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Life Insurance

*22 COULD ABUSES IN THE LIFE INSURANCE INDUSTRY LEAD TO PENALTIES?

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In recent years, a number of aggressive life insurance schemes have been shut down by the IRS. If the life insurance industry does not police itself, could it be headed for penalties in the same manner as big accounting firms?

Reading about the huge fines recently paid by KPMG caused me to think about the fate of the life insurance industry. Although the industry does not seem to see itself on the precipice, one wonders how far away it really is. The IRS and Treasury have certainly targeted the industry as one needing controls. If it continues to spiral toward trouble, could the life insurance industry be hit with fines and federal regulations like the big accounting firms? Or could it be heading for an even worse fate--loss of its federal income tax exemptions?

For the record, I'm an unabashed supporter of the role of life insurance in estate planning. When used properly, life insurance planning improves business succession planning, asset protection planning, charitable planning, and general estate planning. But I wonder if the industry sees the signposts of pending danger.

Life insurance industry under the Treasury's magnifying glass

For some time now, it appears the life insurance industry has garnered the attention of Regulation writers at the Treasury--and not for its good deeds. For years, certain members of the life insurance industry have busily been designing plans to exploit perceived tax loopholes to sell products (policies) that otherwise might not have been needed or wanted. And these plans were frequently marketed based on literal (some would call it 'hyper-technical ') readings of certain Treasury Regulations, Code sections, or court cases. One of the reasons to wonder if the life insurance industry's fate will follow that of the big accounting firms is that these plans were often sold with an 'opinion letter' from one of the big accounting firms (or a big law firm) confirming that, under a literal reading of the tax law, the plan should work-- or might never be audited.

The following are just a few 'recent' examples of schemes hatched by the insurance industry which, once understood by the Treasury, were ultimately closed down:

A few years ago, the life insurance industry created a new business selling products to fund a plan called 'charitable split-dollar' insurance. The plan involved a public charity and presumptively used the charity's tax exemption to leverage the already favorable environment for split-dollar ownership of life insurance.

Charitable split-dollar also offered large income tax deductions, so it was very attractive to ***23** clients with substantial incomes. Most of the money ended up, not in the hands of the charity, but in a trust for the benefit of the 'donor's' children and grandchildren--or available to the donor himself in the form of loans. The plan was promoted

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by some life insurance salespeople and included very large premiums (and commissions). For the most part, the life insurance industry condoned the activity of its salespeople and accepted the split-dollar ownership structure.

At the time this plan was being sold, arguments were made that the plan was supported by an opinion of a large accounting firm and that the opportunity to play the 'audit lottery' justified taking the risk.

Well, as we all know, the Code writers at Treasury and ultimately Congress eventually learned about charitable split-dollar, recognized its 'abusive' use of a charity's income tax deductions, and shut down the plan entirely. [FN1] As a result, hundreds (perhaps thousands) of clients had to 'undo' their plans. But the profits generated by the life insurance industry and the salespeople who promoted the plans were generally retained.

Then, a couple years ago, the Treasury learned of the aggressive use of 'equity split-dollar' arrangements. In general, these plans allowed companies to buy large insurance policies on key employees and/or owners and 'shuttle' the growth in the cash value of the policies (the 'equity') from the companies to the executives/owners--presumably with no tax. These plans appealed to the most affluent business owners and usually involved large policies with substantial premiums (and commissions), and were heavily marketed by the life insurance industry.

In response to these perceived abusive plans, the Treasury issued new Regulations which changed the entire split-dollar regime. In September 2003, final Regulations were issued, and now split-dollar plans are taxed under a new set of rules designed and implemented to deter these types of equity plans. [FN2]

Similarly, the IRS finally caught up with promoters of aggressive welfare benefit plans. Using the cover of Section 419A(f)(6), certain life insurance salespeople promoted a plan that promised to act like a qualified retirement plan with employer deductions for contributions, but without the 'pesky' qualified plan contribution limits and, in some cases, without estate tax inclusion. To accomplish the goals, the plans were aggressively funded with huge cash value life insurance products. These insurance funded welfare benefit plans were touted as super-retirement plans and were often marketed to professional practices. [FN3]

In July 2003, the Treasury issued final Regulations under Section 419A(f)(6), and they curtailed the aggressive welfare benefit plans. Essentially, the Regulations made nondeductible the contributions that caused the plans to be experience-rated, which means primarily those plans created and funding large cash value life insurance policies.

In the past year, the IRS and Treasury have focused on the life insurance industry's gamesmanship in 'springing value' insurance and annuity products. This process led to Proposed Regulations and then in August 2005, the Treasury released final Regulations under Section 402(a) also affecting the Regulations under Sections 79 and 83. The insurance industry loophole these Regulations were intended to close occurred with respect to life insurance policy valuations in connection with qualified retirement plans, split-dollar plans, group insurance plans, and Section 83 valuations.

Given some ambiguity over how to properly value life insurance contracts that are distributed or sold from qualified plans, and given the huge impact of taxes on those plan assets as a component of estate planning (estate tax plus income tax as income in respect of a decedent ('IRD'), plus state income taxes, and sometimes generation-skipping taxes), certain promoters in the life insurance industry found a way to create and promote a scheme that seemed to 'eliminate' value for tax purposes. By exploiting a literal reading of the Regulations on valuation of life insurance products and a literal reading of 'springing cash value,' the life insurance industry created a cottage ***24** industry called 'pension rescue' planning. [FN4]

This product appealed to the wealthiest clients and invariably involved substantial life insurance policies and premiums (and commissions). And the entire purpose for the sale of the product was to use corporate dollars to fund a life insurance policy, reduce the apparent value of the assets in the plan for tax purposes, and to have that value 'spring' back later in the form of a fully paid-up substantial life insurance policy held in an irrevocable life insurance trust. This business was so lucrative that life insurance companies created products specifically designed to meet this planning opportunity--and then gave the sales force incentives to go out and sell the plan. [FN5] Similar games were also played with 'springing value' annuity policies.

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Once the IRS learned the details of how the plan worked (and how it was being promoted), the IRS responded by closing the loopholes with Regulations. [FN6]

The life insurance industry continues to create/promote aggressive strategies

The trend of churning out new 'cutting edge' plans continues in the life insurance industry. In late August 2005, I heard of a new 'scheme' involving charities, limited partnerships, and huge life insurance policies. Basically, the plan works like this: a wealthy client places investment assets into a limited partnership ('LP') (retaining the .5% general partnership interest), and contributes the limited partnership interests to a donor-advised fund of a public charity. The client takes a huge income tax deduction. Then annually, as the assets in the LP earn income, 99.5% is not taxable as it flows through the K-1s to the charity. But the income (and some of the principal) is 'loaned' back to the creator of the plan for an interest-only promissory note. The note is secured by a large life insurance contract that pays off the debt at the client's death.

This plan was designed to create a huge income tax deduction and to allow the client access to his funds 'income tax-free.' In return for this huge tax benefit, the only cost is the premium for a large life insurance contract. Like the other plans mentioned above, if each step is examined in isolation and the tax law is read literally--without concern for its spirit and intent--the transaction sounds as though it has merit. But does anyone wonder how the IRS will deal with this arrangement when and if the IRS learns about it in its true details?

A recent discussion on the ABA's Real Property, Probate and Trust Law Section ('RPPTL') list-serve highlighted another developing trend. Annuity salespeople are apparently aggressively promoting a concept called 'private annuity trusts.' As described, these plans work by real estate investors trying to avoid or delay income tax (although for long-term property it would be at lower capital gains rates) on the sale of real estate. This strategy generally calls for a sale of the property to a trust in exchange for the trust's promise to pay a private annuity for life. The trust then takes a basis in the property equal to the present value of the annuity (the sale value of the property), and turns around and sells the property to a third party. The trust pays no capital gains tax because its basis equals the value of the property sold. Then the client recognizes the income over his life expectancy as the annuity payments are made.

What has made this transaction of interest to life insurance sales people (annuity sales people, technically) is the added promise that, to pay the annual annuity obligation, the trust should take the proceeds from the sale of the real estate and invest that amount in an immediate annuity. One commentator on the list-serve stated: 'There are growing armies of insurance agents out hawking private annuity transactions 'to avoid capital gains taxes on property sales' through three or four cookie-cutter firms.' I have not yet seen this plan in my practice but assume the commentators on the list-serve are not making it up.

The impact of stranger-owned life insurance

In a January 2005 ESTATE PLANNING article, Stephan R. Leimberg highlighted the epidemic commonly referred to as stranger-owned life insurance ('SOLI') (in a charitable or an individual context). [FN7] That article described the practice of selling 'something for nothing' life insurance to rich clients who have not fully insured to their net worth. Generally, in exchange for a fee, the client allows a policy to be ***25** issued on his or her life which two years later is sold to a life settlement firm. As with the other schemes described above, SOLI plans involve huge policies (meaning the premiums and commissions are huge). And the client who didn't want insurance basically invests nothing but a medical exam.

The premiums are paid by a financing arrangement, and the policy is sold to a third-party life settlement firm trying to create a dead pool that outsmarts the insurance industry. The agent involved makes a commission on the initial sale of the policy and usually another on the settlement of the policy. Lest you not recognize the appeal, the commissions in a SOLI transaction can easily exceed $500,000 in a single case. So the life insurance sales people have a tremendous incentive as do the insurance carriers.

There has been debate about whether the insurance companies condone this business or not. On the one hand, some have argued that sales of life insurance policies have generally declined since 2001, and the insurance carriers are happier to sell policies regardless of the intended use. On the other hand, some have argued that the life

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insurance carriers are not happy with a business where large investors are buying up policies because the investors believe the insurance carriers are under-pricing policies. (Generally, the argument is that the carriers use lapse assumptions to reduce premium charges, so if you buy enough policies and don't allow them to lapse, you can beat the carriers.) Certainly, many of the more reputable and well-known insurers have refused to sell policies that are intended to be owned by strangers, and these insurers require disclosure of such intent in their policy applications, but these two-year transactions are intended to avoid such disclosure.

SOLI seems to be an extension of the 'wet-ink' transactions of the late 1990s and early 2000s. Those programs were designed for life settlement firms to buy the policies almost instantly upon issue (while the ink was still wet). In SOLI transactions, the intent from the moment the policy is issued is to sell it, and the client invests nothing in it. The fiction relied upon by its promoters is that by waiting two years, you somehow cleanse the 'problems,' including those nagging state insurable interest laws. In the case of wet ink transactions, the life insurance industry did police itself, and all the insurers refused to issue policies that were intended to be 'flipped.' [FN8]

Regardless of whether the life insurance industry is happy about these transactions or not, it is impossible to ignore their existence. The frequency of clients being approached to 'loan' their life expectancies to these transactions, both on a private basis and through some charitable connection, seems to be increasing. Perhaps the life insurance industry will again police itself in the context of the SOLI policies.

Could the life insurance industry be headed for penalties?

Considering the recent Regulations, it certainly appears that the IRS and the drafters of Regulations at the Treasury recognize a pattern. The pattern involves certain members of the life insurance industry noticing cracks in the tax system, designing plans to exploit these tax loopholes and then attempting to market the plans to 'drive trucks through' these cracks. And the IRS seems to have concluded enough is enough. How can this trend at the IRS be ignored? It appears the recent spate of Regulations designed to curtail schemes created and promoted by members of the life insurance industry are signposts of growing weariness at the IRS with the life insurance industry. If the insurance industry does not begin to police itself, will the IRS continue its piecemeal responses or will it become more aggressive?

If the government regulators attacked the big accounting firms for creating and selling abusive tax schemes, what makes the life insurance industry immune? It is possible that penalties will be issued if government regulators conclude the life insurance industry is illegally profiteering (I'm not suggesting they are, but merely noting that a regulator might conclude such) by building and promoting abusive tax shelters.

If enough life insurance plans become listed transactions, the industry should be concerned about its fate. Indeed, if that result should occur, then like the big accounting businesses, the life insurance industry may wind up paying hefty fines. Again, I am not advocating for that result, but just noticing the parallels and warning signs.

***35** If not facing fines, it has also been suggested that bigger trouble could lie in waiting for the life insurance industry: loss of tax-favored treatment. As a result of a genuine public policy favoring families supporting themselves after the death of a loved one, life insurance has historically been afforded income tax benefits not available to other businesses--its products grow in value on a tax-preferred basis, and the recipients of the death benefit do not pay income tax. But with the rise of increasingly abusive transactions, this policy is undermined. To the extent the life insurance industry is deemed to be using its products to scheme the Tax Code, the regulators (government) might decide the industry is no longer worthy of its tax-favored status.

This result was recently suggested by Stephan Leimberg in his article on SOLI. [FN9] As he argued, by changing the nature of life insurance into an investment vehicle (or into a tax shelter vehicle), the promoters of these products are undermining the justification for the income tax benefits associated with life insurance (the income tax-free accumulation of cash value and receipt of death benefits). As the focus shifts from selling quality life insurance products to clients who want and need them to selling gimmicks to clients who otherwise don't want or need life insurance, the industry places itself in greater peril.

Maybe there are just a limited number of bad products and bad producers in a generally quality industry. Indeed,

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three organizations representing the life insurance industry strongly criticized SOLI policies. As reported by Leimberg in his SOLI article, [FN10] The American Council of Life Insurers, the Association of Advanced Life Underwriters, and the National Association of Financial Advisors each proclaimed support for state laws forbidding third-party institutions from purchasing life insurance policies as an investment vehicle.

So there is reason for optimism that the life insurance industry will examine its actions and will police itself, because a few bad apples can spoil it for everyone.

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[FN1]. In December 1999, after the IRS made it clear it would disallow deductions in the charitable split-dollar arena, Congress enacted IRC Section 170(f)(10). That Code section generally disallowed deductions when a charity used contributed funds to pay premiums on life insurance on the donor. See Addis, 118 TC 528 (2002), aff'd 374 F.3d 881, 94 AFTR2d 2004-51334 (CA-9, 2004).

[FN2]. Generally, the loan regime for split-dollar arrangements is published in Reg. 1.7872-15.

[FN3]. For several excellent discussions of Section 419A(f)(6) welfare benefit plans and the Regulations enacted to curtail these plans, see Leimberg Information Services, Inc. ('LISI') website service (http://www.leimbergservices.com). See also Leimberg, Carsrud, and Ratner, ' Section 419A Proposed Regs. Clarify Rules Governing Death Benefit Only Plans,' 29 ETPL 491 (Oct. 2002).

[FN4]. See Leimberg and Ratner, 'Valuation of Life Insurance: Rev. Proc. 2005-25 Provides New Guidance,' 32 ETPL 13 (Aug. 2005).

[FN5]. See Zartisky and Leimberg, Tax Planning With Life Insurance (Warren, Gorham & Lamont).

[FN6]. The new Regulations can be found under Section 402(a).

[FN7]. Leimberg, 'Stranger-Owned Life Insurance ('SOLI'): Killing the Goose That Lays Golden Eggs!,' 32 ETPL 43 (Jan. 2005) (referred to herein as Leimberg's 'SOLI article').

[FN8]. This author previously wrote about these deals; see Baskies and Samuels, 'Aggressive Viatical Settlement Transactions: Gambling on Human Lives, ' 28 EPTL 76 (Feb. 2001).

[FN9]. See note 7, supra.

[FN10]. Id.

33 Est. Plan. 22, 2006 WL 322306 (W.G.&.L.)

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