the trustee, with a similar exception
  – How does the trustee determine FMV?
    • Same questions
  – Again, takes the policy(ies) out of a creditor and spouse protected entity (except to the extent policies are exempt under state law)
Overview of options for the “undoing” or the “fixing” (cont.)

• Have the settlor enter into a swap for the policy (if possible under the trust), based on FMV
  – Raises a different set of fiduciary duty issues for the trustee, under the Rev. Ruls.
  – How does the trustee determine FMV?
    • Same questions
  – Same creditor protection issues
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DEALING WITH EXISTING SPLIT-DOLLAR ARRANGEMENTS

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SPLIT-DOLLAR LIFE INSURANCE

• What is a Split-Dollar Arrangement (SDA)?
  – Agreement between two parties “split” costs and benefits of life insurance
    • Employer-employee relationship
    • Family relationship (e.g. grantor & trust)
  – Normally temporary financing – need exit plan
  – **Practical Advice**
    • Always consider exit planning AT INCEPTION
SPLIT-DOLLAR LIFE INSURANCE (cont.)

• Pre-Final Regs: Before Sept. 18, 2003
  – Based on 1960’s Revenue Rulings
  – Advantageous for “primary beneficiary” of policy benefits

• Post-Final Regs: After Sept. 17, 2003
  – Split dollar not dead, but rules changed dramatically
  – Provide roadmap but uncertainty remains – little guidance after Final Regs
  – Transitional relief for pre-Final Reg “grandfathered” SDAs
  – 409A (2005–2007) also impacts - topic for another time
SPLIT-DOLLAR LIFE INSURANCE (cont.)

• SDAs still attractive post-TCJA?
  – Historically used to pay large life insurance premiums with minimal gift tax implications
  – Still advantageous with “temporary” enhanced gift/estate exemptions
  – Can structure with higher probability of success
    • *i.e.*, exit strategies actually contemplated and funded
SPLIT-DOLLAR LIFE INSURANCE
TAX REGIMES

• Types of SDAs – Taxation
  – Economic Benefit Regime
  – Loan Regime

• **Owner named on policy** determines regime
  – Two exceptions (Reg. §1.61.22(c)(1)(ii)(A)(1) & (2)):
    • *Private SDA:* Donor is deemed policy owner under non-equity SDA between donor and donee (e.g., irrevocable life insurance trust (“ILIT”))
    • *Compensatory SDA:* Employer/service recipient is deemed policy owner in non-equity SDA for performance of services
SPLIT-DOLLAR ARRANGEMENTS – WHICH REGIME?

• Economic benefit regime applies if:
  – Premium payor owns policy and the non-owner (e.g., an ILIT) has right to designated Death Benefit payment
  
  or

  – ILIT owns policy and deemed owner rules for private SDAs apply

• Otherwise, it is a loan arrangement
LOAN REGIME

• Loan regimes only applies to a loan if:
  1. Payment made by lender to/for policy owner (ILIT)
  2. Payment is loan under general federal tax law principles or a reasonable person would otherwise expect full repayment; and
  3. Repayment is to be made from or secured by the policy Death Benefit, Cash Value, or both

• Application very broadly construed
  – Final Regs allow SDA parties to make a “Split-Dollar Loan Representation” (Reg §1.7872-15(d))
SPLIT-DOLLAR LIFE INSURANCE TAXATION BY REGIME

• Economic Benefit
  – Taxed based on annual cost of current life insurance protection – economic benefit (EB) cost
  – Determined using lower of Table 2001 or carrier’s qualifying alternative term insurance rates

• Loan
  – Taxed based on adequacy of interest charged on loan:
    • Adequate interest: General tax rules for debt instruments apply, except as modified in final regs
    • Inadequate: Generally treated/taxed as a below-market loan
CURRENT PROBLEMS WITH YOUR SDA

• EB Problems - Increasing Annual EB Cost
  – Carrier changes
    • May no longer provide annual required reporting of alternative term rates
      – Query: Do the annual term rates qualify under the Final Regs?
    • Concern: Future alternative term rates will no longer be provided or will not qualify
      – Forces use of much higher Table 2001 rates
CURRENT PROBLEMS WITH YOUR SDA (cont.)

• EB Problem - Increasing Annual EB Cost
  – Insured continues to age
    • Better health care, medical advancements, etc. = longer life expectancy (LE)
    • Concern: Annual EB cost increases each year with age – may become impractical if death is only exit
      – Note: even a current “good” policy issued in the 90’s can become a “poor” policy if insured’s LE is getting closer to policy maturity or end of contractual rights as opposed to guarantees in GUL in later policies
  – Survivorship policy - death of one insured
    • Concern: Immediate, substantial increase in annual EB cost
CURRENT PROBLEMS WITH YOUR SDA (cont.)

• EB Problem – Equity Build-Up:
  – Substantial equity in grandfathered EB SDA due to impressive policy performance over the term
  – EB costs are about to increase (likely death of one insured) and survivor no longer wants SDA
  – Concern: How do the parties address termination or roll-out?
    • Query: “No inference”.....
CURRENT PROBLEMS WITH YOUR SDA (cont.)

• Loan Problem – Steadily Increasing AFRs:
  – Steadily Increasing AFRs
    • Long-Term AFRs have stayed between 1.9% and 3.32% but Short and Mid-Term AFRs have increased dramatically:

<table>
<thead>
<tr>
<th>AFRs</th>
<th>Long-Term</th>
<th>Mid-Term</th>
<th>Short-Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 2012</td>
<td>2.4%</td>
<td>0.95%</td>
<td>0.24%</td>
</tr>
<tr>
<td>Dec. 2014</td>
<td>2.74%</td>
<td>1.68%</td>
<td>0.74%</td>
</tr>
<tr>
<td>Dec. 2018</td>
<td>3.31%</td>
<td>3.07%</td>
<td>2.76%</td>
</tr>
<tr>
<td>Jan. 2019</td>
<td>3.15%</td>
<td>2.89%</td>
<td>2.72%</td>
</tr>
</tbody>
</table>

  – Last time Long-Term AFR was this high was March 2014 (3.36%)
  – *Lowest* Long-Term AFR was 1.90% in August and September 2016
CURRENT PROBLEMS WITH YOUR SDA (cont.)

• Loan Problem – Steadily Increasing AFRs:
  – Increases annual costs of annual loans to pay required policy premiums
  – Also, new “large” loans for multi-year funding of premiums require a much higher annual interest cost
  – **Concern:** Prior solutions to address/plan for either annual debt service or long-term interest repayment are not working as smoothly
CURRENT PROBLEMS WITH YOUR SDA (cont.)

• EB/Loan Problem – Delayed Switch-Dollar:
  – EB but should have switched to Loan years ago
    • EB costs rose faster than parties realized
    • But now new loan is more expensive
  – Analysis is harder as both EB and Loan costs appear to be increasing in the near term
    • Particularly true on survivorship policies upon death of one insured
  – Query: Switch now or wait until required? But what will relevant AFR be then?
CURRENT PROBLEMS WITH YOUR SDA (cont.)

• EB/Loan Problem - Poor Management:
  – EB
    • Annual EB costs were not used (or never)
    • Alternative term rates used were not qualified
    • Improper accounting for EB on either income or gift tax side
    • Equity build-up in EB regime post-Final Regs not being reported properly, but.....

– Remember special deemed owner rule - non-equity treatment should apply IF: (i) donor (deemed owner) is entitled to greater of premiums or policy cash value; and (ii) non-owner (ILIT) only receives current life insurance protection

– However, with positive policy performance, this causes an annually increasing (equity) includible part of SDA reimbursement in gross estate of donor
CURRENT PROBLEMS WITH YOUR SDA (cont.)

• EB/Loan Problem - Poor Management:
  – Loan
    • Failure to file required Split-Dollar Loan Representation either annually or at inception (if only applicable at such time)
    • Still loan under general tax principles?
      – “Bona Fides” never did or no longer appear to justify reasonable person would expect repayment
      – Likely still OK based on Preamble to Final Regs
    • Interest charge, if applicable, was not properly reflected, treated, or cured if non-grantor trust owner
CURRENT PROBLEMS WITH YOUR SDA (cont.)

• Grandfathered Problem - Material Modification
  – Modification has occurred or is required
    • Prior or recent 1035 exchange was performed
  – Remember so-called “Angel List” was non-exclusive list of non-material changes. But.…
    • IRS will not rule and never issued any helpful guidance
  – Equity build-up is about to be rolled out
    • Ancient Employer Plan about to terminate upon retirement, sale, or liquidation of Employer
    • Arguable income/gift taxation, but… Query: “No Inference”
CURRENT PROBLEMS WITH YOUR SDA (cont.)

• Third-Party Premium Financing Problems:
  – Interest costs have become excessive
  – Third-party financing is no longer desirable
  – Collateral, if any, outside of policy may be declining or no longer sufficient
CURRENT PROBLEMS WITH YOUR SDA (cont.)

• Any SDA/Premium Finance – Global Problems
  – Exit strategy did not perform as planned or is no longer feasible
  – Change in circumstances for the client or economic/legal/tax environment:
    • Design now determined to be too risky or aggressive (e.g., intergenerational split-dollar, particularly if formed as EB SDAs)
    • Estates of Cahill, Morrissette, Levine (ruling is expected soon)
POSSIBLE SOLUTIONS

• Use Enhanced Lifetime Gift Tax Exemptions
  – Can mitigate economic pressures
  – Solve for future required premiums
  – May be able to restate or “refinance” post-Final Regs EB or Loan SDA
  – Can unwind transaction in its entirely BUT
    • Carefully analyze applicable income, gift, and employment tax issues
    • Address consistently
POSSIBLE SOLUTIONS (cont.)

• Modify, Decant, Terminate ILIT
  – Address any trust concerns (beneficiary, trust provisions, lack of flexibility, etc.)

• Roll-Out Policy
  – If only viable planning option
  – Parties must review all tax issues and address consistently
  – Must consider valuation
  – Consider creditor protection alternatives to owning policy outright
POSSIBLE SOLUTIONS (cont.)

• Exit Third Party Premium Finance Arrangement
  – Use available assets to pay-off financing
  – Alternatively, use policy and contract rights thereunder, including potential Life Settlement
  – Switch to Loan SDA, where applicable and practical
PRACTICAL PLANNING ISSUES WITH TERMINATION OF A SDA

• Repayment of Receivable or Loan
  – Make sure you address income, gift and valuation issues.
  – Release of Collateral Assignment
  – Timing between gift and repayment (practical, optics – best practices)
PRACTICAL PLANNING ISSUES WITH TERMINATION OF A SDA (cont.)

• Termination of Agreement
  – Consider same income, gift and valuation issues.

• Transfer of Policy
  – Insurance paperwork
  – Consider transfer-for-value concerns

• Address equity roll-out, if any
  – Consider same income, gift and valuation issues
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A CLOSELY HELD BUSINESS OR A BUSINESS OWNER OWNS A POLICY

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Closely-held businesses and business owners use life insurance for a variety of reasons.

The policy premium can be paid in the following ways:

(i) out of the assets of the business,
(ii) with a cost sharing arrangement,
(iii) with compensation paid to the employee; or
(iv) premium financing arrangements or other loan arrangements.
What are the alternatives to receiving the death benefit?

(1) Continue to pay expenses as they arise, if the business can support it.

(2) Borrow funds. Consider the cost of borrowing, even if a lender would be willing to lend money on the strength of the business when the owner has died.

(3) Create an investment fund in the business. However, investments in a C corporation could be subject to accumulated earnings tax. This alternative requires the company to set aside funds on a regular basis that may be needed for the business. It also requires a great deal of discipline and foresight on the part of the owners.
(4) Sell the business. If the estate or family takes back a promissory note, the estate or family becomes a creditor of the business. Furthermore, they may not be able to wait for the note payments to pay the estate taxes or to meet the family needs.
IF BUSINESS OR BUSINESS OWNER DECIDES THE POLICY IS NO LONGER NEEDED

1. Distribute Policy to Insured:
   A. If owner, it could be a dividend (S corporation issues) if corporation owns policy
   B. If Employee: it could be compensation
   C. If partnership owns policy, effect on capital accounts, permissible under agreement? Consent of other partners may be required.

2. Sell Policy
   A. To Insured
   B. To third parties

3. Retain Policy
   A. Does Insured own Business?
   B. Cost of Premiums