

**Life Insurance Planning:
Cahill, Tax Cuts and Jobs Act
and More**

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Stern Slavutin—2 Inc. Law Easy ChronicIllnessPlanning.org A KEY ESTATE PLANNING GUIDE

**Life Insurance Planning:
Cahill, Tax Cuts and Jobs Act
and More**

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and Martin Shenkman

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**Life Insurance:
Historical Perspective**

Some Background

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Life Insurance Last 25 Years

- 1991 – 62 life insurance company insolvencies. The importance of financial strength ratings.
- 1997 – Demutualization of major life insurance companies. Some clients have stock in their ILIT's – basis may be zero
- 2008 – Financial crisis. Only one major insurer got into trouble – AIG.
- 2008 – 2018 - Low interest rates. Monitoring policy performance is so important – treat insurance portfolio like other assets that are continuously monitored.
- 2017 – Failure of Penn Treaty - long-term care insurance. Old long term care policies with strong carriers are very valuable today because lifetime benefits are no longer available.

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2017 Tax Act

Many Changes Affect Life Insurance

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2017 Tax Act

- The Tax Cuts and Jobs of 2017 ("TCJA," "2017 Tax Act") has far-reaching effects on many areas of financial planning, and life insurance is no exception.
- 4 provisions with the greatest effect on life insurance planning:
 - Increased lifetime gift tax exclusion.
 - Lower 21% maximum corporate tax rate.
 - New Section 199A income tax deduction for trusts.
 - New rules for life settlements.
- In addition the increased use of non-grantor trusts will raise planning issues for many ILITs and how insurance trusts fit into the typical estate plan.

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Life Settlements: New Rules

- Although life settlements occupy a narrow space in the life insurance sector, the changes could be significant for individuals who do use them.
- The new rule is found in section 13521(a) of the TCJA and reverses the IRS' previous position on these transactions.
- Life settlements allow holders of policies, that would otherwise be cancelled, to sell their policy to an institutional buyer willing to pay a percentage of the face amount of the policy.
- This particularly applies when the insured is expected to live 10 years or less.
- Some tax may be owed on the policy sale, but the net may be higher than it would have been without the life settlement.
- This change in the definition of basis applies retroactively to transactions entered into after August 25, 2009, meaning some taxpayers may be eligible to apply for a refund.

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Life Settlements: New Rules

- An in-depth analysis of any life settlement should be made prior to engaging in the transaction. Trustees will want a well-documented rationale to show beneficiaries why they recommend the life settlement.
- The TCJA also added new reporting requirements applicable to sales and the payment of reportable death benefits after December 31, 2017.
- Any transaction that qualifies as a "reportable policy sale" must make a return setting forth certain information.
- The TCJA provides that, for transfers made after December 31, 2017, exceptions to the transfer for value rules do not apply to transactions that qualify as reportable policy sales.

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Tax reporting for Life Settlement Transactions

- The Act imposes reporting requirements in the case of the purchase of an existing life insurance contract in a reportable policy sale and imposes reporting requirements on the payor in the case of the payment of reportable death benefits.
- The reporting requirement applies to every person who acquires a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale during the taxable year. This is the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured (apart from the acquirer's interest in the life insurance contract).
- An indirect acquisition includes the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.

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Tax reporting for Life Settlement Transactions – Report Details

- Under the reporting requirement, the buyer reports information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. The information reported by the buyer about the purchase is: (1) the buyer's name, address, and taxpayer identification number ("TIN"), (2) the name, address, and TIN of each recipient of payment in the reportable policy sale, (3) the date of the sale, (4) the name of the issuer, and (5) the amount of each payment.
- On receipt of a report described above, or on any notice of the transfer of a life insurance contract to a foreign person, the issuer is required to report to the IRS and to the seller: (1) the name, address, and TIN of the seller or the transferor to a foreign person, (2) the basis of the contract (i.e., the investment in the contract within the meaning of section 72(e)(6)), and (3) the policy number of the contract.
- When a reportable death benefit is paid under a life insurance contract, the payor insurance company is required to report information about the payment to the IRS and to the payee. Under this reporting requirement, the payor reports: (1) the name, address and TIN of the person making the payment, (2) the name, address, and TIN of each recipient of a payment, (3) the date of each such payment, (4) the gross amount of the payment (5) the payor's estimate of the buyer's basis in the contract. A reportable death benefit means an amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.

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Transfer for Value Rules and Policy Sales

- The Act provides that the exceptions to the transfer for value rules do not apply in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale. Thus, some portion of the death benefit ultimately payable under such a contract may be includable in income.

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Basis of Life Insurance Not Reduced by Cost of Sale

- In Revenue Ruling 2009-13,1003 the IRS had ruled that income recognized under section 72(e) on surrender to the life insurance company of a life insurance contract with cash value is ordinary income. In the case of sale of a cash value life insurance contract, the IRS ruled that the insured's (seller's) basis is reduced by the cost of insurance, and the gain on sale of the contract is ordinary income to the extent of the amount that would be recognized as ordinary income if the contract were surrendered (the "inside buildup"), and any excess is long-term capital gain.
- Gain on the sale of a term life insurance contract (without cash surrender value) is long-term capital gain under the ruling. The Act overrules the above and provides that in determining the basis of a life insurance or annuity contract, no adjustment is made for mortality, expense, or other reasonable charges incurred under the contract (known as "cost of insurance").
- This change specifically reverses the position of the IRS in Revenue Ruling 2009-13 that on sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance.

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Planning for the Temporary Exemption

Use or Lose it
Exemption Affects
Planning

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New Exemptions: New Planning

- The TCJA increased the basic exclusion amount from \$5 million to \$10 million, adjusted for inflation.
- A new Chained CPI mechanism will compute the inflation-adjusted amounts.
- An individual will be able to exclude \$11.18 million in 2018; a married couple using portability will be able to exclude \$22.36 million.

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More on the New Exemption

- The generation-skipping transfer ("GST") tax exemption also increased to \$11.18 million in 2018.
- These large exclusion amounts have made many new planning opportunities using life insurance available for wealthy clients.
- These new exemptions have many clients who might not be wealth compared to the new exemptions incorrectly viewing existing life insurance planning as unnecessary.

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More on the New Exemption

- Although significant as these increases are, they are currently temporary provisions.
- Exemption amounts are scheduled to sunset to their pre-TCJA amount (adjusted for inflation) beginning in 2026.
- This gives financial planners eight years, beginning in 2018, to help clients make the most of these large exemptions.
- The greatest planning opportunities are in lifetime gifts and GSTs rather than in the context of the estate tax.
- A change of control in Congress could cause these amounts to decrease sooner than currently planned.

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Impact of Exemptions on Different Wealth Level Clients

- The primary beneficiaries of these increased exemption are moderate wealth individuals and families – perhaps those with estates of say \$5M to \$40M. Many have previously used part of their lifetime exclusions and will benefit from being able to exclude additional amounts.
- For families with wealth up to perhaps \$200M these new high exemptions may facilitate note sales and other transactions without the need for guarantees.
- Ultra High Net Worth (“UHNW”) Taxpayers are planning aggressively, not because of the exemptions, but because of the fears of what future changes in Washington may bring.
- One disadvantage to make large gifts now: a gift with a low basis - basis is carried over. This may present an income tax problem when the asset is sold unless alternate measures are taken. The calculus will vary by wealth level, appreciation and other factors. Planners might weigh the potential growth in the value of the asset versus potential capital gains tax at the point of sale.

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Existing Life Insurance

Termination May Not be Advisable

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Many Should Not Drop Existing Coverage

- Many, perhaps most, individuals with estates of less than \$11.18M should not drop existing life insurance policies because they no longer have estate tax exposure.
- If the provisions do sunset as planned, the individual may need the policy if he or she survives the next eight years.
- Individuals may develop medical problems that make them ineligible for life insurance policies later on.
- Existing permanent insurance policies may have significant cash value and act as conservative savings vehicles.
- Most individuals have retained their life insurance policies over the last 20 years even as the exemption has risen from \$600,000 to \$11.18 million.
- Insurance may address a range of other planning needs.

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Existing ILITs

- Many clients created ILITs to pay an estate tax that may no longer apply to them.
- The insurance itself should be reviewed by someone with the capability of evaluating the current policy and any options to modify or repurpose it. Then the trust instrument itself should be reviewed. The options that might be pursued might include one or more of the following:
 - Continue the plan as is.
 - Continue the plan but make a large one-time gift to the ILIT using the increased exemption to avoid the need for future annual gifts or Crummey notices.
 - Modify the life insurance into a paid-up policy and essentially freeze the insurance component of the plan.
 - Exchange the policy for a new policy that better serves current needs. For example, a policy that maximized death benefit might be replaced with a policy focused on cash accumulation that can be borrowed against by the trustee and distributed to the spouse who is a beneficiary in future years.
 - Decant the trust into a new trust that improves the administrative and other provisions.
 - Use a non-judicial modification to modify the trust in a manner beyond what a mere decanting might permit.
 - Terminate the policy and distribute the cash value received to the heirs as beneficiaries of the trust and terminate the trust.
 - Sell the policy into the secondary market and retain the trust (whether in its initial format or modified by a decanting) and invest the proceeds from the policy sale for future distribution to ILIT beneficiaries.

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New/Enhanced Life Insurance Plans

New Planning

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New Exemption Can Fund New Insurance Coverage/Plans

- Clients can use the increased exclusion to fund the purchase of a large amount of life insurance.
- A married couple who has previously used their lifetime exclusion now has \$11.18 million available for gifts.
- Example - they could purchase a life insurance policy with annual premiums of \$100,000 (\$3 million over 30 years).
- With discounts, a gift of \$2.0 million to an irrevocable life insurance trust could be used to prepay all premium payments.

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MEC Considerations

- When funding insurance policy premiums upfront, planners should be aware of the modified endowment contract (MEC) rules.
- MEC rules involve the "seven pay test."
- MEC can have adverse tax consequences when taking money out of the policy's cash value later.
- Example: for a policy with \$3 million cash value funded by a gift of \$2 million, a withdrawal of \$100,000 would be considered taxable income.
- Most individuals buying life insurance for estate liquidity purposes may not be overly concerned about the MEC issue.
- If a policy will build up significant cash value, gifts could be spread over 3-4 years to avoid the MEC characterization.

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Fund Robust ILITs to Avoid Need for Annual Gifts and Crummey

- Clients could use income-producing assets such as real estate to pay life insurance policy premiums.
- If an individual owns commercial real estate which nets \$300,000 annually, 1/3 of this asset could be gifted into a trust to pay annual insurance premiums of \$100,000.
- No further gifts would be necessary to fund policy premiums.

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Split-Dollar Life Insurance Planning

New Playing Field and New Developments

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Unwind Existing Split-Dollar Arrangements

- Clients could exit from split-dollar arrangements.
- In split-dollar, a donor funds premiums into a trust; upon termination of the arrangement, the donor is to be repaid premium amounts.
- The value of the economic benefit must be picked up as a gift each year under split-dollar; these amounts may become burdensome over time.
- Employment split-dollar agreements may have income tax ramifications as well.
- Terminating a split-dollar arrangement established before the 2003 regulations may expose built-up equity to income tax.

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Cahill

- Estate of Cahill v. Commissioner, T.C. Memo. 2018-84 (June 18, 2018).
- Bad fact case?
- How far can the Court extend the “in conjunction with” concept, put forth in Estate of Powell to IRC Sec. 2036(a)(2) and 2038?
- The court made a broad application of IRC Sec. 2703(a) to the economic benefit split dollar agreement.

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Premium Financing for Life Insurance

Unwind Some Deals; Watch Rate Changes

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Unwind Some Premium Financing

- Clients could exit from premium financing arrangements.
- In premium financing arrangements, a trust that owns the policy has been borrowing money.
- Each year the premiums are funded by a loan, and loan interest has to be paid and increases annually.
- This can become burdensome, and parties may prefer to extricate themselves from the arrangement similar to the split-dollar situation.
- Parties do not face potential adverse tax consequences when terminating premium financing arrangements.

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Pension Owned Life Insurance

Evaluate Changing Owners

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Retirement Plans Owning Policies

- Clients could move a life insurance policy owned by a retirement plan into a life insurance trust instead.
- This would prevent the policy from being included in the individual's estate at death.
- Prohibited Transaction Exemption (PTE) 92-6 permits the sale of an insurance policy from a retirement plan to a participant or a trust for fair market value.
- Advisory Opinion 2006-03A states that the sale of a second-to-die policy from a profit sharing plan to the insured and spouse would qualify for this exemption as well.

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Corporate Life Insurance

New Corporate Rates

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Changes to Corporate Taxes

- TCJA lowers the maximum corporate income tax rate to 21% and eliminates the corporate alternative minimum tax.
- These provisions are aimed at large, publicly held C corporations, which historically faced double taxation at both the corporate and individual shareholder levels.
- Some private company clients may operate C corporations and others may be considering converting from an S corporation or LLC.
- Clients should discuss this decision with their accountants before making the conversion to a C corporation.

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Insurance May Mitigate Accumulated Earnings Issues

- Use the retained earnings in a C corporation to fund a split-dollar arrangement.
- This avoids the double taxation issue because only a relatively small amount is deemed a distribution to the shareholder.
- This is an opportunity to move dollars subject to the relatively low 21% level of taxation into an insurance trust as part of a split-dollar arrangement.

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Key Person Life Insurance

- Purchase key-person or buy-sell insurance.
- Term insurance is typically used but permanent insurance may be more appropriate in some cases.
- Permanent insurance may be used when the cash value is needed to fund a deferred compensation agreement or because long-term expectations for the business are favorable.
- Permanent insurance premiums are higher, but the ability to use funds subject to lower tax rates to buy insurance makes this option more attractive than before the TCJA.

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Non-Grantor Trust Planning and Life Insurance

Non-Grantor Trusts are the Rage but...

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Income Tax Planning and Non-Grantor Trusts

- Non-Grantor trusts are the rage post-TCJA to take advantage of a range of income tax deductions. These may include: 199A, charitable contributions, SALT deductions, and more.
- A client can transfer an asset, for example, real estate, that produces income of \$157,500 to a non-grantor irrevocable trust.
- The trust may then qualify for an income tax deduction of 20% of QBI under 199A.
- The donor may remove the asset out of her estate and may obtain a current 199A income tax deduction.
- A non-Grantor trust probably cannot hold life insurance since the payment of premiums from income would characterize the trust as a grantor trust. So separate (whether new or old) grantor ILITs will still be necessary. The Non-Grantor Trusts may have to loan money to the grantor-ILITs. This may be a new use of split-dollar loan arrangements.

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Planning after the Tax Cuts and Jobs Act of 2017

Summary of Insurance Planning Tips

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Insurance Planning Tips – Changes from the 2017 Act

- Use insurance to fund long term charitable planning goals.
- Exemption will sunset. At minimum buy term with good conversion features so if the exemption drops and you then have health issues you can convert. Small cost now. Great protection later if needed.
- Use a cash rich policy to achieve tax deferral if you reside in a high tax state.
- Insure the risk of premature death in a non-reciprocal SLAT.
- High Standard deductions might eliminate medical expenses so re-evaluate Long Term Care.
- Repurpose survivorship policies for moderate wealth policies. Modify policy, exchange for new policy, decant the ILIT – use all the flexibility trust laws and policy planning options permit.
- Use C corporation profits to fund.
- Evaluate all insurance options and structures after clients restructure in light of the Act: e.g., divide SSB, convert S corporation or LLC to C corporation, and more.

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Insurance Planning Tips – The Good Ol' Stuff

- Asset protection – cash rich policy inside an irrevocable trust.
- Blended and other complex family arrangements – use insurance to fund bequests for one team and bequests for the other to avoid interaction and disputes.
- Fund liquidity issues.
- Ballast for other investments. Example - Average individual investor earned about 2.2% on their securities over the past 20 years (not counting 2017)!
- Fund buy sell.

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Conclusion and Additional Information

Insurance Planning Remains Vital

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Conclusion

- The 2017 Tax Act made dramatic changes to the tax system which affect every insurance plan.
- Many of those changes are temporary so cancelling plans could prove a mistake.
- Practitioners should endeavor to guide clients to take advantage of the new opportunities.

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