

**THE ISSUES RAISED BY USING PRIVATE PREMIUM FINANCING
TO PAY TRUST-OWNED POLICY PREMIUMS**

**TAX MANAGEMENT ADVISORY BOARD MEETING
MIAMI, FLORIDA
MARCH 20, 2008**

**LAWRENCE BRODY, ESQ.
BRYAN CAVE LLP
ST. LOUIS, MO**

**MARY ANN MANCINI, ESQ.
BRYAN CAVE LLP
WASHINGTON, DC**

The Issues Raised By Using Private Premium Financing

To Pay Trust-Owned Policy Premiums

I. Private Premium Financing - General

While the facts of individual situations of private premium financing will vary, in a typical transaction, the proposed insured, as grantor, will create an irrevocable insurance trust to become the owner of a new policy on his or her life (or on the lives of the grantor and his or her spouse on a survivorship basis). The insurance trust will pay all or a portion of the premium payments due on the policy with funds borrowed from the grantor/insured. The trust will pay interest on the loan, annually, at the applicable federal rate, usually with funds received directly or indirectly from the grantor, either as part of the initial trust funding or as annual gifts; the principal of the loan will be repaid at the end of the term of the loan or at the insured's (or the surviving insured's) death. In some cases, the interest will accrue at the AFR and be repaid with the principal at the insured's death.

II. Impact of The Final Split-Dollar Regulations

The Final Split-Dollar Regulations (Reg. Sec. 1.61-22(b)) define a split-dollar arrangement as one between an "owner" and a "non-owner" of a life insurance contract, pursuant to which either party pays all (or a part) of the premiums and at least one party is entitled to recover all or a portion of those premiums and that recovery is to be made from or is secured by the proceeds of a policy. Loans used to pay premiums that are secured by the policy (private premium financing arrangements) are included in this broad definition, although, in most cases, so long as interest is paid (or accrued) at the AFR, the general tax rules governing loans, and not the special split-dollar loan rules of the final Regulations, will apply. However, as described below, there are special rules for loans with interest paid at the AFR where the lender is "to pay" the interest to the borrower, for interest which is forgiven, and special filing requirements for non-recourse loans, all of which could apply to private premium financing transactions.

If a payment made under a split-dollar loan is non-recourse, the Regulations (Reg. Sec. 1.7872-15(j)) treat the loan as a loan that provides for contingent payments (increasing the complexity of calculating the tax consequences and testing for the adequacy of interest), unless the

parties to the arrangement provide a written representation with respect to the loan that indicates that a “reasonable person” would expect all payments under the loan to be made. The word “non-recourse” is not defined in the Regulations; it isn’t clear if it is broad enough to mean a recourse loan to a trust with no assets other than a policy. The Regulations require that, subject to future IRS rules, that representation be attached to both parties tax returns for each year such a loan is made. If a loan is or could be determined to be non-recourse, this requirement should be complied with, to avoid treating the loan as one that provides for contingent payments.

The most significant provision of the Regulations relating to split-dollar loans which is applicable to private premium financing is one that disregards stated interest on a loan (converting it to a loan governed by Section 7872), if “all or a portion of the interest is to be paid directly or indirectly by the lender (or a person related to the lender)” Reg. Sec. 1.7872-15(a)(4)(i). The most troublesome aspect of this rule is that there is no apparent provision that would exclude the lender’s payment of the borrower’s interest obligation from the borrower’s income, so that the borrower appears be taxed on both the imputed income under Section 7872 and the actual income from the bonus arrangement – an implausible result. In a donor-donee loan arrangement, the lender would, under this provision, appear to have made two gifts each year – the interest gifted and the interest deemed gifted under Section 7872. A “facts and circumstances” test will be used to determine if the interest is “to be paid” by the lender; there is no definition in the Regulations of the phrase “to be paid.”

As examples, the Regulations (Reg. Sec. 1.7872-15(a)(4)(ii)) provide that amounts to be paid by an employer under a fully vested non-qualified deferred compensation arrangement that will pay the employee an amount of the interest due under the split-dollar loan will be disregarded. However, a fully vested non-qualified deferred compensation arrangement that provides for payment equal to the employee’s salary, which the facts and circumstances show is not related to the employee’s interest obligations, will not be disregarded. Clearly, a bonus plan to pay the interest to the employee would be subject to this rule, even though not discussed in these “indirect” payment examples. In addition, although not described in these examples, in a donor-donee arrangement, if the facts and circumstances show that the donor is “to pay” the interest to the donee (as a gift), as is common in donor-donee premium financing arrangements, the loan would become subject to Section 7872.

It is unclear how a less formal arrangement might be treated, such as one in which an employer makes a decision, on an annual basis, to provide a bonus to the employee in an amount equal to the employee's interest obligation, or a donor makes occasional gifts to the donee of the interest due or one or more larger gifts which are unrelated to the interest due (but which are invested and used, over the years, to pay the interest).

The other significant new provision of the Regulations (Reg. Sec. 1.7872-15(h)(iii)) applicable to split-dollar loans which applies to private premium financing treats stated interest that is waived or forgiven by the lender as transferred from the lender to the borrower, increased by a deferral charge, equal to the underpayment of tax interest penalty.

Accordingly, even those split-dollar loans (as defined in the Regulations) that state adequate interest are still subject to certain provisions of the Regulations which are applicable to split-dollar loans. For example, as noted above, if the loan is non-recourse (an undefined term), the parties will have to attach statements to their respective tax returns each year a loan is made under the arrangement, in order to prevent the loan from being treated as providing for contingent payments under the Section 7872 rules. In addition, as discussed, if interest is forgiven by the lender, a deferral charge would apply.

For any loan in which the parties either expect the lender will forgive the interest or otherwise may be treated as providing the funds for the interest, if interest is stated, the parties would risk triggering the new provision of the Regulations applicable to split-dollar loans that treats a loan where interest is to be paid at the applicable federal rate as a below market loan, subject to Section 7872. As discussed above, there is no definition of the phrase "to be paid," and the Regulations indicate that a facts and circumstances test will be used to determine whether the parties intended that the lender was "to pay" the interest to the borrower. As noted above, perhaps the most troubling aspect of that provision is that, in a private premium financing context, the lender would have made a gift of the interest and would also have made a gift loan under Section 7872. While gifts which are clearly unrelated to the interest ought not trigger this provision, there is no certainty that they won't, since it will be a facts and circumstances test.

III. The Income Tax Effects of the Transaction on the Grantor, the Trust, and the Trust Beneficiaries

How the trust will be taxed for income tax purposes during the grantor's lifetime is dependent upon whether the trust, or a portion of a trust, is treated as a grantor trust or a non-grantor trust. If the trust is treated as a wholly grantor trust, all items of income, deductions and credits against tax attributable to the trust flow out to the grantor. If the trust is a non-grantor trust, the trust is taxable on the income that is not distributed to the beneficiaries in accordance with the complex trust rules.

There are several advantages to intentionally create the trust as a grantor trust for income tax purposes.

First, since a grantor and his or her wholly grantor trust are treated as the same taxpayer for income tax purposes (literally, the grantor is treated as owning the trust assets for income tax purposes), transactions between them are ignored for income tax purposes. Rev. Rul. 85-13, 1985-1 C.B. 184; but see Rothstein v. United States, 735 F.2d 704 (2nd Cir. 1984). That result would allow the trust to buy an asset from the grantor on an installment basis without recognition of gain by the grantor or taxation of interest on the note (however, the grantor will continue to be taxable on income earned by the trust and on gains realized on sales of trust assets).

That result would also allow the trust to purchase a policy on the life of the grantor from the grantor without gain and without application of the transfer for value rule, under a number of exceptions to the transfer for value rule of Section 101(a)(2)(A). Under Rev. Rul. 2007-13, 2007-11 I.R.B. 684, a transfer of a policy by the insured/grantor (or even by another grantor trust created by the insured/grantor) to a grantor trust created by the insured/grantor is ignored as a transfer for value purposes. Such a transfer would otherwise qualify for a number of exceptions to the transfer for value rule, even if it were treated as a transfer for income tax purposes, since, under the ruling, it would be treated as a transfer to the insured for those purposes, and, in any event would have a carry-over basis in the hands of the transferee trust.

Such a sale, however, may not avoid application of the three year "look-back" rule of Section 2035 under the exception to Section 2035 for transfers for full and adequate consideration. Section 2035 may still apply, even if the policy was sold to the grantor trust for its "fair market value" (as determined for gift tax purposes) because, for purposes of Section 2035, the sale price, in order to be considered full and adequate consideration may be the full face amount of the policy (which is the amount that would have been includable in the insured's estate had the sale not taken place and the insured had died owning the policy).

In such a sale, must the sale price be the amount necessary to replace the policy in the insured's estate for estate tax purposes (its face amount) or is it its gift tax value under the Section 2512 regulations? Compare TAM 8806004, dealing with a single life policy on the life of the owner (holding that, in order for the sale price to equal full and adequate consideration for purposes of Section 2035, the sale price had to equal the amount necessary to replace the amount that would have been included in the insured's estate for estate tax purposes had the insured died owning the policy) with PLR 9413045, dealing with a survivorship policy owned by one of the insureds (holding that full and adequate consideration for purposes of Section 2035 was the policy's gift tax value, if the insureds were not "near death"). The difference between these holdings appears to be generated by the difference between the policies involved – the survivorship policy would presumably have been included in the seller's estate at its fair market value under Section 2031 (which uses the same standards of valuation of policies owned by a decedent on another's life as is used in the gift tax area) even if transferred within three years of the owner's death, if the other insured were then alive.

On the other hand, as discussed below, if, on termination of the trust's grantor trust status, the trust has outstanding obligations (to the grantor or otherwise), termination of that status would be treated as a sale of the policy for the debt, potentially triggering gain for the grantor. As discussed below, because of that risk, consideration should be given to planning the trust as a non-grantor trust from the outset; as also discussed below, because of Section 677(a)(3), obtaining that result takes special planning and drafting of the trust.

Finally, a grantor's payment of an income tax liability generated by income from assets in the trust, which is actually his or her liability under the grantor trust rules, should not be treated as a gift to the trust: this effectively allow the trust to invest on an after-tax basis, and would have the economic effect of allowing a grantor to "add" more assets to the trust for the benefit of the trust's beneficiaries.

While it seems sensible that the grantor's payment of his or her own income tax liability should not be a gift, the Service, in Ltr. Rul. 9444033, stated that, by paying a trust's tax liability, a grantor would be treated as having made an additional transfer to the trust, unless the trust instrument provides for the reimbursement of the grantor from trust funds. This position had been subject to considerable criticism, and in Ltr. Rul. 9543049 the Service deleted the language in Ltr. Rul. 9444033 relating to the gift tax implications of the grantor's payment of the income tax liability generated by the grantor trust income.

Rev. Rul. 2004-64, 2004-2 C.B. 6 put this issue to rest, by holding that no gift resulted from the grantor's payment of the income taxes on income includible in his or her gross income which was generated by his or her grantor trust.

In Rev. Rul. 2004-64, the IRS ruled that when the grantor or a grantor trust pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, the grantor is not treated as making a gift of the amount of the tax to the trust beneficiaries, because the grantor, not the trust, is liable for the income taxes. The IRS also ruled that if the trust instrument directs the independent trustee to reimburse the grantor for the amount of income tax, the reimbursement is not a gift from the beneficiaries of the trust to the grantor, because the reimbursement is mandated by the terms of the trust. However, the grantor's right to be reimbursed from trust assets for the tax is a right to have trust property expended in discharge of the grantor's legal obligation, so the full value of the trust would be includible in the grantor's gross estate under Section 2036. This is also true if governing state law requires the trust to reimburse the grantor for the taxes paid, unless the trust instrument provides to the contrary.

The ruling further held that a mere authorization in the trust instrument to reimburse the grantor for taxes the grantor pays on income tax attributable to the trust will not cause the trust to be includible in the grantor's estate. However, this assumes "there is no understanding, express or implied," between the grantor and the trustee regarding the trustee's exercise of its discretion. Other facts the ruling notes that might cause estate tax inclusion are a power retained by the grantor to remove the trustee and appoint the grantor, and applicable law subjecting the trust assets to the claims of the grantor's creditors.

The safest approach to avoid these issues appears to be to draft the trust instrument to prohibit reimbursement of the grantor for the tax on trust-generated income. However, compelling reasons to authorize reimbursement may be present in some cases. If so, careful consideration should be given to whether the factors that might cause inclusion in the grantor's gross estate are present. Among other things, the trust instrument must not give the grantor the power to appoint himself or herself as trustee, directly or indirectly (such as the grantor having the power to remove a trustee and replace the removed trustee with a non-independent trustee) and the trust should not be created pursuant to the laws of a state that might subject the trust assets to the claims of the grantor's creditors because of the reimbursement provision.

If a potential grantor of a grantor trust wanted to avoid this issue (or if he or she simply did not want to be "out-of-pocket" for the income taxes generated by trust income) the trust could include a reimbursement clause. If a reimbursement clause is included in the trust, however, then not only is there possible inclusion of the trust in the grantor's estate for estate tax purposes, but if the grantor paid the income tax and was not reimbursed by the trust, a gift would result, not from payment of the income tax liability, but from failure by the grantor to enforce his or her right of reimbursement.

The other, perhaps more certain way, to prevent the grantor of what would otherwise be a grantor trust from being taxed on the trust's income, when that becomes an economic issue, is to give the grantor the power to release the power(s) that made the trust a grantor trust (or to give the trustee the power to revoke those powers). Note, however, that if the trust is a grantor trust as to ordinary income because of the Section 677(a)(3) power to pay premiums out of trust income, that power can't be released by the grantor and would not normally be allowed to be revoked by the trustee (unless the trust can be modified under state law). However, an independent Trustee (as defined in Section 672(c)) could be given the power to amend the trust agreement, and, exercising this power, delete the provision that permits the payment of premiums from the income of the trust.

Also note the IRS pronouncement that a grantor trust which contained a "togglng" power, allowing the trustee to turn off grantor trust status and turn it back on, which was used to achieve a tax savings for the grantor, was declared to be a "transaction of interest" in Notice 2007-73, 2007-36 I.R.B. 545, and as such was a reportable transaction and subject to the taxpayer reporting requirements under Treas. Reg. Section 1.6011-4(b)(6), and Sections 6111 and 6112. Presumably, a power solely to "turn off" grantor trust status but not then "turn it back on" would not be subject to this rule.

Income taxation of the trust and beneficiaries after the grantor's death.

After the grantor's death, the assets in the trust (the proceeds from the life insurance policy and any other trust property) will either remain in trust or be distributed outright to the beneficiaries, assuming the policy is not a survivorship policy. If the assets are distributed to the beneficiaries the trust will terminate. However, if the proceeds from the insurance policy remain in the trust, the trust and its beneficiaries will be taxed in accordance with the non-grantor trust rules.

Income tax consequences on the termination of the trust's status as a grantor trust (either at the grantor's death or during his or her lifetime).

Assuming the trust is drafted as a grantor trust, it will cease to be a grantor trust upon the death of the grantor or upon termination of the power(s) which caused it to be treated as a grantor trust during the grantor's life, because the grantor relinquished that power (or all such powers) or they were revoked under a power granted in the trust instrument. As a result, the trust will no longer be disregarded for income tax purposes, and instead will be treated as a separate taxable entity. If there are two grantors - because each contributed to the trust, or joint or community property was contributed - at the death of the first grantor, half of the trust's grantor status would presumably end, however, if state law uses a contribution rule and considers a trust with two grantors the same as a joint account, if the deceased grantor contributed all of the property to the grantor trust, the entire trust may lose its grantor trust status.

As discussed below, on termination of the trust's grantor status during the grantor's lifetime, if the trust then has any outstanding liabilities (to the grantor or to a third party), the termination of that status will be treated as a sale of the policy by the grantor for the liability. That deemed sale would generate gain, to the extent the outstanding liability exceeded the grantor's basis in the policy. For that reason, as noted above, consideration should be given to creating the trust as a non-grantor trust. As discussed above, this requires special drafting of the trust to avoid the application of Section 677(a)(3), which would otherwise make most irrevocable insurance trusts grantor trusts (at least as to ordinary income).

There is less certainty about the income tax consequences of termination of grantor trust status as a result of the death of the grantor, where the trust has outstanding liabilities (to the grantor or to a third party). As discussed below, some commentators believe that the grantor's death has no tax consequences; under that analysis, death is not an event that triggers gain recognition. Another possible result, and the one which the IRS would likely come to, is that the income tax consequences on the death of the grantor follow those that are deemed to occur when grantor trust status is terminated during the grantor's life, as set forth in the regulations under Section 1001 and other authorities, discussed below. Under that analysis, the income tax consequences would be the same whether termination of grantor trust status is a result of the grantor's death or a termination of the applicable grantor trust power(s) during the grantor's life.

On termination of the trust's grantor trust status during the grantor's life, the grantor will be deemed to have transferred to the trust for income tax (but not for gift or GST tax) purposes both: (i) the assets in the trust, and (ii) the liabilities of the trust. See Treas. Reg. Section 1.1001-2(c) Example 5; Madorin v. Commissioner, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222; TAM 200011005 (Mar. 17, 2000).

Under the Section 1001 Regulations, there may be immediate income tax consequences to the grantor when grantor trust status is terminated, if the trust has any outstanding liabilities (whether to the grantor or to a third party) and those liabilities exceed the grantor's basis in the assets deemed transferred to the trust; however, as in any other capital asset sale context, the grantor will recognize gain only to the extent the liabilities of the trust exceed the grantor's basis in the assets deemed transferred to the trust. Under the general rule of Treas. Reg. Section 1.1001-2(a)(1), the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of such sale or disposition; in this case, the trust's deemed assumption of the grantor's liabilities will be treated as a discharge of the grantor's liabilities in consideration for the assets (the policy) that the grantor is deemed to have transferred to the trust.

However, Treas. Reg. Section 1.1001-2(a)(3) provides an exception to this rule when a liability is incurred for purposes of acquiring property and is not taken into account in determining the transferor's basis in such property (arguably, for example, where the loan is between the grantor and the trust and thus is ignored for income tax purposes under Rev. Rul. 85-13, above). Under these circumstances, the assumed liability will not be included in the amount realized by the transferor and therefore will not cause recognition of gain. Note that the exception does not, by its terms, apply to liabilities disregarded for income tax purposes because of the relationship of the lender and the borrower and the implications of Rev. Rul. 85-13, above; it may be that it was intended to apply to liabilities that were too contingent to be an adjustment to basis.

Example 5 of Treas. Reg. Section 1.1001-2(c) illustrates what is deemed to occur on termination of grantor trust status during the grantor's life. In the Example, a grantor was considered to be the partner of a partnership in which the grantor trust held an interest. Upon termination of grantor trust status because of the renunciation of a grantor trust power, a constructive transfer of the partnership interest to the trust was deemed to occur. The Example concludes that the grantor is required to recognize gain to the extent the allocable share of

partnership liabilities assumed by the trust exceeds the grantor's basis in the partnership interest. Similarly, in Madorin v. Commissioner, above, a grantor transferred to a grantor trust an interest in a partnership that held encumbered assets. The grantor deducted the net losses from the partnership until the trustee renounced a power that had caused the trust to be a grantor trust. The court held that the grantor was thereupon released from his share of the underlying liabilities and recognized a gain to the extent that these liabilities exceeded the basis of the partnership interest.

In applying the general rule of Treas. Reg. Section 1.1001-2(a)(1) to a private premium financing transaction, on the termination in status of the trust as a grantor trust, the grantor will be deemed to have transferred the life insurance policy to the trust in exchange for the trust's assumption of the loan incurred in connection with the trust's acquisition of the policy. Under the general rule, the grantor will realize income to the extent the liability (i.e., the amount of the loan on termination of the trust's grantor trust status) assumed by the trust exceeds the grantor's basis in the policy. Normally, the grantor's basis in the policy would be the total of the premiums paid on the policy, less any non-taxable dividends received (in the case of a participating, whole life policy), perhaps, if the IRS position is correct, less the cost of the insurance protection provided. Compare the IRS position contained in Ltr. Rul. 9443020 with the holding of Gallun v. Cir., 327 F.2d 809 (7th Cir. 1964); in both that Letter Ruling and in CCA 200501004, the IRS held policy basis was reduced by the value of the insurance protection provided (which the rulings held could, in the absence of other proof, be approximated by the difference between premiums paid and cash value – of course, however, that difference is made up of more than just the cost of insurance charges), while in Gallun, basis was held to be premiums paid, less non-taxable dividends.

If the exception of Treas. Reg. Section 1.1001-2(a)(3) applies, because the liability (the loan) was incurred in connection with the acquisition of the policy and is not taken into account in determining the grantor's basis in the policy – which would be true of a loan between a grantor and his or her grantor trust – then no income will be realized by the grantor on termination of the trust's grantor trust status, even if the liability deemed assumed by the trust exceeds the grantor's basis in the policy.

It should be noted that at least one article has suggested that this exception does not apply to exclude liabilities that were originally incurred by the trust, rather than the grantor, to acquire assets. See Deborah V. Dunn & David A. Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, Journal of Taxation, July 2001. Citing TAM 200011005, the

article concludes that in order to fall within the exception of Treas. Reg. Section 1.1001-2(a)(3), the liability must have been incurred as a result of the grantor's acquisition of an asset, rather than the trust's. It may be, however, that the factual background described in TAM 200011005 may require a narrower application of the ultimate conclusion reached by the IRS than the article suggests.

In TAM 200011005, the grantor transferred appreciated stock to a grantor trust that was administered as two separate GRATs for a short period, with the grantor trust making annuity payments to the grantor. In order to make the required annuity payments to the grantor, the trustee borrowed money from another trust. On termination of grantor trust status, the trust disposed of the appreciated stock to remainder trusts for the benefit of the grantor's nephews. The IRS held that under Treas. Reg. Section 1.1001-2(a), the debts incurred by the grantor trust for purposes of making the annuity payments and secured by the trust assets should be treated as amounts realized by the grantor when the trust ceased to be a grantor trust. The taxpayer argued, in relevant part, that the exception provided by Treas. Reg. Section 1.1001-2(a)(3) should apply, because the debt was incurred by reason of the trust's acquisition of the stock. The IRS disagreed, stating that language of the exception can only be reasonably read to refer to indebtedness incurred in connection with the grantor's acquisition of the stock. In essence, the debt under these facts was not acquisition indebtedness, because neither the grantor nor the trust incurred the debt in order to *acquire* the stock; rather, the trust incurred the indebtedness because it held the stock.

The article correctly summarizes the conclusion of TAM 200011005 that the liabilities must have been incurred as a result of the *grantor's* acquisition of the stock in order to fall within the intended application of the exception; however, the article fails to discuss the specific facts which lead the IRS to this conclusion in the TAM. Arguably, if the *trust* had incurred the liabilities in connection with *acquiring* the stock, the exception would have applied. Applying this reasoning, the liability incurred by the insurance trust for purposes of acquiring the life insurance policy could be the type of acquisition indebtedness contemplated by Treas. Reg. Section 1.1001-2(a)(3), and, therefore, under that reasoning, any discharge of that indebtedness resulting from termination of the trust's grantor trust status would fall within the exception and would therefore not be included in the amount realized by the grantor for income tax purposes.

However, even if the exception contained in Treas. Reg. Section 1.1001-2(a)(3) does not apply in the insurance trust situation, the termination of the trust's grantor trust status still should not result in a recognition of gain by the grantor, as long as the liability incurred by the trust

to acquire the policy does not exceed the grantor's basis in the policy. Subject to the IRS position on basis of a policy, discussed above, the trust's basis in the policy should equal the premiums it paid to acquire the policy (regardless of the fact that it financed those premium payments) and because the trust is treated as a grantor trust and therefore considered a disregarded entity for income tax purposes, under Rev. Rul. 85-13, above, the grantor's basis in the policy should be the same as the trust's basis in the policy. Assuming that the loan proceeds (the liability) equal the premiums paid for the policy (the basis in the policy), the liability associated with the policy and deemed assumed by the trust will be offset by the grantor's basis in the policy (again, perhaps adjusted, as discussed above); therefore, no income should be recognized by the grantor on termination of the trust's grantor trust status during the grantor's life.

As discussed above, there is substantial uncertainty and debate among commentators regarding the income tax consequences on termination of grantor trust status as a result of the grantor's death, where the trust has outstanding liabilities at that time. As discussed above, the authorities dealing with the income tax consequences on termination of grantor trust status where the trust has outstanding liabilities only pertain to termination during the grantor's life. See Treas. Reg. Section 1.1001-2(c) Example 5; Madorin v. Commissioner, above; Rev. Rul. 77-402, above; and TAM 200011005.

Some commentators view the transfer of assets that is deemed to occur on the grantor's death as tantamount to a testamentary transfer of the assets to the trust. Under this theory, a gain-on-death rule is contrary to the rule of Section 1001 and, accordingly, no gain should be triggered on the deemed transfer of the assets to the trust upon the death of the grantor.

On the other hand, the IRS will likely argue, and other commentators believe, that when grantor trust status is terminated by the grantor's death, the deemed transfer of the assets to the trust triggers gain to the extent any assumed liability exceeds the grantor's basis in the assets transferred, just as in the case of termination of grantor trust status during the grantor's life. See Treas. Reg. Section 1.1001-2(c) Example 5; Madorin v. Commissioner, above; Deborah V. Dunn & David A. Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, above; Fred Nicholson, Sale to a Grantor Controlled Trust: Better Than a GRAT, 37 Tax Management Memorandum 99 (1996), in which the author acknowledges that the reasoning in Treas. Reg. Section 1.1001-2(c) and the Madorin case, above, may cause the recognition of gain on

the grantor's death to the extent the deemed transfer of assets subject to a liability exceeds the grantor's basis in those assets.

Thus, under this analysis, as discussed above, on the grantor's death and the corresponding termination of grantor trust status of the trust, the grantor will be deemed to have transferred the life insurance policy to the trust in exchange for the assumption by the trust of the loan incurred in connection with the acquisition of the policy. Under the general rule of Treas. Reg. Section 1.1001-2(a)(1), the grantor will recognize gain to the extent the liability assumed by the trust exceeds the grantor's basis in the policy. However, if it is determined that the exception of Treas. Reg. Section 1.1001-2(a)(3) applies, because the liability was incurred in connection with the acquisition of the life insurance policy and was not taken into account in determining the transferor's basis, then no gain will be recognized by the grantor (or his or her estate) on termination of the trust's grantor trust status, even if the liability deemed assumed exceeds the grantor's basis in the policy.

If the exception contained in Treas. Reg. Section 1.1001-2(a)(3) does not apply in the insurance trust situation, because, for instance, of the conclusion reached in TAM 20011005, termination of the trust's grantor trust status should still not result in a recognition of gain by the grantor because the liability (the loan proceeds) should equal the grantor's basis in the insurance policy (the premiums paid by the trust to acquire the policy), again, potentially adjusted as discussed above. Consequently, the liability associated with the policy and deemed assumed by the trust will be offset by the grantor's basis in the policy, and no gain should be recognized on the termination of the trust's grantor trust status as a result of the grantor's death.

There is another issue that may arise upon the termination of the trust's grantor trust status and the resultant deemed transfer of the policy in exchange for the release of the grantor's liability – whether a transfer for value of the policy under Section 101(a)(2) has occurred upon that deemed transfer, when the grantor trust becomes a non-grantor trust. If so, it would be important to analyze the transfer to ensure that the deemed transfer or the trust, which is now a non-grantor trust, falls into one of the exceptions to the transfer for value rule. See Brody and Leimberg, *Avoiding the Tax Trap of the Transfer for Value Rule*, Vol. 32 Estate Planning, No. 10, at 3 (2005), and *Using a Transactional Analysis to Avoid the Transfer for Value Rule*, Vol. 32 Estate Planning, No. 11, at 3 (2005) for a full discussion of the transfer for value rule and those exceptions.

Under the transfer for value rules of Section 101(a)(2), life insurance proceeds in excess of the owner's investment in the contract will be taxed as ordinary income if there has been a transfer of the policy or any interest in the policy during the insured's lifetime for valuable consideration. If a policy is transferred for value, the amount includable in taxable income is the death benefit minus (i) actual value of any consideration received (in this case, relief from the liability), and (ii) premiums and other amounts subsequently paid by transferee (which, in this case would not occur).

Transfers for value include a sale of a policy or an interest in a policy, a transfer of rights in and to policy proceeds for consideration, and transfers of a policy subject to a loan (which exceed the owner's basis in the policy). Treas. Reg Sections 1.101-1(b)(4). Transfers are broadly defined under this Section, but it isn't clear that they are broadly enough defined to include a deemed transfer for income tax purposes that does not involve an actual transfer of an interest in a policy or its proceeds – this deemed “transfer” does not change who will benefit from the policy proceeds (i.e., the beneficiaries of the trust don't change), which is the concern which underlies the transfer for value concept. See e.g., PLR 9410034, which held that where a partnership was terminated for tax purposes because 50% of the partners (who would have benefited from the proceeds) changed, there was a transfer for value of its policies; here, however, there is no change in the trust beneficiaries as a result of the grantor's death.

In addition, it is arguable that since the loan from the grantor to his or her grantor trust is ignored for income tax purposes, as discussed above, there is no liability to which the policy is subject, and that at the grantor's death, an interest in the policy is not being transferred, only death proceeds are being paid (unless perhaps the policy were a survivorship policy and the other insured were still alive).

If there is a transfer for value issue in this situation, there is an unresolved issue as to when the “transfer” takes place – at the moment of, the moment before, or the moment after the event ending grantor trust status, in this case, the insured's death. There isn't any direct authority on this issue, but there is an arguably analogous area – the termination of grantor trust status of a foreign trust taxed under Section 679. There, on the one hand, Reg. Sec. 1.679-2(c)(2), provides that the deemed transfer takes place the moment after grantor trust status ends, but on the other hand, Reg. Sec. 1.684-2(e) provides upon the death of the grantor, he or she is treated as having transferred the property to the trust immediately before death. In the transfer for value situation, it

would seem that if the rule is that the policy would be deemed to be transferred the moment after death, there could not have been a deemed transfer of the policy during the insured's life.

There are five exceptions under Section 101(a)(2). If a policy is transferred for valuable consideration, but the transfer fits within one of these exceptions, the death benefit will not be subject to income tax. One of the five exceptions, the carry-over basis exception, could be applicable in the context of a deemed transfer that would occur when a grantor trust becomes a non-grantor trust and the non-grantor trust has an outstanding liability. If the basis in the policy in the hands of the recipient (the non-grantor trust) is determined, in whole or in part, by reference to the original owner's basis in the policy (the grantor trust), the transfer for value rules will not apply. This exception can protect part-sale, part-gift situations where the transferor's basis (the grantor's basis in the assets held in the grantor trust) is greater than the consideration paid by the transferee (the amount of the liability).

If the liability is greater than the grantor trust's basis in the policy, another exception could be utilized to avoid the transfer for value rule. Under that exception, if the trust is a partner of insured, at the moment of the deemed policy transfer (when the trust becomes a non-grantor trust), then for the transfer for value rules will not apply; there is no de minimus rule on how much of a partnership interest the trust would have to own to be considered a partner for this purpose. Accordingly, one way to avoid this issue (if it is an issue) would be to have the trust and the insured be partners in a state law valid partnership prior to the deemed transfer of the policy when grantor trust status of the trust stops.

However, in Section 3.01(8) of Rev. Proc. 2008-3, 2008-1 I.R.B. 110, the Service reiterated that it would not issue advance rulings on either the status of partnerships substantially all of the assets of which consist of life insurance on the lives of the partners, or whether the transfer of the life insurance policies to such partnerships would constitute a transfer for value. But see, PLR 200747002, implying (by not raising the issue), that a limited liability company formed to own policies funding a cross-purchase arrangement would be treated as a partnership for income tax purposes.

The taxation of accrued interest.

Original Issue Discount Rules.

When adequate interest (based on the Applicable Federal Rate) is not paid on a debt instrument or when a debt instrument does not require the current payment of interest, interest income is imputed to the holder of the debt or the seller of the property under the original issue discount ("OID") rules of Sections 1272, 1273 and 1274.

Briefly, Section 1273 provides that the amount of OID is equal to the difference between the issue price of a debt instrument and its stated redemption price at maturity. The term "stated redemption price at maturity" means the sum of all payments due under the debt instrument other than certain qualified interest payments. See Section 1273(a)(2). In general, holders of debt instruments must include in income the sum of the daily portion of OID determined for each day during the tax year the instrument is held, and the OID rules place the holder of a debt instrument on the accrual method of accounting as to any interest (whether stated or imputed) not paid currently. The basis of the debt instrument in the hands of the holder is increased by the amount of OID that was included in gross income. See Section 1272(d)(2). Concomitantly, Section 163(e) generally allows an interest deduction (to the extent not otherwise disallowed by some other Code provision).

Income Tax Treatment Of Accrued OID During Grantor's Life.

Assuming the trust is a grantor trust, and the trust borrows funds from the grantor, any OID (or deemed OID on a below-market loan) accrued on the loan during the grantor's life will be disregarded for income tax purposes. The OID rules, which would ordinarily apply in this situation to impute interest to the grantor on a current basis, do not apply, under the rationale of Rev. Rul. 85-13, above, because the trust is a grantor trust. See also Henkel, *Estate Planning and Wealth Preservation: Strategies and Solutions*, at Chapter 30.11[3].

In Rev. Rul. 85-13, above, the IRS held that a grantor trust is disregarded as an entity for income tax purposes, and the grantor is deemed to own the assets of the trust for income tax purposes. In the ruling, the grantor trust sold appreciated stock to the grantor in exchange for an installment note. The IRS stated that because the grantor is considered the owner of the grantor trust under the grantor trust provisions and, thus, is both the maker and the owner of the installment note,

the purported purchase by the grantor of the appreciated stock is not recognized as a purchase for income tax purposes. Note that in Rev. Rul. 85-13, above, the IRS refused to follow the contrary decision of the Second Circuit in Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984), in which the court considered a transaction substantially similar to the facts in the Ruling in which the grantor claimed an interest deduction on the installment note and a loss on the subsequent sale of the stock to the corporation. The IRS disallowed both deductions. The Second Circuit held that although the grantor must be treated as owner of the trust under the grantor trust provisions, this requires only that the grantor include the trust's items of income, deduction and credits in his or her own computation of taxable income, and that the trust must continue to be viewed as a separate taxpayer. The court, therefore, held that the sale of the trust assets to the grantor in exchange for an installment note was a bona-fide sale and that the grantor acquired a cost basis in the assets.

Similarly, in Ltr. Rul. 9535026, the grantor transferred stock to a grantor trust in exchange for a promissory note paying a market rate of interest for twenty years followed by a balloon payment of principal. The IRS, relying on Rev. Rul. 85-13, determined that in addition to no gain or loss recognition, the grantor trust could not deduct the interest payments and the grantor did not have interest income attributable to the promissory note. See also Ltr. Rul. 9519029, citing Rev. Rul. 85-13, above, which concluded that no gain or loss will be recognized to the grantor or the grantor trust on the transfer of assets by the grantor to the trust to fund the trust, on the transfer of any property from the trust to the grantor in payment of any annuity installments, or on the substitution by the grantor of assets of the grantor for assets of the trust. See also, the Conference Report, Deficit Reduction Act of 1984, H. Rep't. 98-861, 98th Cong., 2d. Sess. 1018, in which the conferees clarified that if a taxpayer makes a below-market demand loan to a trust and the loan is treated as a revocable transfer of property for purposes of the grantor trust provisions, then the grantor trust provisions, and not Section 7872, govern because "it would be anomalous to give effect for tax purposes to a loan made by a taxpayer to himself or herself."

Accordingly, under Rev. Rul. 85-13, above, and subsequent rulings, transactions between a grantor and a grantor trust are ignored for income tax purposes (again, literally, the grantor is deemed to own the trust assets for income tax purposes). Consequently, if the trust owes money to the grantor, there is no debt for income tax purposes, since the debt runs both to and from the grantor and cannot represent a true indebtedness. Thus, the grantor will not recognize interest income and the grantor trust will not be allowed an interest deduction for interest paid on the "disregarded" loan. Moreover, since any debt instruments between the grantor and the grantor trust are disregarded for income tax purposes, no OID (or deemed OID) can arise during the grantor's life. Accordingly, no OID (or deemed OID) is accrued or taxed during the grantor's life on debts between the grantor and the grantor trust.

Accrued OID As Income In Respect Of A Decedent.

Although there appears to be some uncertainty and debate regarding the income tax consequences of OID (or deemed OID) on termination of the trust's grantor trust status as a result of the grantor's death, it appears that pre-death accrued OID (or deemed OID) on a loan from a grantor to a grantor trust should not constitute income in respect of a decedent ("IRD") in the hands of the grantor's estates or heirs. Treas. Reg. Section 1.691(a)-1(b) provides that, in general, IRD "refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent." Thus, the term IRD includes only items of income that, at the time of death, the decedent had earned or accrued, but not yet received for income tax purposes.

As discussed above, the OID rules do not operate during the grantor's life on debts between the grantor and the grantor trust, for income tax purposes, because the trust, and thus the debt, is disregarded for income tax purposes. Consequently, OID on that disregarded debt is not taxed to the grantor, or deducted by the grantor trust, during the grantor's life. Since pre-death OID did not constitute income to the grantor while living, those amounts (the accrued OID) should not constitute IRD in

the hands of the grantor's estate or successors. To conclude otherwise would tax something after death, the accrued OID, that would never have been taxed had the grantor continued to live.

Planning the grantor trust status of the trust.

Given both the potential advantages and risks associated with the trust's grantor trust status, as described above, careful consideration should be given to that status when planning and drafting the trust.

While it's difficult to generalize, where the insured is the lender, it's likely the trust would be created as a grantor trust from the insured's point of view, to prevent the insured from recognizing the receipt of interest from the trust as income or the recognition of original issue discount as income each year, where interest on the loan is accrued and will be paid at the insured's death. In addition, where grantor trust status is important for another planning reason – such as use of the trust as the buyer in an installment sale of appreciating assets from the grantor which is disregarded for income tax purposes under Rev. Rul. 85-13, above, or as the buyer of a life insurance policy from the insured-grantor, in an attempt to avoid the transfer for value rule of Section 101(a) – that planning will likely require grantor trust status for the trust, despite those risks.

More difficult choices will be raised in situations where the insured is the lender, but it seems unlikely that the trust's obligation to the insured will be repaid before his or her death. In that case, the risks associated with grantor trust status if the loan is outstanding at the insured's death will need to be weighed against the current income tax cost of requiring the insured to report the interest received as income (where he or she is the lender) or losing the opportunity to have the insured pay the income tax on trust-generated income with no gift tax consequences (where the lender is a third party).

Again, the safest way to assure non-grantor trust status for an insurance trust by avoiding the application of Section 677(a)(3) is to require the approval of an adverse party to use trust income to pay premiums on a policy on the grantor's (or his or her spouse's) life.