Casey Jones, Who Is Driving that Insurance Train?

"Letting an Investor Bet on When You'll Die."[1]

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[1] The title of a Wall Street Journal article that describes this transaction, dated May 26, 2005.

1. The Reasons for Discussing this Topic Now

The insurance field is expanding in creativity in terms of programs offered. One such development in the last two years is the **nonrecourse** short term insurance programs offered for elderly, high net worth individuals that qualify for the programs, the topic of a Wall Street Journal article on May 26, 2005. These programs allocate the financial benefits of life insurance to private individuals (or charities) and the financiers for the transaction.

That concept is divided into two main categories of programs, one in which a back end interest could be available to charitable institutions. One early program, known as the "LILACs" (Life Insurance and Life Annuity Combinations) program, was disliked by the treasury. A proposed law sought to impose excise taxes on this use of life insurance.[2] These types of programs are definitely wilting, from tax and nontax perspectives.

The other category of life insurance program provides current or back end financial interests to private individuals (the insured or the insured's family).

The Wall Street Journal article notes that these types of programs came into vogue in part by hedge funds and other institutional investors looking for different ways to achieve double digit returns, and an understanding that current insurance pricing could be arbitraged. Although providing certain financial upsides to the insured, "[c]ritics…contend the practice alters the purpose of life insurance by treating it as an investment vehicle for outside speculators."[3]

As for the private inurement programs (no charitable interests), the article quotes Larry Brody as encouraging:

> "From the insured's point of view, there are very few risks, if it's clear you have a real choice at the end."[4]

Although there is an upside to these strategies for clients that enter into the program, one does wonder what is driving advisors to recommend these strategies: is it financial remuneration to the insurance agents, or the possible upside to the client?

Like Casey Jones, the engineer of that fabled train, that fell asleep at the wheel, one wonders, "Trouble ahead, trouble behind, and you know that notion just crossed my mind." And since our clients are being approached by different advisors on this front, it is crucial that the risks and benefits of these programs are understood (or at least the tension points).

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[2] In May, 2005, a Bill was introduced in the Senate to impose an excise tax equal to 100 percent of the acquisition costs on some life insurance, annuity, or endowment contract in which both the exempt organization and a person that is not an exempt organization have both held an interest. Senate Bill 993. Document 2005-10320, 2005 TNT 91-62. In the 2005 Blue Book for fiscal year 2006, the Treasury had also proposed an excise tax on these transactions.

[3] Rachel Emma Silverman, "Letting an Investor Bet on When You'll Die – New Insurance Deals Aimed at Wealthy Raise Concerns," Wall Street Journal, May 26, 2005, page D1.

[4] Not a bad quote for advisors to use to absolve themselves, just a tad bit, from future criticism. The article also notes, perhaps erroneously, that "policyholders are likely to owe income taxes on the accrued interest they would otherwise have been charged."

2. Profile of Clients Entering into the Transaction and Reasons Behind the Transaction

The profile of clients that qualify for these types of program are that they are over seventy-five years of age, insurable and of reasonable health, meet the program's health profile, and are of net worth of $10,000,000 or more. No financial outlay is typically required, and the programs are set up with financing that is nonrecourse and secured only by the insurance policies.

The upsides to each strategy are quantifiable:

1. Typically, the insured, through his or her irrevocable insurance trust (a GST exempt trust is possible), obtains at least two years' worth of life insurance for no out-of-pocket cost. This is a substantial benefit. For example, if the transaction involves $10,000,000 worth of face amount of insurance, and the insured dies within the first two years of the policy (a result that has an actuarial probability of > 6 % for a person aged 80 with standard health), then the $10,000,000, less the borrowing and financing costs, say approximately $1,000,000, will flow free of estate tax cost (and arguably gift tax and income tax as well) to the insured's irrevocable insurance trust. In sum: a $9,000,000 benefit at no cost.

2. Further, the insured, if his or her health changes significantly in the first two years – to the worst – can continue the insurance by paying the costs (premiums + interest + "termination fee") incurred to date, and then paying future premiums.

3. The insured may receive an advance, say 3 % of the face amount, that he or she is required to pay back if the insured (through the insured's insurance trust) continues the insurance after the two years, but is not required to pay back if the insured does not continue the insurance; or the insured may receive a percentage participation interest if the policy is sold after two years.

The above benefits are achieved at no direct cost. The insured gives up his or her insurability, but does not have to provide a cash outlay. Questions raised by these strategies are many.[5] For the most part, the issues raised, though superficially presenting problems with the strategy, are not impossible hurdles to overcome from the legal perspective. As with all planning strategies recommended to our clients, hurdles are presented on the mental accounting front: "though the strategies make sense for a client, will she feel comfortable enough with it to do it, or will she account in the negative in her mind as to the strategy and talk herself into not doing itself for what are objectively irrational grounds?"

There are two categories of concerns to these insurance strategies. Category number one can be summarized by the feel of large insurance policies owned by non-family members: "icky." This concern was well expressed by Stephan R. Leimberg in the article, "Stranger-Owned Life Insurance: Killing the Goose that Lays Golden Eggs!", and discussed later in this outline.

The second category of questions are ones from the legal front, and include the following:

1. Is there an insurable interest?

2. Are there gift tax issues?

[5] We should emphasize that merely raising the question does not necessarily convict the innocent. For a list of all possible evils associated with this strategy, *see Leimberg,* "Is 'Free' Life Insurance Really Free," [unpublished].

3. Is it truly nonrecourse?

4. What is the reputational risk?

5. Is there phantom income on the forgiveness of indebtedness issue?

6. Is there capital gain or ordinary income? What is the amount realized on a gain?

7. What is the role of the advisor in reviewing the program?

3. Why It Could Be Icky

Anecdotally, many clients presented with this strategy do not like the idea of a third party "investing" in their insurability. And this has prevented many an economic deal from occurring.

When the thought of a third party owning insurance profiting by an early mortality is actually pondered, aversion to this concept is reasonable. And yet, with all the life settlements, viatical settlements, insurance-collateral loans and corporate owned insurance that are in place, shouldn't the same concerns exist? The answer is, of course, yes. Fortunately, because we do not live in 18th century England, it is not likely that these parties will cause premature deaths for economic reasons.

Nevertheless, the "ickiness" factor is out there, and best summarized in Stephan Leimberg's article, "Stranger-Owned Life Insurance: Killing the Goose that Lays Golden Eggs!"[6] In addition to asking numerous substantive legal questions that he does not completely answer, his spiritual objections focus on what he believes to be the nefarious nature of the programs and those underwriting the programs:[7]

> "[B]ig-moneyed, high-powered investor groups hope to make life insurance into a mass commodity investment.…"
>
> "Investors are now treating people's lives as fungible assets, just like stocks and bonds are assets, and they are in essence paying the insured to use their insurability."
>
> "One of several risks to the insured is that he alone hopes he lives a long time. He has no control over who eventually will own the contract on his life, and he should understand that the return on their investment varies inversely with the number of years he lives."

Is this a realistic risk? In the Berkshire Hathaway Inc. 2004 Annual Report, it is noted:

> "Berkshire purchases life insurance policies from individuals and corporations who would otherwise surrender them for cash…The original policyholder is usually in good health when we purchase the policy. Still, the price we pay for it is always well above its

[6] Tax Analysts, pp. 811-820 (May 2005/June 7, 2005); originally published in Estate Planning Journal (January 2005).

[7] He does this much like the press demonized, maybe rightly so, the herbicide labeled as "Orange" in the Vietnam War, by adding the sinister sounding "Agent" before it, to re-label it in the press as "Agent Orange."

> cash surrender value …we don't think these bookkeeping charges represent economic losses. If we did, we wouldn't buy the policies."[8]

Query whether knowing that Berkshire and others are investing in this market gives cause for greater or lesser concern? Also, there are clearly litigated cases out there when one party has procured life insurance on the life of another, and then engaged in nefarious, life altering actions to facilitate the death benefit payments under that policy.[9]

4. Insurable Interest

a. Why Important

The concept of "insurable interests" germinated in English common law, but has since been codified and confused by state statutes and state common law. Each state's laws must be examined *de novo* in determining whether the insurable interest laws have been violated, and as importantly, what the recourse for this violation may be.

The insurable interest concept is to preserve public policy, preventing third parties from "trafficking in insurance policies on strangers' lives."[10] Essentially, laws will require the person procuring the insurance to have an interest in the insured's continued life which is sufficient to negate the idea of speculation.

If an insurable interest does not exist when the policy is issued, different results occur depending on state statutes, if applicable, and if not, on state common law. First, the insurance purchased could be void *ab initio*, and no death benefits need be paid (though premiums advanced must be returned less any prior policy withdrawals or borrowings).[11]

This will typically only occur during the two year contestability period. After this time, it will be difficult for a company to deny payment of proceeds, and will depend on case law. However, certain jurisdictions may refuse to enforce life insurance contracts in which the policyholder has no insurable interest in the insured even after the 2 year contestability period.[12] Other jurisdictions will hold that the expiration of the contestability period, typically 2 years for life insurance contracts, bars the insurer from waiving insurable interest as a means of avoiding an insurance contract.[13]

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[8] Berkshire Hathaway Inc. 2004 Annual Report, p. 22 (Buffett 2005).

[9] *See, e.g., Bajwa v. Metropolitan Life Ins. Co*, 208 Ill. 2d 414, 804 N.E.2d 519 (Ill. 2004).

[10] *See, e.g.; Bowman v. Zenith Life Ins. Co.*, 67 Ill. App. 3d 393, 384 N.E.2d 949 (Ill. App. Ct. 1978). For an excellent read on the kind of gaming activities that were being developed in the 18th century in Europe, including the beginnings of the stock market, see David Liss, A Conspiracy of Paper (Random House 2000). The book provides an excellent flavor as to why the insurable interest concept is such an important one.

[11] *See, e.g., Hawley v. Aetna Life Ins. Co.*, 291 Ill. 28, 125 N.E. 707 (1920).

[12] *See* John Alan Appleman, 1A Insurance Law and Practice (West. 1981).

[13] *See, e.g., New England Mut. Life Ins. Co. v. Caruso*. 73 N.Y.2d 74, 338 N.Y.S.2d 217 (N.Y. Ct. App. 1989); *Columbian Nat. Life Ins. Co. v. Hirsch*, 267 N.Y. 605, 196 N.E. 602 (1934). In *Caruso*, the court held that the statutes provided that after the two year contestability period had lapsed without a challenge to the policyholder's insurable interest, the policy must be enforced as against the insurance company. As to the right of the estate to garner the proceeds as against the owner of the policy, that would be a different matter.

And the voidability of insurance coverage even during the contestability period is not without doubt. Asserting as a defense the lack of insurability will succeed or fail, by the insurer, primarily based on case law. And the case law is across the board on this one, with consideration being paid as to whether the actions of the insurance company or its agents constitute estoppel or waiver, and whether the state statutes can be implied to prohibit payment if there is no insurable interest.

Alternatively, if a third party with no insurable interest obtains the death benefit, the insured's estate may be able to obtain those proceeds back, typically by state statute.[14] For example, if the insurance company pays the proceeds to a third party that did not have an insurable interest in the insured, the decedent's estate can maintain an action for those proceeds.[15]

b. Defining What Constitutes an Insurable Interest

"Insurable interest" usually means a family member or charity, and includes (don't forget) the insured. It will include, directly or by implication, a party receiving funds via a debt collateralized by an insurance policy (provided that the collateralized party was not the *de facto* beneficiary, from the beginning, discussed below). Not all State laws define what constitutes insurable interest, and some states rely on well developed (or not so well developed) case law.[16]

For example, McKinney's N.Y. Ins. Laws § 3205 (a) defines insurable interest as:

> "(A) in the case of persons closely related by blood or by law, a substantial interest engendered by love and affection.
>
> (B) in the case of other persons, a lawful and substantial economic interest in the continued life, health or bodily safety of the person insured, as distinguished from an interest which would arise only by…the death…of the insured."

That section of the N.Y. laws allows certain charities to be beneficiaries of insurance policies as well as, presumably, owners. Further, creditors can obtain the benefits of life insurance ownership if the

[14] For example, McKinney's N.Y. Ins. Laws, § 3205(b)(4) provides:

> "If the beneficiary, assignee or her payee under any contract made in violation of this subsection [not having an insurable interest] receives from the insurer any benefits thereunder accruing upon the death, disablement or injury of the person insured, the person insured or his executor or administrator may maintain an action to recover such benefits from the person receiving them."

[15] *Wagner v. National Engraving Co.*, 307 Ill. App. 509, 30 N.E.2d 750 (Ill. App. Ct. 1940). *See also Parduhn v. Bennett, infra*, noting that under Utah law, when a policyholder lacks an insurable interest, the insurance policy is not invalid, but rather vests in the court the power to distribute the proceeds equitably rather than awarding the proceeds to the designee; *Wal-Mart Stores, Inc. v. AIG Life Ins. Co.*, 860 A.2d 312 (Del. 2004), noting that many estates of deceased employees could validly claim insurance proceeds collected by Wal-Mart on the death of these employees provided that the employees' estates could prove that Wal-Mart had no insurable interest. *See also Torrez v. Winn-Dixie Stores*, 118 S.W.3d 817 (Tex. Ct. App. 2003), in which the decedent's estate brought suit against the decedent's former employer in order to procure a constructive trust over insurance proceeds paid to the employer.

[16] For example, Illinois indicates that an employer can have an insurable interest by statute, but does not have a general statute defining insurable interests. ILCS §5/224.1.

insurance is received as a result of a bona fide debt entered into after the insurance is purchased, discussed in more detail below.[17]

In similarity, Oklahoma[18] picks up on this definition:

> "[A] lawful and substantial economic interest in having the life, health, or bodily safety of the individual insured continue, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disability or injury of the individual insured."[19]

Business partners would fall within the above definition. But be careful, it should not be taken for granted that all business partners have insurable interests in one another. This is an oft-contested area. In this regard, even when a business partners, or business may have insurable interests in their respective partners or employees, those interests may or may not survive the termination the employment relationship.[20]

c. Creditors

Up until *Chawla*,[21] the case law on insurable interest had been as expected, if not particularly illuminating. Its focus had been primarily on whether creditors, who obtain an interest in a policy (long?) after its issuance, have an insurable interest. The "yes" conclusion, widely accepted, was noted by the court in *Hota v. Camaj* and statutory law[22]:

> "[A]ny person of lawful age who has procured a contract of insurance upon his or her own life [can] immediately transfer or assign the contract, and does not require the

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[17] *See, e.g., Hota v. Camaj*, 299 A.D.2d 453, 750 N.Y.S.2d 119 (N.Y. App. Div. 2002)(applying New York law, allowing assignee as the insured's creditor to have an insurable interest in the insured's life because life policy was assigned as security for a loan to insured), *New York Life Ins. Co. v. Baum*, 700 F.2d 928 (5th Cir. 1983)(insurable interest in creditor where creditor loaned funds to insured after life policy went into effect); *Martin v. Stubbings*, 126 Ill. 387, 18 N.E. 657 (Ill. 1888). But in 2005, in an advisory opinion, the Department of Insurance indicated that a non-recourse premium financing transaction could violate the state's insurable interest law. N.Y. Office of General Counsel Op. (12.19 2005).

[18] Can there be two more different regions of the country than New York and Oklahoma?

[19] 36 Okla. Ins. § 3604(c)(2). Also, "[i]n the case of individuals related by blood or by law, a substantial interest engendered by love and affection." 36 Okla. Ins. § 3604(c)(1). Further, an "individual heretofore or hereafter party to a contract or option for the purchase or sale of an interest in such shares, has an insurable interest in the life of each individual party to the contract and for the purposes of the contract only, in addition to any insurable interest which may otherwise exist as to the life of the individual." 36 Okla. Ins. § 3604(c)(3). *See, e.g., Tillman ex rel. Estate of Tillman v. Camelot Music, Inc.*, No. 03-5172, 2005 WL 1112086 (10th Cir. May 11, 2005).

[20] *See, e.g., Parduhn v. Bennett*, 112 P.3d 495 (Utah 2005)(partner loses "insurable interest" in other partner when the partnership is dissolved)

[21] *Chawla ex rel. Giesinger v. Transamerica Occidental Life Ins. Co.*, No. CIV A. 03-CV-1215, 2005 WL 405405 (E.D. Va. Feb. 3, 2005) (slip opinion).

[22] *See, e.g.,* Ala. Code § 27-14-21(b).

assignee to have an insurable interest….[T]he defendant was the decedent's creditor, which gave him an insurable interest in the decedent's life."[23]

State laws will discourage unrelated (by business or family) third parties from having an immediate financial interest in a person's life insurance policy, if that is the sole interest. Essentially, having someone "buy" someone's insurability will not meet the "insurable interest" test. For example, if Party or business A buys life insurance on Party B, with or without consideration, and there is no familial or business relationship between Party A and Party B, then the insurable interest criterion will be violated. If Party B buys the life insurance on B's life, and immediately turns over the policy to A, the insurable interest requirement is also violated: substance over form prevails.[24]

A creditor who receives an assignment of the insurance policy as collateral security for a loan should have an insurable interest.[25] The confusion arises as to whether these transactions are really debt, or are merely the purchase of the policy from day one by the lender. If the latter, then the rule prohibiting assignments to one having no insurable interest is relevant.

Most of the cases invalidating the insurance based on the lack-of-insurability issue focus on fact patterns in which a third party procured the application for insurance, and soon after the insured purchased the insurance, was assigned the rights in the policy. The rule is that if a policy is taken out with the intention of immediately assigning it to one having no insurable interest, the transaction is merely a guise for an impermissible wager policy. The leading case is *Grigsby v. Russell*, 222 U.S. 149 (1911), in which the Supreme Court held that where the whole transaction from the beginning was entered into as a mere cover for a wager or gambling transaction then the later assignment of the policy was void. The *Grigsby* holding is one of facts and circumstances:

> "And cases in which a person having an interest lends himself to one without any as a cloak to what is in its inception a wager have no similarity to those where an honest contract is sold in good faith."[26]

In contrast, cases exist which uphold the assignment as valid when done after a period of time from the taking out of the insurance; for example, *Midland Nat. Bank of Minneapolis v. Dakota Life Ins. Co.*, 277 U.S. 346 (1928) (assignment made three years after the policy was taken out); *Lyman v. Jacobsen*, 128 Or. 567, 275 P. 612 (Or. 1929) (assigned two years after inceptions valid); *Page v.*

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[23] *Hota, supra,* 299 A.D.2d at 453-454. *But see* fn. 17 and the New York Insurance Commissioner's opinion to the contrary.

[24] *See, e.g.*, PLR 9110016, 1991 WL 777678 (I.R.S., Mar. 8, 1991), citing NY Law and indicating that obtaining an insurance policy with the intent of transferring it to an organization without an insurable interest is a violation of the insurable interest laws, citing the older *Steinback v. Deipenbrock*, 158 N Y 24 (1899) case for the proposition that an insured who originally purchases a policy payable to the insured, and thereafter assigns it as collateral for a debt, is permissible. Several months later, this Private Letter Ruling was revoked by PLR 9147040, 1991 WL 779729 (I.R.S. Nov. 22, 1991) based on the State of New York's retroactive July 15, 1991 amendment of the New York Insurance Code "to provide that an insured may immediately transfer a newly purchased life insurance policy." The I.R.S. observed that "[t]he legislative history of the amendment indicates that the purpose of the amendment is to permit a person to immediately transfer a policy to charity in circumstances like those described in [PLR 9110016]."

[25] An early American opinion is the case of *St. John v. American Mutual Life Ins. Co.*, 13 N.Y. 31 (N.Y. Ct. App. 1855), expressing the majority view on the topic indicating that an assignment of a life insurance policy by the insured to a third party, creditor, who does not have an insurable interest is not void *per se*.

[26] *Grigsby*, 222 U.S. at 156.

Metropolitan life Ins. Co., 98 Ark. 340, 135 S.W. 911 (Ark. 1911) (assigned one year after inceptions valid).

In these new insurance transactions, is the intent at inception that the policy will be assigned? That is not so easy to answer, given that the insured has two years of insurance coverage and the realistic ability to continue coverage even after the expiration of the two year period.

d. Irrevocable Insurance Trusts

Prior to 2005, and hopefully thereafter, there had not been an issue about an irrevocable insurance trust having an insurable interest. The answer seemed so clear that for it to become an issue is sort of bizarre.

If an insured's family members have an insurable interest, then any vehicle that is made up of these family members should also have an insurable interest. Members of an insured's family include children, grandchildren, and spouse. These people have an insurable interest. A trust for the benefit of these individuals should also have a clear insurable interest.

But then came *Chawla*, a bizarre case.[27] In *Chawla*, the owner and beneficiary of the policy was the insured's "special trust." The beneficiary of the special trust was the decedent's friend. Like *Strangi II*,[28] it is another case that illustrates that bad facts made bad law.

The reason for the bad facts, from a QAD perspective: the insured lied on the insurance application and died a little more than a year after applying, apparently from medical causes that should have been disclosed on the application. And this should have been an easy case for the denial of coverage. The typical governing insurance law is that when there has been a material misrepresentation in the form of an incorrect statement in an application, the insurance policy will be invalidated.[29] So the opinion continues for a number of pages along this correct line of argument, like a perfect extension of the fly line towards the water. But then the opinion sinks, inexplicably and for no reason. In dicta, the court notes:

> "Finally, even absent a material misrepresentation, Plaintiff's claim necessarily fails as a matter of law because the Trust maintained no insurable interest in the life of the decedent thus rendering the policy void."[30]

The effect of this statement, taken as true on its face, is that an irrevocable insurance trust cannot have an insurable interest. The dicta in *Chawla* as to this part of the opinion is wrong and should and can be ignored.

The court's reasoning[31]:

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[27] See footnote 20, *supra*.

[28] *Strangi v. Commissioner*, TCM 2003-145, No. 4102-99, 2003 WL 21166046 (U.S. Tax Ct. 2003).

[29] *See, e.g. Hofmann v. John Hancock Mutual Life Ins. Co.*, 400 F. Supp. 827 (D. Md. 1975).

[30] *Chawla*, 2005 WL 405405 at *6. This has caused estate planners severe pain and deadweight loss in having to deal with an issue that should not be an issue, much like the problem caused by Circular 230 applying to certain estate planning tax strategies.

[31] Excerpts of the court's opinion are taken from *Chawla*, 2005 WL 405405 at **6-7.

Only a person with an insurable interest can procure life insurance; and hence be entitled to life insurance proceeds. True. In determining whether an insurable interest exists in a situation in which an insurance trust owns an insurance policy, inquiry must be had to whether the trust has an insurable interest. True. The relevant state statutes must be examined to determine whether an insurable interest exists. True. A state statute that allows one "related closely by blood or law…has an insurable interest" refers to a trust containing these individuals. True. A carve out from insurable interest that provides, "[A]n interest that arises only by, or would be enhanced in value by, the death [sic] disablement, or injury of the individual is not an insurable interest," means that an insurance trust does not have an insurable interest if the trust promises "to gain more assets upon the decedent's death, *i.e.*, death benefits under the policy, than it would have in the event that decedent had lived. Further, the Trust suffered no detriment, pecuniary or otherwise, upon the death of the decedent." False. This is not the standard in Maryland or any other state because every single insurance trust, irrevocable, or revocable living trust, receiving the proceeds from an insurance policy, would fail this test.

The case is currently on appeal. No precedent cases were cited for the proposition that a trust does not have an insurable interest. It is doubtful whether the Maryland Insurance Commissioner would give much credence to the case and if death occurs after two years, query whether a state statute eliminates the voidability of the policy for insurable interest reasons.[32]

e. Relevance of Insurable Interest to Advanced Strategies or to Any Strategy for That Matter

One question is how important is insurable interest? In the ILIT strategy, it strains credulity to believe that it would really surface as an issue in terms of the payment of benefits. More interesting would be the IRS assertion that section 2033 applies because there is a valid claim by the estate to get the proceeds back from an irrevocable insurance trust (or how about a Section 2035 three year rule on lapse). An assertion by the Service of this position should also lose, unless the insurance is really payable to unrelated third parties.

In the advanced strategies, the insurable interest is important because if the amount promised to the insured's family is based on the eventual recovery of death proceeds, denial of a claim for lack of insurable interest reduces or eliminates the amount to the family. Importantly, it is difficult to imagine that if the insurance is payable in the first two years to the insurance trust, that the insurance company could argue that there is no insurable interest. In that event, the full proceeds (less the debt) are paid to the beneficiaries of the irrevocable insurance trust, which will likely be the insured's family.

If the insurable interest concerns surfaces after the two year contestability timeline, this is really not the insured's problem; it is the concern of the developer of the transaction. In that instance, the insured's estate could theoretically maintain an action against the third party that is then in control of the death proceeds.

If the insurance company denies coverage based on the insurable interest issue, before or after the two year period, then the insured still should not be liable for the full face amount of the insurance policy, or the full amount of the loan. But the practitioner needs to carefully review the underlying

[32] As previously discussed in the text, state statutes often provide that after a policy has been in force for more than two years, it is not contestable by the insurance company except under defined circumstances, such as non-payment of premiums. See, e.g., 215 Ill. Comp. Stat. § 5/224(1)(c) (West 2000).

documents to make sure that the insured is not guaranteeing, representing, or otherwise making any affirmation as to insurable interest.

The one position that the insured cannot find herself in: that the insured represents that the insurance trust has an insurable interest.

5. Is the Gift of "Insurability" a Gift?

In *Dickman v. Commissioner,*[33] the United States Supreme Court held that the use of valuable property "is itself a legally protectible property interest." The question is whether one's "insurability" is the use of a property interest. Translating the question into *Dickman* terms, is there "a measurable economic value associated with the use of" one's insurability in these matters? The answer would clearly seem to be yes.

The only haven provided by *Dickman* is the Court's lack of interest in dealing with familial matters: "We assume that the focus of the Internal Revenue Service is not on such traditional familial matters. When the government levies a gift tax on routine neighborly or familial gifts, there will be time to deal with such a case."[34] This has been correctly interpreted to mean: "Hey, IRS, don't be bugging us with these theoretical and technically correct gift issues; they are not significant enough for us to bother with." Since 1984, the IRS has not bothered the taxpayer with these, to any great degree.

But if an insurance trust is used to engage in an annuity/insurance arbitrage using only funds that the insurance trust borrows from the insured, the net effect is that the insurance trust has used the insured's "insurability" to its advantage. Like the hypothetical questions not answered in *Dickman,* this has the feeling of a gift of opportunity within the family. It would be far fetched to suppose that generically speaking, every "gift of opportunity" would be a taxable gift, thereby constituting an atomic bomb as to all irrevocable insurance arrangements. But then again, Revenue Ruling 79-353 was far fetched, as was its applications to annual exclusions gifts within three years from revocable trusts being included in the gross estate. Stranger IRS pronouncements have occurred. And in the two year transaction, it is the hard wiring of the results that seems more gift-like than a normal transfer of insurability to an irrevocable insurance trust.

In any insurance transaction, including an irrevocable insurance trust, the "insurability" is transferred from the insured to the insurance trust, for the benefit of children, grandchildren, further descendants, and other beneficiaries. Never before has the gift of insurability been deemed to be a gift for gift tax purposes. And, for good reason. Even in the above-discussed transactions, the gift of insurability is really a gift of opportunity. *Dickman* did not hold that gifts of opportunity are taxable gifts.

Insurance, like any other asset, is an investment. Maybe it turns out with a good rate of return on the investment; maybe it doesn't. And for gift tax purposes, the regulations define the gift of an insurance policy as essentially what it would cost to buy a replacement policy at the stage of the gift; *e.g.*, if the insurance program is in its third year, what would it cost to buy a policy at that point, ignoring the future premium funding obligation:

> **(a) Valuation of certain life insurance and annuity contracts.** The value of a life insurance contract or of a contract for the payment of an annuity issued by a company

[33] *Dickman v. Commissioner,* 465 U.S. 330, 336 (1984).

[34] *Dickman*, 465 U.S. at 341.

> regularly engaged in the selling of contracts of that character is established through the sale of the particular contract by the company, or through the sale by the company of comparable contracts. As valuation of an insurance policy through sale of comparable contracts 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 at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used."[35]

Nowhere in the regulations does it say [and it could, if that were the Treasury's intent] that the gift of "insurability" is a gift of something.

And on its face, that omission is extremely logical. Insurance companies are not charitable institutions. They sell policies because they can make money on policies. There should be nothing inherently valuable about one's insurability.

And the gift of such does not carry with it a valuable property right . . . except with regard to these short term transactions (these transactions seem to result in dollars being transferred without any cost). But that is not always the case; if the insurance is purchased at the end of two years, and the then and future costs outweigh the risk adjusted return of that investment, than the owner of the insurance is worse off, investment wise. In that instance, there has not been a gift. Even in situations in which the insurance is not continued, there are income tax risks, discussed *infra*, that could result in a negative return, as well as reputational and other risks. It is not certain that there has been value transferred.

Importantly, each transaction must be reviewed based on its idiosyncratic structure, and there is floating out there the specter of a gift, but that argument would be one of first impression.

6. Is it Truly Nonrecourse

To be recourse to the insured, or to the insured's family, documentation must be signed specifically by the insured indicating that the insured is liable for the financing used to purchase the policy. But in these types of transactions, typically the entity requesting the financing is an irrevocable trust over which the insured has retained no control. Accordingly, only the trust is responsible for paying off the loan entered into it. Absence an express guarantee or similar arrangement between the insured and the financing entity, the insured does not have personal liability. For example, if an insurance trust enters into the loan, and not the insured, the insured is not liable on the loan absent an express guarantee or other documentation.

Moreover, on these programs, the documentation indicates specifically that the loan is (1) nonrecourse to the insured, (2) secured only by the insurance policy, (3) collateralized by the insurance policy, and (4) entered into by a trust that is not beneficially owned by the insured. There is no individual guarantee, and, no representations that the insured guarantees the performance of the policy, the repayment of the loan, or any other representation. So, on its face, the program is typically nonrecourse.

But beware. Standard representations are required to be made in the insurance application by the insured. If the insured makes a misrepresentation, that is substantial, such as committing fraud on the application, then in a de facto kind of way the nonrecourse nature of the transaction shifts to recourse. In

[35] Treas. Reg. §25.2512-6.

the case of a material misrepresentation, the insured could be liable for the full amount of the face amount of the insurance, in a situation in which the insurance company denies coverage. For example, the following phrase was in one recent agreement:

> "If the policy is challenged by the insurance carrier during the two-year contestability period on account of facts that also constitute a breach of this agreement by the insured or the spouse, if any, or on account of any misrepresentations or omissions made, or in connection with, the preliminary or final application, by the insured or the spouse, if any, or upon the suicide of the insured, then the insured or the insured's estate shall immediately pay to [financier] an amount equal to the amount due under the non-recourse financing … that is not recoverable from the insurance carrier."

This is a scary proposition because the practitioner has no control over his or her clients' representations; and the penalty for committing material misrepresentations are harsh.

The practitioner needs to spend substantial amount of time to make sure that the policies are in fact nonrecourse, and each document that needs to be signed should be reviewed in detail, and carefully, to ensure that nonrecourse means nonrecourse (and no personal guarantees are stuck in there).

Deniability of coverage based on lack of insurable interest should not cause "recourse type" concerns back to the insured; this should be a risk of the third party. But the practitioner should carefully review the applicable documents to make sure this is so.

7. Reputational Risk

Using a technique that appears on page 1 of the Wall Street Journal is not a pleasant thought for any client. Abusive tax techniques, such as those involving tax shelters, subjected many clients to a sinking feeling when articles started dissecting the tax abuses inherent in many of those strategies, and the IRS' objectives of imposing penalties.

The insurance techniques currently touted have at their core arbitrage concepts, not tax avoidance. It is possible, albeit unlikely, that these techniques will be the center of attention in any article.

With one caveat: as less ethical insurance practitioners get involved in this area, permutations of the strategy are likely that will have an ugly taint. Iterations involving tax savings, and the tax free nature of the life insurance, are possible. Further, the possible market in selling individual policies, even in an unseemly way, is possible. Clients that are with reputable providers may get scared when the less reputable ones start having stories written about them. But here, this is an identification of a risk that has not yet occurred; so this concern should not be overstated.

8. Income Tax: What Will be Will be and What is Phantom Does Not Exist

In the nonrecourse insurance transactions, the financial results to the insured are myriad. First, the easy. If the insured continues the insurance after the two year period by electing to pay the financing costs (and thereafter assuming the insurance premium obligations), or receives the insurance proceeds during the two year period, then the net amount received should constitute proceeds from life insurance, thereby resulting in it being free of income tax. The proceeds will be net of the then debt used to finance the policy, plus interest and other costs. The income tax consequences of this transaction should be no different than in a typical financed premium structure.

If the policy is surrendered, or sold, after the two year period, then the effect of the proceeds received becomes more difficult to pinpoint. In some cases, the value of the insurance policy at that point will exceed the loan and other financing costs. In other cases, the funds advanced to pay the premiums on the insurance will exceed the value of the insurance policy, when the policy is exchanged or surrendered for the debt. Neither of these variables are, it turns out, important. Instead, the following rules will likely become relevant.

1. Code section 61 provides that gross income includes income from discharge of indebtedness ("COD"). If the debt is extinguished by the surrender of the policy by the trust, at least superficially this looks like a discharge of indebtedness, especially if the policy's value is less than the then amount of the debt. Under §61(a)(12), gross income includes COD income. This general rule would require a taxpayer to recognize COD income when the debt becomes due and cannot be paid.

There are two key exceptions to the general rule that the discharge of indebtedness produces COD income that must be included in gross income. Under Code §108(a)(1), gross income does not include COD income if the discharge of the debt occurs in a title 11 bankruptcy case (Code §108(a)(1)(A)) or if the discharge occurs when the taxpayer is insolvent (Code §108(a)(1)(B)).

For purposes of the insolvency exclusion, the taxpayer is insolvent if, immediately before the discharge of the debt, the taxpayer's liabilities exceed the fair market value of the assets of the taxpayer. Code §108(d)(3). Actual fair market value, rather than book value, is used in determining insolvency. See *Commonwealth Berkeley Associates*, 11 CCH TCM 322 (1952).[36]

Nonrecourse debt complicates the situation. In Rev. Rul. 92-53, 1992 C.B. 48, the Internal Revenue Service ruled that the amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt is taken into account in determining whether a taxpayer is insolvent, but only to the extent that the excess nonrecourse debt is discharged.

However, Code section 108(a)(1)(B) provides that gross income does not include any amount that would otherwise be includible in gross income (by reason the discharge of indebtedness) if the discharge occurs when the taxpayer is insolvent. If the debt exceeds the value of the policy, and the trust owns only the policy, then the trust is insolvent. That Code section should then apply to indicate that there is no discharge of indebtedness.[37]

2. More probing is section 1001. Section 1001 (a) provides that the gain from the sale or other disposition of property is the excess of the <u>amount realized</u> over the <u>adjusted basis of</u> the property.

Section 1001(b) provides that the amount realized is the fair market value of the property received. And under the treasury regulations, this includes the amount of liabilities from which the

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[36] It must be noted that Code §108 does not mean the COD income has no impact at all on the taxpayer. Code §108(b) provides that the amount excluded from income by the insolvency exclusion must be applied in reduction of the tax attributes listed in Code §108(b). These include: basis in depreciable property (if the taxpayer so elects under §108(b)(5)); net operating loss and NOL carryovers; carryover of the general business credit under Code §38; amount of minimum tax credit available under Code §53(b); net capital loss or net capital loss carryover; basis as provided in Code §1017; passive activity loss or credit carryover under Code §469(b); and the foreign tax credit carryover.

[37] If the value of the policy is greater than the debt, then the sale or exchange of the policy would obviate any "cancellation" of indebtedness; and a different income tax analysis should apply, as discussed below.

transferor is discharged as a result of the sale or disposition.[38] And a sale or other disposition that secures a nonrecourse liability discharges the transferor from the liability.[39] Accordingly, the elimination of the principal amount of the debt is definitely included in the amount realized.

The trust's basis in the Policy should[40] equal the purchase price of the Policy (i.e., premiums paid). It is not increased by the accrued interest or other interest like charges (origination fees for example). But the issue of "basis" in life insurance contracts has been the subject of discussion for quite a long time, primarily in the split dollar arena. Intuitively, one would think that basis should equal the amount of premium paid that has not been returned as dividend or used as an income tax deduction (just like any other capital asset). Code section 72 (e) (6) starts to get to this result:

> **(6) Investment in the Contract**
> For purposes of this subsection, the investment in the contract as of any date is –
> (A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus
> (B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this title or prior income tax laws.

However, that section does not refer to when a policy is sold or exchanged, versus merely surrendered. Logically, the same result should apply. However, the Service, in PLR 9443020, ruled to the contrary. In that ruling, the Service defined "adjusted basis" as the amount of premiums paid for the life insurance protection (correct), less any amounts received under the contract that have not been included in gross income (correct), less the "cost of insurance protection provided through the date of sale" (probably incorrect).[41] There are cases to the contrary, impliedly holding that basis on the sale of a life insurance contract is determined in the same manner as if a policy were surrendered and section 72 (e) applied.[42]

There is still the open question of whether the gain is ordinary income or capital gain. As there is no cash surrender value typically in these policies, the full amount received in excess of basis is not attributable to any inside, tax free, build-up. It was this inside cash free build up that has subjected surrendered insurance policies to gain as ordinary income.[43] The flavor of the gain looks more like capital gain than ordinary income, though this holding is still waiting for a *Strangi II*-like case for its birth.

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[38] Treas. Reg. 1.1001-2(a)(1).

[39] Treas. Reg. 1.1001-2(a)(4).

[40] The Cubs should win the World Series in 2006.

[41] *See also* IRS CCA 200504001, 2005 WL 190296 (I.R.S. January 28, 2005) (finding that basis of taxpayer's former life insurance policy "is equal to the amount of premiums paid by the Taxpayer less the sum of (i) the cost of insurance protection provided through the date of sale (such as, loading charges, expense charges, mortality charges and administrative fees) and (ii) any amounts received under the contract that have not been included in gross income).

[42] *See Gallun v. Commissioner*, 327 F.2d 809 (7th Cir. 1964) (finding, however, that under the contract at issue in this particular case, Section 72(e) did not apply). *But see Sutter v. Comm'r*, T.C. Memo 1998-250 (1998), ("loan" not treated as a loan and taxpayer therefore given no basis in policy; the facts in this case do not resemble those that the author has observed in current non recourse financing).

[43] *See Arnfeld v. U.S.*, 163 F. Supp. 865 (Ct. Cl. 1958).

Hence, one argument is that the amount realized (principal amount of the debt) should equal basis (the principal used to pay premiums), and there should be no taxable gain.

An additional controversy is whether interest on the principal debt, which is not repaid, is also included in the amount realized. In that case, there would be taxable income.

From a tax perspective, this would sort of be a bad hurt for the taxpayer. The interest that was accrued led to no tax benefit, it was not added to basis and did not afford the taxpayer with any type of interest expense deduction. Accordingly, taxing this interest would truly be phantom income. And there is no case law (but one important PLR, see below) indicating how that interest should be treated.

One argument that the interest is not included in the amount realized is based on the Supreme Court's recognized "tax benefit theory." That theory is usually applied in the negative, to prevent a taxpayer from receiving tax benefits associated with nonrecourse debt without economic cost. Tax benefits associated with nonrecourse debt include, for example, basis, depreciation deductions, as well as interest deductions.

In the case of the typical structure of the insurance transaction, the only tax benefit will be with regard to the principal advanced to pay premiums. These premium payments are added to basis. Interest that is accrued on the principal loaned to pay premiums is not deductible and does not add to basis.

Under the tax benefit rule, the accrued interest on a nonrecourse debt is included in an amount realized "only where appropriate. "Where appropriate" has been translated to mean in situations in which the accrued interest was deductible, or added to basis, thereby resulting in a tax or economic benefit to the borrower prior to the gain realization event. [44]

Because interest was not deductible and not taken into account in determining basis, it is arguable that, under the tax benefit theory, it should not be part of the amount realized under that section or Treasury Regulation.

One very important Private Letter Ruling, PLR 9251023 (I.R.S., Dec. 18, 1992), in the real estate area, provides this analogous conclusion, recognizing that the amount realized should not include non-deductible interest incurred in a real estate loan and not paid back:

> "In this case, as a cash-basis taxpayer, you have not deducted any of the accrued but unpaid interest on the indebtedness, [a]ccordingly, the accrued interest is not includible in the amount realized for purposes of determining gain or loss with respect to properties 1 and 2. See Crane v. Comm'r, 331 U.S. 1. Similarly, the accrued interest with respect to properties 3 through 8 and with respect to the stock in X is also not taken into account."

9. Giving Up Future Insurability

For understandable reasons, insurance companies require that the amount of life insurance have direct correlation and ceiling related to that person's net worth. As a heuristic, assuming that a person's life insurance cap is perhaps 75 % of that person's net worth, this strategy will certainly exhaust an insured's insurability. This is a disclosure almost always made in these transactions.

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[44] *Crane v. Commissioner*, 331 U.S. 1 (1947); *Commissioner v. Tufts*, 461 U.S. 300, reh'g denied, 463 U.S. 1215 (1983).

For pragmatic reasons, it is hard to imagine this being a problem for our clients. Given our society's aversion to life insurance, and the substantial cost of insurance for insureds over 75 years buying face policies in excess of $10,000,000, it is difficult to imagine a case in which an insured who did not intend to purchase insurance before the program, would thereafter desire to purchase insurance.

10. The Role of the Advisor

The above risks, though not substantial as discrete concerns, become so when the dollars of these transactions are considered. Policies that have aggregate face amounts of $10,000,000, or $20,000,000, mean that these amounts are the possible damages if the transaction does not go as planned. The practitioner needs to consider who bears the financial risk if the transaction goes south, for any reason.

For example, alluding to the above concerns addressed in this outline, is the insurable interest in tact? Were all the representations done correctly? Is the advisor sure about the income tax results?

And most importantly, who is the advisor? Usually, there is a team of professionals focusing on these strategies, including the developer,[45] the insured's accountant, the insured's lawyer, and the insurance salesman. The apportionment of risk and compensation is crucial.

The developer has the systematic risk if the overall transaction is not successful. The financing is substantial, and if the structure is not correct, the developer should be at risk on a substantial level.

If the attorney is advising on the above tax and legal consequences, and the documentation and risks of the transaction, the attorney has the most direct risk if the transaction goes south. The accountant may advise on the income tax portion of the transaction, and has some risk, albeit substantially less than the attorney. The insurance salesman has some reputational risk, and a very small financial risk if the transaction goes south. In sum, the insurance salesman has the least amount of risk in the transaction.

If the attorney is not careful, he or she will find that compensation as between the attorney, the accountant and the salesman is inversely proportional to the risk involved. The starting point for the discussion is that the commission on these types of policies are likely substantial; a heuristic is to assume that a majority of the first year premium gets allocated to the developer and the insurance salesman.

1. Under all circumstances, make sure the insurance salesman lets the attorney know the level of the expected commission.

2. At a minimum, make sure the insurance salesman commits upfront to paying the attorney and accountant fees, regardless of whether the transaction goes through.

3. The attorney should write comprehensive memos and protective letters outlining all potential risks and uncertainties, including those noted in this outline.

4. The attorney should shift the risk of insurance application "misrepresentations" (via letter, signed by the insurance agent) to the insurance agent.

5. The attorney should shift the risk of structural problems in the transaction to the insurance agent (via a letter, signed by the insurance agent).

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[45] For lack of a better word, the "developer" is the creator of the strategy, the one putting together the financing and structure of the strategy.

6. The attorney should demand an opinion letter on the income tax consequences of the transaction from the developer.

7. The attorney should commit the kind of time that is necessitated by these issues to each strategy. To review, research, analyze, and discuss the income, recourse/nonrecourse, and documentation, will require the attorney at a minimum to spend 100 to 200 hours per strategy. At an hourly rate of $500/hour, spending 200 hours results in a fee of $100k, to be allocated to the insurance salesmen regardless of whether the strategy goes through.

The short term insurance program was introduced earlier this year, and discussed in detail at the Pittsburgh ACTEC meeting.

Among the differences between that program and the ones discussed above is that the insured (and the insured's family) have no financial interests in the program at all. Instead, a back end participation interest is held by one or more charitable institutions, which receives funds at the insured's death if certain performance, interest and other hurdles are satisfied, and if after the repayment of all financing and other costs, death proceeds remain. The program itself, prior to the proposed legislation, in all likelihood was structurally in tact. However, the structural integrity of the program is not important because the program itself has two major problems associated with it:

At the Pittsburgh program, the behavioral problem was raised that it did not seem to me that it would be worth the practitioner's risk or effort to entertain these strategies for what could be a, say, $500,000, back end charitable interest at the insured's death. The answer given then by the promoters/developers of this strategy was something akin to "any money going to charity is a good thing."

But the reality is that there are too many behavioral obstacles to overcome to expect this program to be successful. To undertake the review of documentation, convincing of a client (the "insured") to do the strategy, convincing a charity to do this, and other administrative issues, will make this strategy unattainable in about all cases.

ATTACHMENT 1

Annuity/Insurance Arbitrage: Overstatement or Reality?

The definition of "arbitrage:" the practice of taking advantage of a state of imbalance between two (or possibly more) markets for the same or related assets.[46] Pure arbitrage is the purchase of one security and simultaneous sale of another to give a risk free profit.[47]

> **Example 1**: In a connotative sense, we typically regard an investment in two different assets as creating the possibility of an arbitrage.[48] For example, Shell and Royal Dutch are subsidiaries of a holding company and entitled to cash flows from the holding company in required percentages. After adjusting for differences in price attributable to differences in the cash flows and currency adjustments, the price of Royal Dutch versus Shell in January, 1996 was: Royal Dutch: $141/share; Shell: $126/share. Shell was essentially trading at $15/share less than Royal Dutch, or approximately 11.71 % lower. Theoretically, an investor (assuming no transaction costs, which is not actually true in the marketplace) could short one share of Royal Dutch, receive say $141 in cash, purchase one share of Shell at $126, and still be ahead $15/share Any increase in the price of stock in Shell or Royal Dutch should have been parallel since they were receiving the same results from the holding company (one company could not be favored over another in terms of cash flow, other than pursuant to an adjustment taken into account in the above example). But with this investment, the investor, at no cost, was $14 ahead.[49]

1. Components of the Insurance/Annuity Arbitrage

Can an insured use three actions − borrowing, buying an annuity, and buying an insurance policy − to receive a guaranteed rate of return, at no cost? Assuming borrowing is not part of the mix, alternatively can an insured use two actions – buying an annuity and buying an insurance policy – and receive a rate of return greater than the underlying risks inherent in that investment package? Under either of the above two scenarios, can an irrevocable insurance trust be woven into the fabric?

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[46] From *Wikipedia*, on-line enclyclopedia.

[47] Brealey & Meyers, Principles of Corporate Finance,

[48] "Risk" arbitrage is essentially the act of benefiting from differences in price of the same or empirically related commodities, currencies, securities, or other assets traded in two or more markets. The arbitrageur makes money by taking advantage of the price disparity by selling in one market while simultaneously buying in another market. Free markets tend to attract arbitrageurers, and thus converge the disparities toward equilibrium.

[49] See Harvard Business School, "Global Equity Markets: The Case of Royal Dutch and Shell" (case study). The pricing differential could have been a result of illiquidity concerns related to the stocks in the two companies, or that one of the companies at the time was in the S & P 500, and the other was not. The prices did, over time, converge to an adjustment that was much closer, meaning that the arbitrage opportunity noted in the text disappeared. Further, shorting stock is not always available and is often accompanied with its own transaction costs, as is the normal sale and purchase of stock.

2. Premises Underlying the Strategy

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' shift in mortality tables,[50] actuaries can use different assumptions in determining one's expected mortality. In an efficient market, the mortality assumptions built into annuity and insurance products should be the same; that is, each product should use the same actuarial assumptions for a given consumer regardless of which product – an annuity or insurance policy—the consumer is purchasing.

A shift in mortality to a longer expectancy means that a life insurance product, whose costs 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 2**: Assume a 79-year-old in standard health status has an 8 year life expectancy, and the cost of a $1,000,000 face universal life policy based on this 8-year life expectancy is $57,000 annually. Assume the life expectancy assumption is increased 20% 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 8 years, and pays $1,000,000 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% and assume the same linearity in pricing. The single premium annuity payment now will increase to $197,479 annually.[51]

One variable used by the consumer in choosing life insurance policies is the annual premium, the lower being better, all else being equal. One variable used by the consumers in choosing annuity products is to get the greatest annual payout, all else being equal. The incentive of insurance companies in structuring products is, therefore, 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. Since pricing of those 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.[52]

3. The Strategy in Its Simplest Iteration

The nutshell version: Buy an insurance policy with a face amount of $X, and use $X to buy a single premium immediate pay annuity (for these purposes, a "SPIA"). The after tax cash flow from the

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[50] *See* I.R.C. § 7520's shift from mortality tables in 80 CSM to 90 CSM.

[51] The author emphasizes this is merely an example to illustrate the theoretical point. Pricing is **not** this linear.

[52] 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.

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.

> **Example 3**: One possibility would then be for an insured, aged 79, to purchase a life insurance policy, say with a face amount of $1,000,000, which requires premiums of $57,025, annually. The same insured would then invest $1,000,000 in a SPIA that pays $164,515 annually, for the insured's lifetime.[53] The death benefit of $1,000,000 would replace the principal lost of $1,000,000 with the purchase of the SPIA. Each year the insured would receive a net cash flow of $81,684, after taxes, through life expectancy, and $41,684, thereafter. See attachment 2.

The above example has leakage, in various spots. First, it is not a true arbitrage because it is costing the insured the use of money on $1,000,000 between the time the insured purchases the annuity and the insured's death. The value to the insured 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). In the above example, as noted on attachment 2, the after tax rates of return are 8.168 % (through life expectancy) and 4.168 % (after life expectancy).

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 eliminate the sure gain inherent in the transaction. Therefore, concluding that this is the arbitrage gain would be wrong. Instead, a higher cost of capital than the risk free rate of return must be assumed as an investor's desired rate in this type of alternative investment. If the transaction does not exceed that alternative higher risk adjusted rate (whatever it is), then there will not be true arbitrage gain. The 8.168 % may represent a reasonable return based on the risk; the 4.168 % does not. For the transaction in Example 3 to work, a greater rate of return is required. If a third party finances the transaction (at 4 %), discussed below, a pure arbitrage rate of return of 4.17 % exists prior to life expectancy. See attachment 3.

Third, there are transaction costs with the strategy. These can be divided into two categories, the known and the unknown. The known are the initial pricing of the products, which are already taken into account in the products and therefore, though they reduce the arbitrage gain, do not necessarily eliminate it. For example, commission costs and profits to the insurance companies will already be priced into the products. Another known transaction cost, to an extent, is the income tax cost inherent in the annuity. These costs, as illustrated by attachment 3, will have the effect of reducing the overall gain on the strategy, most certainly after the basis is fully recovered (after life expectancy).

The unknown costs are more difficult. One is the cost of the insurance in the long run. For example, typically this type of arbitrage will be done with a universal life product, versus a whole life product, because the premium costs earlier on will be less. As Barry Commoner emphasized, "There is no such thing as a free lunch."[54] The lowest cost universal policies reserve the right to change the mortality costs inherent in annual premiums to account for future, bad mortality experience. Accordingly, a universal policy can afford to require less 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

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[53] In this example, the insured was treated as an 82-year-old for actuarial purposes and for pricing the annuity.

[54] *The Closing Circle: Nature, Man, and Technology*, 1971, in reference to environmental externalities, not insurance products.

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 non-guaranteed 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.[55]

Further, a universal policy could be structured with the anticipation that future premiums will be paid by surplus cash value, which is determined by the interest crediting rate on the policy. But interesting crediting rates are guaranteed at lower amounts than the rates assumed in the arbitrage planning, and future decrease or stability in premium amounts is not guaranteed.

Fourth, not everyone has this kind of free cash flow available for a product/strategy of this kind. Generally, the arbitrage is available only to individuals between the ages of 75 and 89 who have average or above average health.

Firth, the strategy has obvious illiquidity concerns because it is implemented with a term relating to the insured's life. (See Example 4, below).[56]

Sixth, the arbitrage works best when the annuity and insurance mortality and other costs assumptions diverge the greatest. 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.

4. Using a Third Party Financing Arrangement for the Pure Arbitrage

One interesting gambit, to get the full arbitrage opportunity with this arrangement, would be to use a third party to finance the arrangement.

> **Example 4**: Assume the following (from a proposed case). An insured aged 85 is considering the purchase of a one million dollar SPIA that pays $13,480 per month. The same individual is buying a universal life policy that costs $5,759 per month. Note that these are being paid/received monthly because of the age. The annual rate differential, after tax, is 8.6% up through life expectancy, and thereafter 2.8 %. Assume that a Bank is willing to provide the insured with a loan of $1,000,000, renewable annually, at 2% over LIBOR (currently this would be about 4.36 %). If the interest is not deductible (see discussion below), the arbitrage rate of return, after financing, is 4.23%. If not for the required guarantee and collateral issues, this would be a true arbitrage return, as no principal of the insured is at risk. Bad news occurs after life expectancy. After life expectancy, because of the increased income taxes, there is a negative 1.57 % return. If there was a point

[55] 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.

[56] 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?

that the loan (interest or principal) could not be paid, there could be a default. But without recourse to the insured, the loan would simply not be repaid. See attachment 4.

As noted with regard to typical premium finance insurance arrangements, the major (major) problem with this type of transaction is that a third party will require the insured to guarantee the arrangement, as well as often to provide collateral. On the investment side, the guarantee and collateral eliminate the arbitrage element because the return is no longer risk free. For example, if the insurance company defaults, the loan is still payable (by the insured or other guarantor). If the insurance is owned by an irrevocable trust, there are also gift tax elements to this arrangement, as the guarantee would require the third party owner –the irrevocable insurance trust, for example – to pay a guarantee fee to address the gift and section 2042 issues relating to the guarantee.

The arbitrage could be increased if the interest expense incurred in the loan could be argued not to be tied to the purchase of the annuity, and somehow deductible as investment interest. In that event, there is arbitrage gain between .18% and 4.91 % (which does not look great until the percentage is applied against say, a one hundred million dollar loan, the net result being potentially $4,910,000 received with no outlay of capital). See attachment 5. Unfortunately, the interest expense typically falls under section 264 as a non deductible expense.[57]

5. Facing the Grim Income Tax Reaper

Income tax issues are significant, especially the taxation of the annuity. As illustrated by the case studies discussed above, the substantial rate of return that exists in the short run is impaired after life expectancy is reached because of the full income tax that appears in the annuity.

The taxation of the SPIA is governed by section 72 of Internal Revenue Code. Under the simplified version of section 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.[58] The expected return is determined by multiplying the annual annuity payments by the factor shown in Table V of Treas. 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.

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[57] One iteration may be to use an irrevocable insurance trust as purchaser, with a loan from the grantor to the insurance trust. Thereafter, say a year after the transaction is in place, the grantor obtains financing from a third party. Assuming there is no tax exempt bond income in the grantor's portfolio (thereby avoiding section 265 issues), the taxpayer is trying to position itself to have deductible investment income. However, the step transaction principles discussed below could be more applicable to this arrangement than they would the estate tax arrangements, and do pose a concern.

[58] "To determine the proportionate part of the total amount received each year as an annuity which is excludable from the gross income of a recipient in the taxable year of receipt … an exclusion ratio is to be determined for each contract. In general, this ratio is determined by dividing the investment in the contract as found under § 1.72-6 by the expected return under such contract as found under § 1.72-5." Treas. Reg. § 1.71-1.

7. <u>The Insurance Must Remain Insurance</u>

The annuity and insurance will be purchased from different companies. This is intuitive: a company's actuaries are not likely to engage in wide enough pricing disparities on these two products. Moreover, if purchased from one company, there would be substantial income tax concerns. Specifically, there is the issue of whether this will render the life insurance fully subject to taxation at death, as the IRS ruled in 1965.[59] In that ruling, the Service concluded that an insurance and annuity combination purchased from one company removed the insurance element, thereby resulting in the loss of the income tax exclusion. Query further whether the proximity in time and amount of the insurance and annuity, even when purchased from different companies, can invoke the haunting vestiges of the 1965 ruling, thereby rendering the insurance taxable.

8. Structuring the Arbitrage Transaction without Third Party Financing: Pure Estate Tax Arbitrage

One important structural arrangement is to have an irrevocable insurance trust (the "trust") be the initial owner and purchaser of the policy and the annuity. That "**Transaction**" (so-called for purposes of this section) can be described in the following steps.

Step one. The trust is structured as a grantor trust with respect to the insured, so that the income tax cost of the annuity is shifted to the grantor.

Step two. The trust borrows from the insured the principal amount for the annuity purchase, using AFR rates. These may in the short run be higher than market rates; but should be lower in the long run. For October, the long term AFR is 4.84%.

Step three: A SPIA and life insurance policy will be purchased by the trust. For simplicity, assume the face amount of the insurance policy is the same as the cost of the SPIA.

The arbitrage is an estate tax arbitrage, more than anything else, at essentially no cost.[60] As attachment 6 illustrates, the elimination of the taxable income to the insurance trust increases the overall return to the insurance trust. Using the $1,000,000 borrowing rate for the purchase of a SPIA, attachment 6 illustrates that the net amount (after income tax) in the irrevocable insurance trust is $44,252 after the first year, $239,683 after the fifth year, and $596,798 after ten years. If the arrangement is financed at $10,000,000 versus $1,000,000, 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. But there were no transfer tax costs to set it up.

Two concerns arise with this strategy. First, there is still the investment risk: The may run into insolvency problems. This is a structural risk, not an estate tax risk.

Second, there is the risk that the IRS could apply a step transaction principle to collapse all steps; or asserts a 2036 argument. Among the collapsible steps is the loan, initially. Would a third party loan money, unsecured, to the trust? Would the third party charge a higher interest rate if it knew that its

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[59] Rev. Rul. 65-57.

[60] The loan is not secured by the insurance policy, to avoid split dollar and § 2036 and § 2042 issues.

buyer's income tax would be shifted to it, the lender? And if there is a pure arbitrage created, isn't this known up front (and **priced** into the bargain) by all parties?[61]

A. Step Transaction Doctrine

Courts will sometimes view all the steps of a transaction as a whole. In essence, if taxpayer takes steps A → B → C to lead eventually to result D, and if the step transaction doctrine is deemed to apply, the court then recharacterizes the taxpayers' actions as going from step A directly to result D and disregarding the intermediate steps.[62]

In the income tax area, there are three different tests that have been applied to determine if the steps of a transaction should be ignored. Although the courts may discuss these tests as alternatives in determining if a step transaction is to be found,[63] often a court will focus on just one of these tests in its determination.[64]

One test, the "binding commitment" test, collapses the steps if, "at the time the first step is entered into, there was a binding commitment to undertake the later step."[65] Note that this test would not unwind the Transaction.

A more liberal standard, the "interdependence test," asks whether the steps are so interdependent that "the legal relations created by one transaction would have been fruitless without a completion of the series."[66] The interdependence test focuses upon each step in a series of events, and asks whether those steps were interdependent of the other steps or whether they have independent significance. Note that this test would not unwind the Transaction.

The most liberal standard is the "end result" test. This test ignores intermediate steps if it appears that a series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result.[67] The end result test skips to the end of the entire series of steps, and evaluates whether this is what the parties were trying to achieve, without regard to the steps interposed between the beginning and end. Subjective intent is relevant because it allows the court to determine whether the taxpayer directed a series of transactions for an intended purpose. Under the end result test, a series of transactions are stepped together if they are prearranged parts of a single transaction intended from the outset to reach a specific end result.[68] This test could re-characterize the Transaction as

[61] Arguably not because of the idiosyncratic risks associated with the insurance companies defaulting on the insurance or annuity payments, or not meeting the projections built into the strategy, as discussed earlier in the text.

[62] In applying the step transaction doctrine, the Supreme Court has stated that a given result at the end of a straight path is not made a different result because reached by following a devious path. *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938)

[63] *True v. U.S.*, 84 AFTR2d Par. 99-524 (1999)

[64] *Penrod v. Commissioner*, 88 T.C. 1415 (1987)

[65] *Commissioner v. Gordon*, 391 U.S. 83, 96 (1968).

[66] *Redding v. Commissioner*, 630 F. 2d 1169, 1177 (7th Cir. 1980), *cert denied* 450 U.S. 913 (1981).

[67] *King Enterprises v. United States*, 418 f 2d at 516 (1969).

[68] *True v. U.S.*, 84 AFTR2d Par. 99-524 (1999). It is certainly arguable that the end result test subsumes the requirements of the other tests, and therefore it would be more appropriate for a court to consider which alternative prong of the step transaction doctrine to apply, versus applying all three.

the grantor purchasing the annuities and the insurance, thereby ignoring the loan and deeming the entire insurance trust includible in the grantor's gross estate.**

There is the important question of whether the end result test can even be applied by a court in the transfer tax area.[69] Application of the step transaction doctrine to complicated and substantial income tax cases has resulted in uneven results. It is difficult to tell when and how the courts will apply a specific prong or alternative of the step transaction test. As this doctrine moves over to the estate and gift tax area, it is likely that a more conservative application of it will result.

The step transaction doctrine is an outgrowth of the substance over form doctrine, in which congressional intent is observed by interpreting a statute consistent with the actions of the parties. This means, reasonably, that the parties cannot say they are doing one action -- consistent with the Code -- and then actually act differently -- inconsistent with the Code. From a legislative intent perspective, the "binding commitment" test is the truest application of the step transaction doctrine. Because that test asks whether the parties allowed the intermediate steps to really have any meaning, to create legally enforceable rights at those intermediate steps; versus the form of the transaction being to achieve the end result and no independent, enforceable, acknowledgeable rights were being created by the intermediary steps.

To be true to congressional intent, a court need be very careful before determining that a step would never actually be undertaken. For example, courts could invoke the step transaction doctrine in virtually every estate and gift tax planning case. This is because a taxpayer almost always has a final objective in mind, which is to transfer wealth to the next generation at the least transfer tax cost.

The extension of the step transaction to the transfer tax area is the exact approach U.S. Tax Court Judge Renato Beghe urged in his dissenting opinion in *Strangi I*:

> "[T]he facts of this case invite us to use the end-result version of the step-transaction doctrine to treat the underlying partnership assets – the property originally held by the descendant – as the property to be valued for estate tax purposes."[70]

Notably, the step transaction analysis dissent in *Strangi* was joined only by Judge Robert Ruwe; and was implicitly rejected by the majority of the Tax Court.

The cases cannot be reconciled. Analogizing to *Maxwell*, a court could be tempted to apply an end result analysis to invoke the step transaction doctrine to this strategy.[71] Whether a particular court

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[69] Courts have been willing to apply lesser versions of the step transaction doctrine, such as the integrated transaction approach. *See, e.g., Brown v. U..S.*.329 F.3d 664, C.A. 9 (Cal.), 2003; argued and submitted 2003; *See also Sather v. Commissioner*, 251 F.3d 1168, C.A. 8, 2001, submitted: January 12, 2001

[70] *Strangi*, 115 T.C. 478 (2000). Judge Beghe advised that he was not using the step transaction to conclude anything about the fair market value of the transferred limited partnership interests. Instead, he said, the step transaction doctrine identifies the property subject to tax. Accordingly, by treating the formation of the partnership, its corporate general partner and the transfer of the limited partnership interest to the children as one transaction solely to achieve a discount, Judge Beghe would then ignore all of the steps and include all the partnership assets in the decedent's estate. The reliance seems to be, primarily, on *Penrod v. Commissioner*. However, in *Penrod*, the Tax Court found that an exchange of stock did qualify as a reorganization and prevented the Service from immediately taxing the gain.

[71] *Maxwell v. Commissioner*, 3 F.3d 591 (C.A.2, 1993) (holding that promissory notes issued with an intent that the holder/seller would forgive $20,000 of principal each year did not constitute consideration). *But cf.*

will go this far depends in part on their willingness to legislate. Because in that instance, the imposition of the step transaction doctrine will be tantamount to legislation, essentially fixing a tax strategy that is permitted under the clear terms of the statutes. Not all courts would go this far. In this regard, compare the *Strangi II* holding and dicta against the taxpayer with the Third Circuit's emphasis in *D'Ambrosio,* 101 F.3d 309 (1996):

> "[I]t is not our role to police the techniques of estate planning by determining, based on our own policy views and perceptions, which transfers are abusive and which are not. That is the properly the role of Congress, whose statutory enactments we are bound to interpret. As stated *supra*, we think the statutory text better supports Appellant's argument."

B. Section 2036 Analysis

Alternatively, the court could apply a 2036 analysis, referencing the *Strangi II* and *Thompson* concepts. Here, the retained interest would be the implied right to receive annual interest payments, 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 section 2036.[72] And the *bona fide* sale test as outlined in *Strangi II* and *Thompson* could be a concern.

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 Section 2036.[73]

In contrast, the Fifth Circuit in *Kimbell* focused on its prior decision in *Wheeler*, 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'."[74]

The *Kimbell* court emphasized that, "[i]n order for the sale to be for adequate and full consideration … the transaction [must be] entered into for substantial business and other non-tax

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Haygood v. Commissioner, 42 T.C. 936, 1964 WL 1247 (1964), not acquiesced, 1977-2 C.B. 1, 1977 WL 185635 IRS ACQ Dec 31, 1977, and not followed by Rev. Rul. 77-299, 1977-2 C.B. 343 (1977), *Kelley v. Commissioner*, 63 T.C. 321, 1974 WL 2687 (1974), not followed by Rev. Rul. 77-299, 1977-2 C.B. 343 (1977), and *Wilson v. Commissioner*, 64 T.C.M. (CCH) 583, 1992 WL 201812 (1992).

[72] *See, e.g., Helvering v. LeGierse*, 312 U.S. 531 (1941). *But see Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), in which a clear annuity-insurance combination was not grouped together.

[73] *See also Stone*, T.C. Memo 2003-309 (2003).

[74] *Kimbell*, 371 F.3d 257, 93 A.F.T.R. 2d 2004--2400 (5th Cir. 2004), at 262.

reasons."[75] The court seemed to go a bit further than it went in *Wheeler* in expressing that there must be substantial non-tax and business reasons for a transaction. But, in application, and when the facts in the case are examined for what they were, this added requirement is not a far extension of the *Wheeler* application of the exception.

In *Thompson*, the court concluded there was not full and adequate consideration for the transfers to the partnerships for three reasons: First, although the partnership engaged in economic activities, these did not constitute "the type of legitimate business operations that might provide a substantive non-tax benefit" for the transfers. Second, the type of assets that constituted most of the transfers (marketable securities) made it appear unlikely that there were any significant "potential non-tax benefits." Third, the reduction in value that occurs when assets are contributed to a partnership argues against the possibility of full and adequate consideration being paid. (Not a point relevant to this Transaction.)

The *Thompson* court followed the Fifth Circuit's approach in *Kimbell.* That court did not read "*bona fide*" as necessitating "actual negotiations," and merely required that the transactions be real and documentation evidence such. Like *Kimbell*, the *Thompson* decision rejected the requirement of "actual negotiations" and viewed "*bona fide*" or "good faith" as requiring substantial business and other non-tax reasons for the transaction. The emphasis on active business operations seemed more important in the language of *Thompson* than it did in *Kimbell*. As applied to the insurance trust area, it is hard to imagine a great economic substance argument for the loan, other than perhaps a guarantee of cash flow to the lender, or an interest rate greater than AFR.

9. Novel Gift Tax Issues

In *Dickman*, the United States Supreme Court noted: "We assume that the focus of the Internal Revenue Service is not on such traditional familial matters. When the government levies a gift tax on routine neighborly or familial gifts, there will be time to deal with such a case."[76] This has been correctly interpreted to mean: "Hey, IRS, don't be bugging us with these theoretical and technically correct gift issues; they are not significant enough for us to bother with." Since 1984, the IRS has not bothered the taxpayer with these, to any great degree.

But if an insurance trust is used to engage in an annuity/insurance arbitrage using only funds that the insurance trust borrows from the insured, the net effect is that the insurance trust has used the insured's "insurability" to its advantage. Like the hypothetical questions not answered in *Dickman,* this has the feeling of a gift of opportunity within the family. It would be far fetched to suppose that it would ever arise, thereby constituting an atomic bomb as to all irrevocable insurance arrangements. But then again, Revenue Ruling 79-353 was far fetched, as was its applications to annual exclusions gifts within three years from revocable trusts being included in the gross estate. Stranger IRS pronouncements have occurred.

10. Selling the Arbitrage

The third party financing arrangement presents a pure arbitrage arrangement, but for two elements: the income tax cost as the annuitant matures, and the loan guarantee required of the annuitant. These are probably sufficient impediments for most insureds not to consider the arrangement, or at least to proceed cautiously. But investment bankers may not be as shy. If the arbitrage potential is there, and

[75] *Kimbell, infra* at 265.

[76] *Dickman V. Comm'r,* 104 S. Ct. 1086 (1984), at 1090.

still exists after financing, and if interest can be rendered deductible, this opens up a market for an insured to leverage his or her insurability, i.e., the arbitrage opportunity, to a third party, for consideration. This arrangement will be discussed in more detail in the oral presentation.