Current Developments In Life Insurance Planning

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A. The Concept of Insurable Interest

A life insurance policy is void *ab initio* if the person to whom the policy is issued or to whom the benefits are paid (or both, depending upon the controlling state law), lacks an insurable interest in the life of the insured. The insurable interest rule was enacted by Parliament in 1774 and has been adopted in some form in every state of the United States and the District of Columbia. The universality of the insurable interest rule was recognized by the U.S. Supreme Court in Warnock v. Davis, 104 U.S. 775 (1881).

The insurable interest must exist "at the time of the making of the contract." The insured always possesses an insurable interest in his or her life, as does any person who, as described in Warnock, "expects some benefit or advantage from the continuance of the life of the assured." This is often stated in the reverse: namely, that the person procuring an insurance policy on a third party must suffer an economic injury by reason of the death of the insured.

In a December 19, 2005 opinion of the Office of General Counsel of the New York Insurance Department a step-transaction theory was used void an insurance policy. In the transaction that was the subject of the opinion (which is often referred to as a type of "investor owned life insurance") a bank proposed to lend money to an individual to purchase life insurance policies on the individual's life and to pay the premiums for two years. The loan would be a full recourse loan that would be secured by the policy. Interest would be deferred until the end of the two-year period and the interest rate would be at market rate or higher. The insured had an option to put the policy to a third party investor at the end of the two-year period, for an amount that would cover the repayment amount on the loan, including interest. At the end of the two-year period, the insured could either (i) pay back the loan and keep the policy, or (ii) put the policy to the investor. In addition, a third party would, for a fee paid by the investor, guarantee the investor's obligations under the put. The opinion of the Office of General Counsel did not focus on the provision of the New York insurable interest statute that permits any person to procure insurance on his or her own life, but rather on the part of the insurable interest statute dealing with third parties procuring insurance on another person's life. The opinion letter stated that:

> *"[W]hile it is true that [New York law] expressly allows an individual to procure and immediately transfer or assign to another a policy on his own life...it is the Department's view that the transaction presented involves the procurement of insurance solely as a speculative investment for the ultimate benefit of a disinterested third party. Such activity ... is contrary to the long established public policy against "gaming" through life insurance policies."*

Unquestionably the best and most comprehensive analysis of the insurable interest doctrine and its possible effect on estate planners is contained in *Insurable Interests: Aprèés Chawla, le Deluge?* by Mary Ann Mancini and Howard M. Zaritsky, in the

Winter, 2006 issue of the ACTEC Journal. As pointed out in the Mancini and Zaritsky article "There is a surprising dearth of case and statutory law concerning how one determines whether a trustee has an insurable interest in the life of the trust's grantor or beneficiaries. This issue generally turns on whether one views the trust as a separate legal entity that must have its own basis for an insurable interest (the "entity view"), or as an aggregation of its beneficiaries whose insurable interests provide a sufficient interest for the trustee (the "aggregate view"). Adoption of the entity view means that a trust will only rarely have an insurable interest in the life of the grantor or beneficiary, unless there is between the trust and the insured a special business or investment relationship, such as where they were partners or the insured owes money to the trust.

Adoption of the aggregate view, however, means that most trusts will have an insurable interest in the life of the grantor or beneficiaries, if the trust beneficiaries have an insurable interest. As most gifts in trust are made for the primary benefit of close family members, most irrevocable life insurance trusts would have an insurable interest in the life of the grantor or beneficiaries, under the aggregate view. The aggregate view, however, would still not permit the valid acquisition of a life insurance policy by a trust (or, in some states, designation of the trust as beneficiary of a valid life insurance policy), if the trust beneficiaries are all persons who lack an insurable interest in the life of the insured. Thus, even under the aggregate view, a trust could not be used as a device to convey the economic benefits of a life insurance policy to a group of persons all of whom lacked an insurable interest in the life of the insured."

A review by Mancini and Zaritsky discloses that there are few cases dealing with this issue. Unquestionably, the most disturbing is *Chawla ex rel Giesinger v. Transamerica Occidental Life Insurance Co.*, 2005 WL 405405 (E.D. Va. 2005), aff'd in part, vac'd in part, 440 F.3d 639, 2006 WL 538993 (4th Cir. 2006), where the district court adopted the entity view. The district court held that an insurance contract held by an insurance trust was void on two grounds. First, the court held that the insured had made material misrepresentations in his application. Having found material misrepresentations, the court needed to go no further. Unfortunately, it then found that, as a matter of law, the insurance policy was void because the trust "maintained no insurable interest in the life of the decedent." Under applicable state law (Maryland) a life insurance policy procured by a person on the life of another is valid only if the benefits are payable to the insured, the personal representative of the insured's estate, or to "a person with an insurable interest in the individual insured at the time the insurance contract was made." Having found that the trustee was a person for purposes of the Maryland Insurance Code, the court then applied the requirement of Maryland law that a "lawful and substantial economic interest in the continuation of the life, health, or bodily safety of the individual is an insurable interest but an interest that arises only by, or would be enhanced in value by, the death, disablement, or injury of the individual is not an insurable interest." Since the insurance trust's interest would only be enhanced by virtue of the insured's death, the insurance trust had no insurable interest.

On appeal, the Fourth Circuit affirmed the district court's holding that the insured had made material misrepresentations on his application. The Fourth Circuit, however, vacated the holding of the district court that the trust lacked an insurable interest in the

insured. The court noted that this was an issue of some importance, and that the district court's "reasoning on this point is susceptible to being interpreted as concluding that, under Maryland law, a trust can never possess an insurable interest in a person's life."*94+ The court stated: "Because the district court correctly awarded summary judgment to Transamerica on the misrepresentation issue, its alternative ruling appears to have unnecessarily addressed an important and novel question of Maryland law. And, as a general proposition, courts should avoid deciding more than is necessary to resolve a specific case. This important aspect of the doctrine of judicial restraint has particular application when a federal court is seemingly faced with a state-law issue of first impression. *Cf. Kaiser Steel Corp. v. W.S. Ranch Co.*, 391 U.S. 593, 594, 88 S.Ct. 1753, 20 L.Ed.2d 835 (1968) (observing that, in certain circumstances, federal courts should abstain from ruling on "novel" state-law issue of "vital concern". In these circumstances, we vacate as unnecessary the district court's alternative ruling that the Trust lacked any insurable interest in Giesinger's life.") However, the Fourth Circuit did not question or criticize the legal analysis of the *Chawla* district court; it merely held that the court need not have undertaken that analysis at all. As a result, insurers contending that a trustee lacks an insurable interest can still cite the district court opinion in *Chawla* as the legal analysis of one federal judge.

A review of the decided cases disclose that the Supreme Court of Missouri, *Butterworth v. Mississippi Valley Trust Co.*, 362 Mo. 133, 240 S.W.2d 676 (1951) and the Bankruptcy Court for Massachusetts, *In re LeBlanc*, 217 B.R. 675 (Bankr. D. Mass. 1998). have espoused the aggregate view, and a California Court of Appeals, *Caso v. First Colony Life Ins. Co.*, 2003 WL 21019625 (Cal. App. 4th Dist. 2003), and the U.S. District Court for the Eastern District of Virginia (*Chawla*) have adopted the entity view.

Several states have enacted statutes that address directly the insurable interest of a trust that owns or is the beneficiary of a life insurance policy. Perhaps the simplest approach to avoid the insurable interest problem is to create the trust and to have the life insurance policy acquired in a state whose statutes would assure that the trustee has an insurable interest.

Another possibility is for the insured to purchase the policy, and then to assign it to the trustee. However, this means that the proceeds will be included in the insured's gross estate under Section 2035(a), if the insured dies within three years of the transfer of the policy to the trustee. Moreover, courts may apply a step transaction doctrine as discussed at the start of this section.

For an in depth analysis of this subject, see *Trust, We Have a Problem: Chawla ex. rel. Giesinger v. Transamerica Occidental Life Insurance Company, Its Revelation of a Problem in Insurable Interest Statutes and the Subsequent Effect on Irrevocable Life Insurance Trusts*, 62 Okla. L. Rev. 125 (2009). As of the date of the current revision, the applicability of the insurable interest doctrine to insurance trusts remains troubling.

As of today, the applicability of the insurable interest doctrine to insurance trusts remains troubling.

The concept of insurable interest is also relevant to the concept of STOLI (Stranger Owned Life Insurance) and the secondary market, which is amply illustrated in AXA Equitable Life Ins. Co. v. Infinity Financial Group, LLC, *et.al*, WL 901496 (S.D. Fla). AXA sold $73 million in insurance on the lives of four of the defendants. The complaint alleged a "scheme . . . . to recruit elderly persons [all of the insureds were 68 years of age or older] to pose as applicants for and proposed owners of large-face-amount life insurance policies that were never meant to be retained by the ostensible owners after issuance." The complaint alleged that a conspiracy to dispose of the policies to third-party investors was accomplished by making material misrepresentations to AXA, and by creating trusts to hold the insurance policies in order to disguise the policies' true ownership. AXA alleged that the insurance policies were void under Florida law for lack of an insurable interest. The defendants argued that, under the Florida insurable interest statute, the insurable interest only needed to exist at the inception date of coverage. Therefore, because the amended complaint alleged that the insureds procured the insurance before assigning them to the trusts, no violation of the statute was pled. In the Court's view, however, this rule extends "only to assignments made in good faith, and not to sham assignments made simply to circumvent the law's prohibition on 'wagering contracts. . . . If the plaintiff's allegations are true, the insured never planned to maintain the policies themselves. Rather, the policies were procured only as part of a plan established from the outset, under which third parties were to pay the premiums for the policies and the insured would immediately assign their policies to entities in which other parties would maintain interests. Thus, the amended complaint adequately states allegations that, if proven, would render the policies void for lack of an insurable interest."

A fascinating example of STOLI litigation can be found in a front page article in the Wall Street Journal on June 11, 2010, which discusses an action in the U. S. District Court for the Southern District of New York, which alleges that the agent and others, including the issuing insurance companies, caused several insurance policies with a total face amount of approximately $56,200,000 to be issued on the life of Arthur Kramer, a prominent New York attorney, in violation of the New York Insurance Law provision addressing insurable interest. (See the Amended Complaint in Alice Kramer, as Personal Representative of the Estate of Arthur Kramer, v. Lockwood Pension Services, Inc., Tall Tree Advisors, Inc., Life Product Clearing, LLC Transamerica Occidental Life Insurance Co., Phoenix Life Insurance Co., Lincoln Life & Annuity Co. of New York, and Jonathan S. Berck, Civil Action No. 08 CV 2429 (S.D.N.Y. May 7, 2008). The article was summarized as follows in the June 14, 2010 AALU Washington Report:

> *"In the case, Kramer's widow alleged facts indicating an arrangement to procure seven life insurance policies from defendants Transamerica Occidental Life Insurance Co. (Transamerica), Lincoln Life & Annuity Co. of NY (Lincoln) and Phoenix with the purpose of immediately transferring the beneficial interests in those policies to stranger investors, in contravention of the insurable interest rule as codified in the New York Insurance Law.*

During 2005, defendant Lockwood, an insurance broker and former pension attorney, reportedly instructed Mr. Kramer to establish trusts, naming himself as grantor and his children as beneficiaries and defendant Lockwood Pension Services, or its affiliates, as trustee. In 2007, two years after the trusts acquired an interest in the Transamerica, Lincoln and Phoenix policies (and after the expiration of the "contestability period" on those policies), Mr. Kramer, acting at the direction of the defendants, allegedly directed his children to execute a putative assignment of their beneficial interests in the trusts to stranger third-party investors arranged by Mr. Lockwood. The investors named in the lawsuit included defendants Tall Tree Advisors, Inc. and Life Products Clearing, LLC. Credit-Suisse also appears to have participated as a third party investor.

[According to the WSJ, Credit Suisse reached a confidential settlement with Mrs. Kramer with regard to policies totaling $18.2 million after it produced a document signed by her indicating that she knew about and approved of the assignment of the policies in which Credit Suisse had invested, and had agreed not to contest the assignment.]

Mr. Kramer died unexpectedly on January 26, 2008, and his widow sued to prevent the payment of death benefits of approximately $18,200,000, $28,000,000 and $10,000,000 by Transamerica, Phoenix and Lincoln, respectively, to the defendant investors, claiming that they lacked an insurable interest in Mr. Kramer's life and thus that the transaction was illegal from its inception. The estate claimed that "where the procurement of life insurance violates the insurable interest rule, the remedy is either that the death benefits be paid to the personal representative of the decedent's estate . . . or, if already paid to a stranger investor, that they be disgorged and paid to the personal representative." The plaintiffs allegedly were encouraged by a settlement reportedly paid by the insurer in Life Prod. Clearing, LLC v. Angel, discussed in our Bulletin No. 08-13, to the heirs of a butcher store owner in a STOLI-type situation. Lockwood reportedly sold the policy to the insured - Lobel - in that case as well.

Although nearly 200 pleadings had been filed in the case as of last year, no decision has been reached. Instead, according to the WSJ, "[r]esolution of the sprawling litigation is on hold, pending the New York Court of Appeals ruling on the underlying question of whether the policies were illegal from the start."

B. Gift Taxation Of Life Insurance

The transfer of all ownership rights in a life insurance policy is a taxable gift. As with all gifts, the Treasury Regulations establish the general rule that value of an insurance policy is fair market value, which is defined as the price at which the gifted property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. Treas. Reg. §25.2512-1. This general rule is applied to life insurance in Treas. Reg. §25.2512-6, which states that the fair market value of a life insurance policy "is established through the sale of the particular contract by the company." The Regulations further provide that since sales of comparable contracts are not readily ascertainable -- the secondary market did not exist in the 1960s when these Regulations were written -- if the policy has been in force "for some time," its value "may be approximated" by adding together the interpolated terminal reserve (ITR) of the policy and the unused portion of the last premium and dividend accumulations, less outstanding policy loans at the time of the gift. Treas. Reg. §25.2512-6(a). The Service does not explain what is meant by "some time."

If, because of the "unusual nature of the contract," approximating the value of the insurance policy in accordance with the Treasury Regulations does not produce a value which is "reasonably close to the full value," the approximation method may not be used. Presumably, this exception applies to situations in which the insured is uninsurable at the time of the transfer, in which case the fair market value of the policy would be substantially higher than the amount computed pursuant to Treas. Reg. §25.2512-6(a). Under these circumstances, a facts and circumstances test is employed. For example, in Pritchard v. Comm'r, 4 TC 204 (1944), the decedent sold an insurance policy for its cash surrender value a month before he died of cancer. The estate argued that the policy had been transferred for full and adequate consideration and hence was not included in the decedent's gross estate for estate tax purposes. The Tax Court held that where death was imminent and the insured was uninsurable, the cash surrender value "would be only helpful as a criterion of the minimum value to be placed on the policies. . . ." Id. at 208.

If the vagueness of Treas. Reg. §25.2512-6 is not sufficiently worrisome, consider the fact that for most modern life insurance policies, the central valuation criterion – the policy's ITR – cannot be calculated! In fact, the insurance industry cannot even agree on what should be calculated in place of the policy's ITR!

When the IRS published Treas. Reg. §25.2512-6, the only insurance available for purchase was either whole life or annual renewable term. All aspects of a whole life policy, including cash values, were fixed and guaranteed by the insurer. Under regulations promulgated in part by NAIC (the National Association of Insurance Commissioners) and in part by the individual Insurance Commissioners and legislatures of various states, carriers offering whole life policies were required to set aside a reserve each year to meet their contractual obligations to the owners of the insurance policies. The amount of the reserve at the start of the year was known as the "initial reserve" and the amount of the reserve at the end of the year (the "anniversary date" of the policy) was known as the "terminal reserve." (Thus the "terminal reserve" at the end of Year One

becomes the "initial reserve" at the start of Year Two and so on, *ad infinitum.*) Since all aspects of a whole life policy were fixed, one could actuarially determine the amount of the terminal reserve at the end of any year. If the terminal reserve had to be calculated at a point between the start and end of the policy year, that amount could be calculated – *e.g,* using the language of the Treasury Regulations, it could be *interpolated* – by reference to the year's initial reserve and the actuarially calculated terminal reserve for the end of the year. For example, if the initial reserve of a whole life policy at the start of Year Two was $5,000 and the terminal reserve of that same policy at the end of Year Two would be $8,000, the policy would have an interpolated terminal reserve of $6,500 eighteen months after issuance (the initial reserve increased by 50% of the increase in the reserve during the year). Annual renewable term policies did not have a terminal reserve because the policy matured at the end of each year and had to be renewed or lapsed.

In the years since the Treas. Reg. §25.2512-6 was published, life insurance companies have introduced Universal Life, Variable Universal Life, Indexed Universal Life, Guaranteed No Lapse Universal Life and 10 to 30 year level term policies. All of these products have reserves. However, all of these products are current assumption products; *e.g.,* both current mortality experience and investment performance are passed through to the policy owner. As a result, the "terminal reserve" as of the anniversary date of a current assumption policy is not guaranteed but is instead the product of economic factors that cannot be predicted. Therefore the terminal reserve of a current assumption policy cannot be calculated until the anniversary date (in fact, not until year-end economic performance data is available),which makes it impossible to "interpolate" a terminal reserve for purposes of the Treasury Regulations.

Not only can the carrier not interpolate the terminal reserve of a current assumption policy, the proliferation of insurance products since the 1960s has resulted in there being several different types of reserve calculations, and the insurance industry cannot agree on which of these calculations should be used to approximate a current assumption policy's ITR for purposes of the Treasury Regulations.

Reserve calculations include:

The Tax Reserve, which is the amount used by the insurance company for purposes of calculating federal income tax.

The Statutory Reserve, which is the amount used by the insurance company to comply with the reserve requirements of various states.

(The difference between a Tax Reserve and a Statutory Reserve calculation is primarily -- but not entirely -- attributable to the interest factor that must be used. Usually, these two reserves are close together in a low interest environment and begin to differ as the interest rate environment increases.)

The AG (Actuarial Guidance) 38 Reserve, which is the amount used for current assumption products with no lapse secondary guarantees. The AG 38 Reserve is generally higher than either the Tax Reserve or the Statutory Reserve and it usually

results in a higher reserve calculation than for policies that do not offer secondary guarantees.

The Deficiency Reserve, which is employed for certain current assumption policies for which a "Minimum Reserve" calculation is required by the XXX Regulations of the National Association of Insurance Commissioners. An AG 38 Reserve which includes a Deficiency Reserve will be even higher than an AG 38 Reserve without a Deficiency Reserve.

Not only has the Service not issued guidance for gift tax purposes as to which reserve is to be used when attempting to comply with the ITR requirement of Treas. Reg. §25.2512-6 but the insurance industry itself is not in agreement as to which reserve to use when attempting to approximate the ITR of a current assumption policy. Some insurance companies do not even bother using any of the reserves for calculation purposes. Some use the cash surrender value/cash accumulation value of the policy as the ITR and an smaller number use the California Method – a calculation methodology permitted by the California Department of Insurance -- which treats the ITR as the mean of the cash surrender value and the cash accumulation value.

A study presented at the 2009 Annual Meeting of the AALU (Association for Advanced Life Underwriting) entitled Life Insurance Valuation: Navigating Uncharted Waters, reported on a valuation survey of fourteen carriers. When valuing Universal Life policies without a no lapse guarantee, most of the carriers based their ITR calculation on either the Tax Reserve or the Statutory Reserve. Two used the California Method and one carrier used cash surrender value when calculating ITR. When valuing Universal Life policies with no lapse guarantees, five of the carriers used the Tax Reserve, eight used the Statutory Reserve and eight included a Deficiency Reserve.

Although the Service has provided guidance in Revenue Procedure 2005-25 for valuing a life insurance policy for income tax purposes, this Procedure does not apply to the valuation of life insurance policies for gift tax purposes. Rather, it is limited to IRC §79 (cost of permanent benefits provided under a group life plan), IRC §83 (property transferred in connection with performance of services), and IRC §402 (qualified plan distributions.)

At least three suggestions can be derived from this confusion:

1. If you have a client who owns a current assumption policy without secondary guarantees and intends to both (i) engage in a 1035 exchange for a policy with secondary guarantees and (ii) transfer the policy to an irrevocable life insurance trust (ILIT), it would be a good idea to consider transferring the policy to the ILIT and allowing the ILIT to engage in the 1035 exchange. The gift tax value of the policy without secondary guarantees should be lower (and possibly substantially lower) than the gift tax value of the policy after the 1035 exchange.

2. By the same token, if the client owns a current assumption policy with secondary guarantees and intends to both (i) engage in a 1035 exchange for a policy

without secondary guarantees and (ii) transfer the policy to an ILIT, it would probably be a good idea for the client to engage in the exchange before transferring the policy to the ILIT, since the gift tax value of a current assumption policy without secondary guarantees should be lower (and possibly substantially lower) than the value of the same policy with secondary guarantees before the exchange.

3. When acquiring a life insurance policy that might later be transferred to an ILIT, the valuation methodology of the carrier should be considered. measured by the replacement value of the policy.