Executive benefits consulting firm, Fulcrum Partners LLC, is pleased to distribute this **AALU WashingtonMarketplace Report,** *"Trouble Ahead, Trouble Behind," and You Know that Notion Never Crossed My Mind: Avoiding 5 Common Mistakes in Life Insurance Planning,"* to its clients and friends.

This continuing series of articles is intended to provide in-depth insight into trends, events, and issues that impact the design and operation of nonqualified executive benefit plans. Fulcrum Partners is an independent member of the BDO Alliance USA.

The *WRMarketplace* is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led ***by Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca Manicone.*** **WRMarketplace #17-24 was written by Greenberg Traurig Shareholder Jonathan M. Forster.**

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TOPIC: "Trouble Ahead, Trouble Behind," and You Know that Notion Never Crossed My Mind: Avoiding 5 Common Mistakes in Life Insurance Planning.

MARKET TREND: As estate planning involving personal life insurance becomes commoditized, so does the chance that a minor oversight will have a major tax impact.

SYNOPSIS: According to experts, some of the most common mistakes in life insurance planning include: (1) failure to qualify gifts to irrevocable life insurance trust ("ILITs") for the annual gift tax exclusion; (2) improper allocation of GST tax exemption to ILIT gifts; (3) retention of incidents of ownership in an ILIT-owned policy; (4) failure to understand the planning implications of a policy classification as a modified endowment contract; and (5) triggering tax on an otherwise non-taxable policy exchange under Internal Revenue Code ("Code") §1035. Find out how to identify and avoid them.

TAKE AWAY: In a world of increasing commoditization, adding value is key. Advising on product selection and identifying common trouble spots in the development of a life insurance plan can offer advisors significant opportunities to provide value to their clients. Collaborating with other allied advisors early on in the client's planning also can alleviate many of these problems without creating extensive delays to policy issuance.

Life insurance is a core component of many estate plans and is often viewed as a relatively simple method to provide family security and estate liquidity at a client's death. However, pressures to minimize costs, yet provide coverage, through sophisticated plans can lead to oversights that result in unexpected tax consequences. Here are some of the most common trouble spots that experts see when reviewing life insurance plans:

1. FAILURE TO QUALIFY FOR ANNUAL EXCLUSION GIFTS

Many clients rely on the annual exclusion from gift tax ("**annual gift exclusion**") to make gifts to their irrevocable life insurance trusts ("**ILITs**") to fund premiums.[1] A gift only qualifies for the annual gift exclusion if the recipient has a "present interest" in the gift. As gifts to ILITs typically do not satisfy this requirement, ILITs often contain "*Crummey*" withdrawal powers that allow designated trust beneficiaries to withdraw the gift from the trust, up to the annual gift exclusion amount for each beneficiary. The trustee typically provides the beneficiaries with notice of their powers to withdraw. If unexercised within a set time (*e.g.*, 30 days), the powers lapse, and the trustee invests or uses the funds (e.g., to pay policy premiums).

The IRS continues to focus on the use of *Crummey* powers in ILITs, and failure to follow proper administrative procedures in handling these powers may result in (1) limits on the annual exclusion gifts a client can make to the ILIT beneficiaries, (2) characterization of all transfers to the ILIT as taxable gifts, (3) the imposition of gift tax, and/or (4) the loss of gift tax exemption.

- ***Practical Insight***: ILITs are not "set it and forget it" propositions. To ensure the intended tax treatment, clients and trustees must follow best practices (as discussed in detail in *WRMarketplaces No. 13-08* and *14-04)* in the on-going administration of ILITs funded with annual gift exclusions. As this is a common trouble spot, insurance advisors may want to initiate or maintain contact with clients by offering reviews of an ILIT's policy administration.

2. IMPROPER GST TAX EXEMPTION ALLOCATION TO ILITS

Unlike the annual gift exclusion, the annual exclusion from generation-skipping transfer ("**GST**") tax requires that the trust receiving the gift must (1) benefit only one individual during his or her life (who is a skip person for GST tax purposes (*e.g.*, a grandchild)) and (2) the trust assets must be paid to that individual during life or be includible in his gross estate at death.

Accordingly, gifts to typical ILITs will <u>**not**</u> qualify for the annual GST tax exclusion, even if they qualify for the annual gift exclusion, because the ILITs have multiple beneficiaries and are drafted to prevent inclusion of the trust assets in a beneficiary's estate. If not fully exempt, GST tax will apply to these ILITs when trust assets are distributed to a skip person or when the interests of all non-skip persons in the ILIT terminate. In these cases, the so-called "automatic allocation" rules may help, as they automatically allocate GST exemption to any contribution made to a qualified "GST trust."[2] The rules, however, are complex and generally only apply to contributions made after 2000. Further, the taxpayer must confirm the trust's GST status and independently track the GST exemption automatically allocated each year.

> ***Example:*** John and Jane created a dynasty ILIT for their descendants in 1996 and funded it annually for 20 years with $40,000 in annual exclusion gifts to pay premiums on a survivorship policy. The trustee has provided

Crummey notices to the required beneficiaries, but John and Jane have not filed any gift tax returns allocating GST tax exemption. Since the GST exemption automatic allocation rules only applied to their gifts from 2001 and after, no GST exemption has been applied to their gifts from 1996 through 2000.

Currently, the ILIT's applicable fraction for GST tax purposes is .75 ($600,000 (amount of GST exemption allocated to the trust) over $800,000 (value of the property transferred to the trust)). The inclusion ratio is .25 (1 − .75). The applicable GST tax rate to the taxable distribution is .10 (40% top federal estate tax rate x .25). Assume after their deaths and the deaths of their children, a taxable termination occurs on $12 million of trust value. The GST tax would be $1.2 million ($12,000,000 x .10).

- ***Practical Insight***: This is one of the most common, complicated, and expensive-to-fix trouble spots in ILIT planning. To avoid this issue, clients who make annual exclusion gifts to GST-exempt ILITs should ensure the proper allocation of their GST tax exemption to those contributions, rather than relying on the automatic allocation rules. This may include the filing of a federal gift tax return for the sole purpose of documenting the allocation of GST tax exemption, even if the client has not made any taxable gifts that would otherwise require a return. Proper reporting also requires communication among the client's insurance, legal, and tax advisors to confirm the ILIT's terms, its intended GST-exempt status, and the total annual contributions that will require allocation of GST exemption.

3. INCIDENTS OF OWNERSHIP IN ILIT-OWNED POLICIES

An insured that retains any "incident of ownership" over a policy at death, whether individually or through a trust, will trigger inclusion of the policy proceeds in his or her estate. "Incidents of ownership" extend well beyond the mere holding of title to a policy and include, for example, the insured's ability to change beneficiaries or to access policy cash value, including the power to pledge the policy for a loan (e.g., coverage on a business owner pledged as collateral for a line of credit).

This issue also frequently arises when an existing ILIT designed to own a policy on one spouse acquires a survivorship policy on both spouses. Using the existing ILIT can seem an efficient way to reduce planning costs and minimize administrative hassles by consolidating the life insurance planning in a single trust. However, single-life ILITs may (1) name one spouse as a trustee without restricting his or her ability to exercise incidents of ownership over insurance policies held by the ILIT or (2) provide a spousal beneficiary with a limited power to appoint trust assets to others. These powers can result in inclusion of the ILIT assets in the spousal trustee/beneficiary's estate at death if the ILIT owns a survivorship policy (see *WRMarketplace No. 13-44* for a detailed discussion of "incidents of ownership").

- ***Practical Insight***: Advisors and clients must proceed cautiously with regard to any powers provided to the insured under an insurance planning arrangement, and survivorship policies should be owned only by ILITs specifically drafted to accommodate survivorship coverage.

4. FAILURE TO UNDERSTAND IMPLICATIONS OF A MEC

For most life insurance contracts, withdrawals of policy cash value by the policy owner are not taxable, up to the owner's tax basis in the policy. A different rule applies to life insurance contracts classified as modified endowment contracts ("**MECs**").[3] Lifetime distributions from MECs are taxed as ordinary income until the distributions exceed the gain in the MEC. Policy loans and pledges of MECs as collateral for loans are similarly taxed as MEC distributions. Further, a 10% penalty tax is imposed on the includible amount of the MEC distribution (or deemed distribution), with limited exceptions (*e.g.*, MEC owner is 59½ or older or disabled) (see *WRMarketplace No. 15-15* for a more detailed discussion of MECs).[4]

MEC status generally is not an issue as long as a client does not want lifetime access to policy cash value and the policy otherwise satisfies the planning objectives (e.g., a policy acquired primarily for death benefit protection). Yet, issues frequently arise with MECs because their implications as part of the overall life insurance plan have not been fully considered:

> ***Example:*** A spousal lifetime access trust ("**SLAT**") owns a policy insuring Adam, the 55-year-old grantor of the SLAT. The gain in the policy is $250,000 (the SLAT's tax basis of $600,000 less policy cash value of $850,000). To facilitate a distribution to Jack's spouse, a SLAT beneficiary, the trustee takes out a $200,000 loan on the policy. If the policy is classified as a MEC, the loan is deemed a distribution of $200,000, taxable as ordinary income. Furthermore, a 10% penalty tax may apply to the includible amount of the distribution (10% x $200,000 = $20,000).

➢ ***Practical Insights***: Given the potential adverse tax consequences of MEC status, the selection between a MEC and a non-MEC product should consider the following factors:

- **<u>Need for Cash Value Access</u>**. If the client does not anticipate taking policy loans or withdrawals during life, MEC status may not be important. For lifetime access planning (such as with a SLAT), MEC status likely will not be preferred.

- **<u>Split-Dollar Planning</u>**. Given that pledges of a MEC as loan collateral are taxed as MEC distributions, MEC status is likely undesirable where the policy will be pledged as collateral for a split-dollar loan.

- **<u>Desire for Future Flexibility</u>**. Once classified as a MEC, a policy will remain a MEC, even if exchanged. This can limit flexibility in product modification if the client's circumstances change and access to cash value is desired.

5. CREATION OF "TAXABLE" 1035 POLICY EXCHANGES

Code §1035(a) allows the exchange of one life insurance contract for another, generally without the recognition of gain or loss upon the exchange (a "**1035 exchange**"). This provision allows the deferral of taxation for individuals who merely exchange one policy for another better suited to their needs. 1035 exchanges are popular because they permit clients to adapt their long-term life insurance planning to changed economic and family circumstances, but they must be carefully implemented to avoid the following (see *WRMarketplace No. 14-39* for a more detailed discussion of 1035 exchanges):

- **Different Insureds**. The exchanged policies must (1) have the same owner and (2) relate to the same insured. Thus, a policy owner cannot 1035 exchange a policy for a new policy with a new insured (*e.g.*, as may be allowed under a "policy exchange rider" that permits a business to switch the insured under a key-employee policy to replace a terminated or departed employee). Nor can a single life policy be 1035 exchanged for a survivorship policy insuring the same individual and another person (such as a spouse). This rule also prohibits a 1035 exchange of two single life policies insuring respective spouses for a survivorship policy insuring both spouses.[5]

- **New "Force-Out" Period**. A withdrawal of policy cash value in the first 15 years of a non-MEC contract that reduces the future death benefits may generate an immediate income tax liability. The withdrawal is includable in gross income to the extent of the policyholder's gain in the contract (excess of the policy's cash value over the policyholder's basis) up to a "recapture ceiling," and may be referred to as "forced-out gain." A policy received in a 1035 exchange is treated as a ***new*** policy for this purpose.[6]

- **Taxable Boot.** Any money or other non-like kind property ("**boot**") received in a 1035 exchange in addition to the new policy will **not** qualify for non-recognition treatment and may result in reportable gain to the taxpayer. A common "boot" situation is the 1035 exchange of a policy subject to an outstanding loan. The exchange generates boot if the loan is not carried over to the new policy, and policy cash values are used to satisfy the loan.

  > ***Example:*** B owns Policy 1, with $100,000 of cash value, a $70,000 tax basis, and an outstanding policy loan of $40,000. B exchanges Policy 1 for Policy 2, issued without any loans. B's amount realized is $100,000: $40,000 of boot (extinguished loan) plus Policy 2, with a cash value of $60,000. B recognizes $30,000 of gain ($100,000 amount realized - $70,000 basis in old policy).

  The boot treatment of policy withdrawals made within a short timeframe of a 1035 exchange (e.g., 6 months) to pay off a loan also can be problematic. The IRS has indicated that policy withdrawals made to pay-off an existing policy loan, followed shortly by a 1035 exchange of the policy, constitute a single integrated transaction taxable under Code § 1035 and result in tax on the withdrawal as boot.[7] Yet, the

IRS reached a different result in a private letter ruling involving the proposed pay-off of a policy loan after a 1035 exchange by using withdrawals from the new policy.[8] Thus, clients and advisors should proceed cautiously whenever a policy considered for a 1035 exchange involves outstanding policy loans.

- **New MEC Testing**. In addition, a new policy received in a 1035 exchange for a non-MEC policy must undergo a seven-pay test to determine whether it constitutes and will be taxed as a MEC. The risk of failing this test for the new policy may increase if there is a reduction in its death benefit compared to the old contract or if the owner contributes additional funds at the time of the exchange.[9]

TAKE AWAYS

In a world of increasing commoditization, adding value is key. Advising on product selection and identifying common trouble spots in the development of a life insurance plan can offer advisors significant opportunities to provide value to their clients. Collaborating with other allied advisors early on in the client's planning also can alleviate many of these problems without creating extensive delays to policy issuance.

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NOTES

[1] Generally, a person's first $14,000 (in 2017, indexed) of annual gifts to a donee is excluded from federal gift tax.

[2] *See* Treas. Reg. §26.2632-1 for a definition.

[3] A MEC is a life insurance contract that: (1) is entered into or materially changed after June 21, 1988, and (2) fails the "seven-pay test" (see Code §7702A). A policy fails this test if at any time in the first seven years, the total premiums paid for the policy exceed the total net level premiums that would have been paid up to that point for a fully paid-up policy requiring seven level annual premiums (see Code §7702A(b); §7702A(c)).

[4] See Code §72(v)(2) for the applicable exceptions.

[5] See PLR 9542037. Interestingly, however, the IRS has privately ruled that, after the death of one insured, the exchange of a survivorship policy for a single life policy insuring the surviving insured qualifies as a 1035 exchange (see PLRs 201304003, 9330040, and 9248013 (all involved trust-owned policies).

[6] *See* PLR 9044022.

[7] *See* e.g., PLR 9141025.

[8] *See* PLR 8816015.

[9] *See* PLR 8816015. Advisors also should pay attention to potential 1035 exchanges of policies issued before June 21, 1988, as they are grandfathered from MEC testing unless there is a material change, such as a 1035 exchange.

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