Life Insurance Could Be the Quintessential Value-Shifting Asset

Contractual restrictions imposed by insurers diminish the value of partial interests in life insurance, thus justifying valuation discounts when these interests are transferred.

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Knowledge of how to plan with life insurance is essential for all wealth planning advisors. For instance, estate planners are often involved in the transfer of life insurance policies, typically into one or more irrevocable life insurance trusts (ILITs). In this situation, the advisors generally focus on the funding of these policies, often involving split-dollar arrangements, premium financing, *Crummey* gifts, and leveraging strategies such as installment note sales and GRATs, after the policy has been transferred or acquired.

Unfortunately, too little attention is put on the tax-efficient transfer of an existing policy to a trust, or trusts, in the first place. Yet, a fairly simple, but potentially powerful concept can produce sizeable transfer tax savings: Fragmenting a single policy into two or more inter vivos transfers results in a significant valuation reduction for transfer tax purposes. This is because ownership of less than a 100% interest in a policy results in the owner having an asset of little value. The valuation reduction should be far greater than the discounts that are allowed for interests in limited partnerships and other entities.

Overview

The need to make valuation determinations arises continuously, both within the area of taxation and outside of it. Although valuation issues run the gamut in the tax field, they have the greatest impact in the area of transfer taxes. The very essence of these taxes is valuation, and virtually all noncash assets that are transferred by gift or at death must be valued.

As a general proposition, property is taxed for transfer tax purposes at its fair market value at the time the transfer is complete.[1] Certain assets, such as securities, are relatively simple to value. Some assets—such as closely held business interests, entity interests, and partial interests—often present difficult and complex valuation problems. Other assets—such as annuity interests, life estates, term interests, and remainder interests following life estates and estates for terms of years—are arbitrarily valued by using tables adopted by the IRS.[2] In addition, certain valuations are significantly affected by the special valuation rules of Chapter 14 of the Internal Revenue Code.

A very basic concept in estate planning is that a life insurance policy (with limited exceptions) should be transferred at least three years before death at its relatively low current value in order to avoid inclu-

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sion at its face value.[3] The distinction between gift (or sales) value of life insurance policies and transfers subject to the estate tax is often dramatic. This differential is substantially magnified by using a simple variation in the planning process.

This article will discuss a narrow, but virtually untapped, planning opportunity that all estate planners encounter at some time in their careers and which can result in substantial benefits to their clients—gifts of fractional interests in life insurance policies. Indeed, gifts of fractional interests in life insurance, because of the inherent nature of the product, are transfers that should receive valuation discounts far in excess of the typical entity discount, in order to reflect the relatively low value of those interests. This conclusion has been verified in conversation with several well-respected appraisers.

The ability to apply this concept is expected to increase sharply as a result of the proliferation of life insurance being acquired as a "living" asset either:

1. As a safe asset class similar to owning a municipal bond.
2. As a retirement planning alternative.
3. As an asset that in many states has creditor protection benefits superior to other investments.

In those situations, the death benefit is secondary to the lifetime virtues. Because the policy is acquired to take advantage of the lifetime benefits, it is generally transferred to an ILIT later in life when death is more imminent and the valuation considerations are meaningful in the planning process.

Basic valuation rules

The general rule in Treasury Regulations is that "the value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts."[4] In arriving at that determination, "[a]ll relevant facts and elements of value as of the time of the gift shall be considered in every case."[5]

The estate tax system and the gift tax system vary in several ways that benefit lifetime transfers rather than transfers at death or transfers that are otherwise subject to the estate tax system.

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Tax-inclusive/tax-exclusive. The estate tax is a tax-inclusive tax, while the gift tax is a tax-exclusive tax. Thus, assets includable in the estate are subject to a tax on the tax. For example, based on the tax rules that are scheduled to apply after 2012, $1 million of wealth subject to the 55% estate tax bracket would result in a $550,000 tax and $450,000 passing to the beneficiary. This is an effective tax rate of 122% on the transferred property.

In contrast, under the gift tax rules, the same $1 million asset could produce a net lifetime transfer of $645,000 to the beneficiary and a gift tax of only $355,000. This differential is magnified with life insurance, where the gift tax value, according to Regulations, has been roughly the cash value, while the estate tax value is the entire death benefit.

In whose hands is the asset valued? Another major variance between the estate and gift tax valuation systems is that for estate tax inclusion purposes, the assets are valued based on what interests the decedent owned (or is deemed to have owned) at the time of death, irrespective of where those assets are transferred.

For gift tax purposes, the interest transferred is measured by what a hypothetical willing buyer would pay for it.[6] The distinction is illustrated by the facts of Rev. Rul. 93-12.[7] In that ruling, gifts of 20% interests in stock were made to each of the donor's five children. Each gift was valued as a separate minority interest. Had the same transfers taken place at death, no minority interest discount would have been permitted for estate tax purposes because the decedent would have owned 100% of the stock at the time of death.

These disparities have led to the widespread use of the transfer of noncontrolling interests in entities, principally FLPs and LLCs, to depress the value of property passing from an estate owner in the estate planning process.

Typical gift planning

A key component of wealth shifting is the compression of the fair market value (FMV) of the asset being transferred. With gifts of hard-to-value assets, the determination of that value is often a very difficult and elusive process where reasonable valuation experts will

1 Regs. 20.2031-1(b) and 25.2512-1.
2 Reg. 25.2512-5.
3 Sections 2035(d) and 2042.
4 Regs 20.2031-1(b) and 25.2512-1.
5 Reg. 20.2512-1.
6 Land, 303 F.2d 170, 9 AFTR2d 1955 (CA-5, 1962).
7 1993-1 CB 202.

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disagree. It is essential to remember that irrespective of all of the machinations in determining the FMV of a gift, the real question is as follows: What bundle of rights and interests in the transferred property did the recipient obtain from the donor? The general rule is applicable unless other federal law supersedes the general rule, such as transfers that give rise to the application of Chapter 14. This exception to the general rule, however, clearly does not apply to the planning discussed herein.

Traditional entity valuation planning

In its most traditional form, the client creates an entity (such as an FLP) and then transfers a noncontrolling interest in it. The transfer is typically made either as a gift, a sale (to a trust for a note of equal value), or to fund a GRAT. The value of the transferred property is determined by applying a valuation discount to its pro rata value in the entity. Generally, this is a two-step process:

1. The overall value of the entity is determined.
2. Various adjustments are made to the value determined in step 1 to reflect the reduced FMV of the interest transferred.

   The major adjustments are:

- A minority interest discount, which recognizes that a noncontrolling interest owner is unable to control company policy, establish compensation, compel distributions or force liquidations.
- A lack of marketability discount, which reflects the inherent lack of ability to get in and out of investments with no ready market.

When both of those components are present, the value is substantially less, and a larger discount ought to reflect the combination of the impediments.

Various other factors within the bundle of rights mentioned above also influence the value of an asset and the ability to sell the asset. Potential buyers often look at what benefits they can derive from the asset, such as the projected or anticipated cash flow. For example, an interest in a limited partnership that requires distributions is generally more attractive to a potential buyer than an interest in a nearly identical limited partnership that does not require distributions. An interest in property where there are severely limited rights to enjoy any benefits for a considerable period is less attractive, and therefore less valuable, than an interest of which benefits are expected to be enjoyed currently.

Likewise, valuation adjustments are appropriate in the context of transferring a partial interest in a life insurance policy.

Advantage of gifts of partial interests in life insurance

The transfer tax advantage of making lifetime gifts of partial interests in life insurance may be counterintuitive. Yet, the contrast between the typical policy transfer and partial interest transfers sheds light on the justifications for those benefits.

Typical plan. In a very typical transfer of a life insurance policy from the insured into an ILIT, the insured owner sets up a single "pot" trust, often funding it with multiple *Crummey* powers of withdrawal and for larger policies combining *Crummey* gifts with other strategies, such as selling discountable income-producing assets to the trust. The transfer (whether by gift or sale) in most instances will be of the entire policy.

Determination of the gift tax value (or sales price, if a sale was made) of a policy has historically been considered fairly simple. Under Reg. 25.2512-6(a), it is the cost of a comparable contract. Where this is "not readily ascertainable when the gift is of a contract which has been in force for some time and on which further premium payments are to be made, the value may be approximated by adding to the interpolated terminal reserve ... the proportionate part of the gross premium last paid...." Recent developments, such as the growth of the life settlement market, have placed that value into question.

Further muddying these waters has been the expanded use of universal life with secondary guarantee (ULSG) policies. The seemingly anomalous features of ULSG policies are that they require a significant annual premium while crediting sometimes negligible cash values; at the same time, the policy's face amount is guaranteed for the life of the insured, which requires significant insurer reserves to be set aside for the contract. The IRS-viewed value of these policies may be much higher than most advisors anticipate.[8] This increase in value also increases the potential application of the enhanced planning strategy suggested below. Irrespective of the value determined for the policy itself, it is the second step of the valuation process that creates the substantial wealth-shifting benefits.

Enhanced planning. In many situations, significant transfer tax benefits can be achieved by slightly revising the plan. Unless qualifying for the gift tax annual exclusion is an over-riding consideration,[9] rather than transferring the

[8] As discussed in presentations given by Lawrence Brody, a partner in the St. Louis, Missouri, office of Bryan Cave LLP. He may be contacted at lbrody@bryancave.com.

[9] The prevailing view is that gifts of a fractional interest in a life insurance policy will not qualify as annual exclusion gifts. See footnote 11 *infra*, for a more-in depth discussion of the subject.

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policy itself, the client should consider transferring fractional interests in the policy. For example, assume that the client has a spouse and three children. The client could set up three separate trusts, one for each child. The spouse ordinarily would also be a beneficiary (and perhaps, the preferred beneficiary) of each trust. The client would then transfer a one-third interest in the policy to each trust. Under that scenario, each child for whom a trust has been created would be a preferred beneficiary of the trust set up for the child and a secondary beneficiary for the trust set up for his or her siblings. Because the distribution standards would be different, separate trusts would be justified. Each one-third interest would be valued as a separate gift.[10]

Because fractional interests in the policy are transferred, the legal rights and interests that each separate trust receives is valued as a fractional interest in that policy. These beneficial interests that the recipients receive are very different than the rights and interests in the policy that a 100% owner of a policy would have obtained. Thus, under the "willing buyer/willing seller" definition of the Regulations, the value of the gifts to each separate trust are substantially reduced. That will be reflected in the fact that the aggregated value of the three transfers will be substantially less than where a single transfer were made of the entire policy. The IRS and the courts have even denied such interests from qualifying as annual exclusion gifts.[11] Regardless of whether one agrees with this conclusion, it is a holding pursued successfully by the government and further evinces the lack of value such an interest enjoys, apparently even in the eyes of the IRS.

Benefits of owning a fractional interest in a life insurance contract are virtually nonexistent. What are the "bundle of rights" of a policy owner? During the insured's life, the economic value is primarily access to cash value and dividends. These values are accessed, or enjoyed, by exercising the right to borrow on the policy, to take dividends in cash, to surrender the policy, and the like. The benefit of the policy at death is to receive or direct the death proceeds. Each of these rights can be exercised only by written direction of the "owner" to the insurer, and the owner is determined by policy records.

The key is that insurance carriers create contractual rules and restrictions regarding their policy, and any interest in the insurance contract is acquired subject to those rules and restrictions. If policy records identify several joint owners, any policy action or election—such as those listed below—requires unanimity among all of the owners to be effective:

- Change a beneficiary.
- Take policy dividends in cash.
- Borrow against the policy cash values.
- Surrender the policy, either in whole or in part.
- Exchange the policy for another policy.
- Pledge the policy.

This unanimity is normally required even if one joint owner wants to exercise any of these rights on a pro rata basis. The authors have contacted several major carriers to confirm this rule. Each insurer has told us that, where policy records indicate joint owners, no policy action directed by a single joint owner, other than to transfer that joint owner's pro rata interest, will be executed unless agreed on by the remaining joint owners.

In other words, as a result of the insurer-imposed contractual restrictions, the owner of less than the entire policy does not have any meaningful rights. In the absence of cooperation by other co-owners, the only potentially realistic right that a "willing buyer" would receive is a right to a pro rata portion of the death benefits at the death of the insured. Even that right is potentially tainted. If an infusion of premium money is required to protect the policy, and the other owners are unwilling to pay their share, then if the fractional owner does not do all of the funding, the policy may be subject to some adverse changes, or may lapse. Thus, if a premium request is made, the owner of a fractional interest in the poli-

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[10] Note 7, *supra*.

[11] Ryerson, 312 U.S. 405, 25 AFTR 1191 (1941); Kouras, 188 F.2d 831, 40 AFTR 491 (CA2, 1951). This theory has been criticized. See Price and Donaldson, *Price on Contemporary Estate Planning* (CCH, 2010), § 6.45.1, which states, "Logically, an exclusion should be available if each donee has the right to transfer or otherwise deal with his or her interest in the policy independent of the other owners." This theory has been successfully advanced by the IRS with regard to allowing FLP interests to qualify for the gift tax annual exclusion. Price, TCM 2010-2; Hackl, 118 TC 279 (2002), *aff'd* 335 F.3d 664, 92 AFTR2d 2003-5254 (CA-7, 2003). We agree with the position espoused by Dean Price and Prof. Donaldson. The power-holder has an immediate, unconditional right to the interest which he or she can immediately transfer to someone else, the hypothetical "willing buyer," although at a large reduction in value. Thus, it should be a present interest. Because the interest has a limited market except at a huge discount, that factor should be reflected in the valuation discount.

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cy may have to make a difficult economic judgment: whether to pay the entire premium or to have the limited benefits in the policy disappear through a lapse.

Because the Regulations assume that the "willing buyer" is a stranger, who presumptively does not have the normal liquidity needs of a family member, the possibility of having to make that decision will occur more often than if the policy was owned by family members, particularly if there is a liquidity need for the insured's family. In fact, since the "willing buyer" is a stranger, presumptively, he or she will not know the insured's health when making that decision.

Furthermore, an individually owned life insurance policy is often used in order to obtain financing, or otherwise to secure an obligation. Because a fractional interest in a policy has little value, its use for these purposes is reduced, which should further compress its value for gifting purposes.

Caveat—transfer all ownership. The transferor should transfer his or her entire interest in the policy, and not retain any of it, if the transfer is by gift. Because of the unanimity requirement, the retention of any of interest in the policy after a gratuitous transfer would enable the transferor, in essence, to prohibit the change of beneficiary, and the transferred interests would be exposed to estate tax. For example, Section 2038(a)(1) provides, in relevant part, that a transfer by the decedent whereby the decedent has retained a power "either alone or in conjunction with any other person ... to alter, amend, [or] revoke..." the transferred interest will result in the inclusion in the donor's estate. A transfer by sale would be within the "adequate and fair consideration" exception to the general rule, *provided* that the transferor receives consideration equal to the value of the interests transferred.[12]

Entity discounting v. fractional interest discounts

Based on the factors discussed above, the discount for a fractional interest of a life insurance policy should far exceed the entitydiscount applicable to FLP interests.

Due to the contractual prohibitions, a partial owner has literally no control over a life insurance policy.

Advisors have developed many strategies that are designed to reduce value, many of which appear egregious and contrived to the IRS, Congress, and the courts. Some of these were corrected by Chapter 14. In addition, the IRS has had success in attacking the use of entity discounting through several avenues, such as the step-transaction and business purpose doctrines, for example. Those potential attacks do not apply in the context of a co-owner of a life insurance policy. Because the restrictions in a life insurance contract are contractual in nature, established by the carriers themselves without any consideration of the valuation issues, they should receive more respect from the IRS and the courts.

Due to the contractual prohibitions, a partial owner has literally no control over a life insurance policy. He or she cannot borrow against the policy, surrender it, or even change the beneficiary without the unanimous consent of all co-owners. Moreover, the general partners of an FLP have a strong fiduciary obligation to the partnership and the remaining partners. A co-owner of a policy does not have any duties to the other co-owners.

Furthermore, no market exists for such an interest. Because the "willing buyer/willing seller" test presumes that the transfer would be to a stranger, and not the insured or the insured's family, there realistically would not be a market for such an interest, even in the life settlement market. In addition, because the Regulations presume that a "stranger" would be "buying" the interest, the recipient of the proceeds would not be protected under the exceptions to the "transfer for value" rules of Section 101. The discounts for lack of control and lack of marketability should reflect these impediments.

Conclusion

The same valuation adjustments that apply to most inter vivos transfers of less than complete ownership in property should also apply to transfers of fractional interests in life insurance. In fact, the discounts for life insurance interests should be greater than those for most alternative types of property. The recommended planning is available in numerous instances, and the authors suspect that the discount was not taken in the past for many transfers of partial interests of life insurance contracts. The use of fragmenting life insurance policies can often result in substantial tax savings for the transferor and his or her family. Thus, in many instances, discounting should be considered in connection with the transfer of life insurance policies. ■

12 There are also inclusion considerations under Sections 2036(b) and 2042 where the "retaining transferor" is the insured, which are beyond the scope of this article.

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