By Louis S. Harrison

Insuring the Efficacy of Your Irrevocable Life Insurance Trust

Background

As planners, we often look to different structures to achieve estate tax savings, with continuing evolution of traditional techniques in new directions. Often these directions are a result of creative financial engineering. This month's column looks at the traditional irrevocable life insurance trust combined with a new technique now being discussed, the annuity/insurance combination.

The traditional irrevocable insurance trust is used to transfer the face value of the insurance policy estate and gift tax free, using annual exclusion gifts to transfer the premium dollars each year to the trust to pay for the insurance. Under the new iteration of this technique, an insurance trust would purchase both a life insurance product and an annuity product.

The strategy attempts to use the different pricing of annuities and insurance products, on the same individual, in an arbitrage fashion. For example, as evidenced by the IRS's shift in mortality tables,[1] actuaries can use different assumptions in determining one's expected mortality. A shift in mortality to a longer expectancy means that a life insurance product, whose cost is based in part on how long the insured will live, will have lower premiums. Further, insurance products are typically priced taking into account that not all insurance policies are held to maturity (a variable that also lowers costs). Conversely, a shift in mortality to a lower life expectancy means that an annuity, whose payout is based in part on how long the insured will live, will have higher payouts.

Example 1. Assume a 79-year-old in standard health status has an eight-year life expectancy, and the cost of a $1 million face universal life policy based on this eight-year life expectancy is $57,000 annually. Assume the life expectancy assumption is increased 20 percent to 9.6 years; although the calculation of premium cost to life expectancy is not linear, an extrapolation of cost based on a geometric progression would be to decrease the policy cost to $45,600 annually. Contrast this with a 79-year-old in standard health status who has a life expectancy of eight years and pays $1 million to purchase a single premium immediate annuity (SPIA). The immediate annuity is $164,515 annually. Now assume that the life expectancy assumptions decrease by 20 percent and assume the same linearity in pricing. The single premium annuity payment now will increase to $197,479 annually.[2]

The incentive of insurance companies in structuring products is to lower the expected annual premiums in life insurance products and to increase the annual payouts in annuity products versus those offered by their competitors. Because pricing of these two products is based on mortality assumptions, a tweak in mortality assumptions can allow the products to be more competitively priced. Hence, Company A may use a longer mortality assumption when determining the price of a life insurance policy of an individual than Company B will use when determining the price of an annuity contract for that same individual.[3]

The Strategy in Its Simplest Iteration

The insurance trust purchases an insurance policy with a face amount of $X and uses $X to buy a single premium immediate pay annuity (for these purposes, an "SPIA"). The after-tax cash flow from the annuity would be used to pay for the premium on the insurance policy, and the differential in the annuity cash flow would be garnered as profit and pass through to the insurance trust free of tax for the use of the beneficiaries.

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Example 2. An insurance trust set up by an insured, aged 79, purchases a life insurance policy on the grantor's life, say with a face amount of $1 million, which requires premiums of $57,025, annually. The same insured would then invest $1 million in a SPIA that pays $164,515 annually, for the insured's lifetime.[4] The death benefit of $1 million would replace the principal lost of $1 million with the purchase of the SPIA. Each year the insurance trust would receive gross cash flow of $107,490.[5]

Structuring the Transaction

The irrevocable insurance trust ("the trust"), as the initial owner and purchaser of the policy, should be structured as a grantor trust with respect to the insured, so that the income tax cost of the annuity is shifted to the grantor.

In order to fund the initial annuity purchase, the trust will likely borrow from the insured the principal amount for the annuity purchase, using required Code Sec. 7872 rates. There are no transfer tax costs to set it up. Thereafter, the SPIA and life insurance policy will be purchased by the trust. For simplicity, the transaction can be structured so that the face amount of the insurance policy is the same as the cost of the SPIA (Example 2).

Example 3. Using the $1 million borrowing rate for the purchase of a SPIA, the chart accompanying this column illustrates that the net amount (after income tax) in an irrevocable insurance trust for an insured who is age 85 at the inception of the arrangement. After the first year, the net amount is $44,252, $239,683 after the fifth year, and $596,798 after 10years. If the arrangement is financed at $10 million versus $1 million, the numbers gain more significance ($5,967, 980). And, in the worst case scenario, in which the annuity cannot service both the loan and the insurance premium amount, the insurance trust defaults.

Concerns with the Strategy: Tax

There is the risk that the IRS could attempt to apply a step transaction principle to collapse all steps, or assert a Code Sec. 2036 argument. Neither attack is very well based, but each is out there as a possible concern. For example, among the initially collapsible steps is the loan. Would a third party loan money, unsecured, to the trust? Would the third party charge a higher interest rate if it knew that its buyer's income tax would be shifted to it, the lender? These questions, though reasonable in the consumer setting, would require an aggressive and, as of yet, not judicially approved application of the step transaction doctrine.

Alternatively, the court could apply a Code Sec. 2036 analysis, referencing the *Strangi II*[6] and *Thompson*[7] concepts. Here, the retained interest would be the implied right to receive annual interest payments,

Assumptions	
Exclusion Ratio	0.895941742
Client Age	85
Annuity Cost: SPIA	$1,000,000
Face Amount of Insurance	$1,000,000

Age	Annual SPIA Payout	Income Cost Borne by the Insurance Trust	Net Spia Cash Flow	Insurance Premium (at 5%; guaranteed 4 %)	Differential Return in Dollars	Cost of Loan at 4.86 %	Excess return	After tax accumulation that is free of estate tax(inc. at 4 %)
85	$161,760	$0	$161,760	$69,108	$92,652	-$48,400	$44,252	$44,252
86	$161,760	$0	$161,760	$69,108	$92,652	-$48,400	$44,252	$90,274
87	$161,760	$0	$161,760	$69,108	$92,652	-$48,400	$44,252	$138,137
88	$161,760	$0	$161,760	$69,108	$92,652	-$48,400	$44,252	$187,915
89	$161,760	$0	$161,760	$69,108	$92,652	-$48,400	$44,252	$239,683
90	$161,760	$0	$161,760	$69,108	$92,652	-$48,400	$44,252	$293,522
91	$161,760	$0	$161,760	$69,108	$92,652	-$48,400	$44,252	$349,515
92	$161,760	$0	$161,760	$69,108	$92,652	-$48,400	$44,252	$407,748
93	$161,760	$0	$161,760	$69,108	$92,652	-$48,400	$44,252	$468,310
94	$161,760	$0	$161,760	$69,108	$92,652	-$48,400	$44,252	$531,294
95	$161,760	$0	$161,760	$69,108	$92,652	-$48,400	$44,252	$596,798
96	$161,760	$0	$161,760	$69,108	$92,652	-$48,400	$44,252	$664,922
97	$161,760	$0	$161,760	$69,108	$92,652	-$48,400	$44,252	$735,771
98	$161,760	$0	$161,760	$69,108	$92,652	-$48,400	$44,252	$809,454
99	$161,760	$0	$161,760	$69,108	$92,652	-$48,400	$44,252	$886,084

which clearly comes out of the transferred property (through the purchase of the annuity). There are older cases dealing with the life insurance/annuity combination that could be extended in principle to implicate Code Sec. 2036.[8] And the *bona fide* sale test as outlined in *Strangi II* and *Thompson* could be a concern.[9] But the application of Code Sec. 2036 is not very clear and still would require a rather constrained reading of the statute.

Nontax Issues

First, there is an investment issue. In our examples, the insured must consider the alternative use of money on $1 million between the time the insured purchases the annuity and the insured's death. The value to the insured and insurance trust is really the differential between the rate of return on the transaction and the risk adjusted rate of return that the insured could have received on alternative transactions (the opportunity cost). Is the insured better off lending the money to the trust and having the trust purchase an asset other than the life insurance/annuity combination?

Second, the insurance companies are not the equivalent of the U.S. government, and each company, the one paying the annuity and the one that will pay the death benefit, could default. A default over and above the state-covered insured amount will be costly for the insured (arguably no effect on the insurance trust as there was no gift to begin with).

Third, there are transaction costs with the strategy, including commission costs and profits to the insurance companies. Another known transaction cost, to an extent, is the income tax cost inherent in the annuity. These costs will have the effect of reducing the overall gain on the strategy, most certainly after the basis is fully recovered (after life expectancy).

Fourth, the strategy has obvious illiquidity concerns because it is implemented with a term relating to the insured's life.[10] Further, an unknown cost is the cost of the insurance in the long run. The lowest cost universal policies reserve the right to change the mortality costs inherent in annual premiums to account for future, bad mortality experience. As Barry Commoner emphasized, "There is no such thing as a free lunch."[11] Accordingly, a universal policy can afford to require smaller premiums up front because if societal health gets worse going forward, it can always increase the mortality costs associated with policies; in contrast, whole life policies guarantee these costs, and hence amortize the risk by increasing premiums required throughout the life of the policy. Therefore, if engaging in the strategy using a nonguaranteed insurance policy, an insured cannot be guaranteed that his or her or its annual premium costs for the life insurance policy will be at a fixed cost.[12]

Fifth, the arbitrage works best when the annuity and insurance mortality and other costs assumptions **diverge** the greatest. (Please clarify) To uncover this, "shopping" the annuity and life insurance markets, understanding the built-in assumptions, navigating health and medical issues, and engaging in successful negotiations will all be crucial. Meaning: It is tough to find the right companies without substantial resources.

Conclusion

The use of different investment assets within an insurance trust, combined with the life insurance, is worthy of consideration. One such different investment is an annuity on the insured. In the right circumstances, the annuity/insurance combination can be a powerful transfer tax technique within the irrevocable life insurance trust.

ENDNOTES

1 *See* Code Sec. 7520's shift from mortality tables in 80CNSMT to 90CM. Table 80CNSMT is located at Reg. §20.2031-7(d)(7); Table 90CM is located at Reg. §20.2031-7A(e)(4).

2 The author emphasizes that this is merely an example to illustrate the theoretical point. Pricing is *not* this linear.

3 Although other variables go into the pricing of these products, such as commissions, profit margins and interest crediting rate assumptions, it is the divergence in mortality assumptions that creates the arbitrage opportunity. This kind of pricing discrepancy works better for older insureds because the percentage pricing differential can be significant.

4 This example is based on insurance and annuity quotes received in May 2004. In this example, the insured was treated as an 82-year-old for actuarial purposes and for pricing the annuity.

5 Income tax issues would be borne by the insured, not the insurance trust, because this is a grantor trust. The taxation of the SPIA is governed by Code Sec. 72. Under the simplified version of Code Sec. 72, a portion of the annuity each year is deemed a return of principal (the exclusion ratio) for a period of time, and the remainder is taxable income. The exclusion ratio, which is determined by reference to IRS tables, is a fraction equal to the investment in the contract divided by the expected return. The expected return is determined by multiplying the annual annuity payments by the factor shown in Table V of Reg. §1.72-9 corresponding to the annuitant's age (as of the annuity starting date). A heuristic is that the annual payout is multiplied by the IRS prescribed life expectancy to get the expected return. This forms the denominator of the exclusion ratio. The numerator is the amount of consideration paid for the SPIA. Each year, then, for an older individual, the amount of the annuity excluded from tax is significant, until the annuitant reaches life expectancy. After life expectancy, the entire consideration paid for the annuity should have been returned to the owner of the annuity, and the full annuity then becomes taxable to the owner.

6 *A. Strangi Est. II,* Dec. 55,160(M), TC Memo. 2003-145.

ENDNOTES

[7] *T.R. Thompson Est.,* 84 TCM 374, Dec. 54,890(M), TC Memo. 2002-246.

[8] *See, e.g., E. Le Gierse,* SCt, 41-1 USTC ¶10,029, 312 US 531, 61 SCt 646. *But see Fidelity-Philadelphia Trust Co. v. Smith,* SCt, 58-1 USTC ¶11,761, 356 US 274, 78 SCt 730, in which a clear annuity-insurance combination was not grouped together.

[9] The Tax Court in *Strangi II* used a harsh application of the term "*bona fide*" in the full and adequate consideration exception. The Tax Court looked for actual negotiations between family members to demonstrate and satisfy this requirement; and absent such negotiations, refused to implement the full and adequate consideration exception to Code Sec. 2036.

In contrast, the Fifth Circuit in *Kimbell* focused on its prior decision in *Wheeler, J.M. Wheeler,* CA-5, 97-2 USTC ¶60,278, 116 F3d 749, in which it had held that the *bona fide* full and adequate consideration exception applied if the transaction was not a sham or illusory and if objective facts demonstrated that the transfer was made for full and adequate consideration. In reaching its holding, the *Kimbell* court emphasized: "However, we made it clear that just because a transaction takes place between family members does not impose an additional requirement not set forth in the statute to establish that it is *bona fide* . . .. A transaction that is a *bona fide* sale between strangers must also be *bona fide* between members of the same family. In addition, the absence of negotiations between family members over price or terms is not a compelling factor in the determination as to whether a sale is *bona fide*, particularly when the exchange value is set by objective factors…. In summary, the *Wheeler* case directs us to examine whether 'the sale … was, in fact a *bona fide* sale or was instead a disguised gift or a sham transaction.'" *D.A. Kimbell, Sr.,* DC Tex., 2003-1 USTC ¶60,455, 244 FSupp2d 700.

[10] As is amply demonstrated, or attempted to be demonstrated in the family limited partnership marketability cases, illiquidity of an asset results in a justifiable discount off of face value (one aspect of the so called marketability discount). How much is this illiquidity worth?

[11] Barry Commoner, The Closing Circle: Nature, Man, and Technology (1971), in reference to environmental externalities, not insurance products.

[12] If the policy is a variable policy that increases cash value in the policy based on both premiums paid (in excess of the annual insurance and insurance company's costs allocated to the policy) and market performance, the insured is then subject to the market performance variable. Because this arrangement is intended to be an arbitrage arrangement, from a pragmatic perspective, no one would subject it to this kind of market risk. Meaning: a variable policy will not be used in this arrangement. Or, the universal policy could have a guaranteed mortality charge, with the strategy of a lower premium being tied solely to not reserving cash value. However, the guaranteed mortality charge will increase the premium, thereby decreasing the arbitrage opportunity.