THE CASH VALUE

BENEFICIARY DEFECTIVE

INHERITOR’S TRUST

Advanced Planning Issues

Split-Dollar and Premium Financing Arrangements

and

Modern Portfolio Theory and Life Insurance

Lawrence Brody, JD, LL.M., AEP® (Distinguished)
Bryan Cave LLP

Robert G. Alexander, JD, LL.M., EPLS, AEP®
Alexander & Klemmer, S.C.

Gary L. Flotron, M.B.A., CLU, ChFC, AEP®
University of Missouri – St. Louis
G. L. Flotron & Associates

All Rights Reserved
IMPORTANT DISCLAIMERS AND NOTICES

These materials are intended for educational purposes only. They are designed to provide accurate and authoritative information in regard to the subject matter covered. However, neither Attorney Lawrence Brody, Attorney Robert G. Alexander, nor Gary L. Flotron are offering legal, accounting, insurance, investment or other professional advice in these materials. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.

The forms and sample language have been developed and are included herein exclusively for purposes of illustration and discussion and are not designed or intended to be utilized (or adapted for uses) in any Will, Trust or other dispositive instrument.

The materials in the exhibits have been included with the express permission of the authors.

These materials are provided solely for educational purposes. These materials cannot be sold, copied, reproduced or distributed in any form or manner whatsoever without the express written consent of the authors.

IRS Circular 230 Disclosure:

To ensure compliance with requirements imposed by the U. S. Internal Revenue Service, we inform you that any tax advice contained in this document (including any attachments) was not intended or written to be used, and cannot be used, by any taxpayer for the purpose of (1) avoiding tax-related penalties under the U. S. Internal Revenue Code or (2) promoting, marketing or recommending to another party any tax-related matters addressed herein.

© 2010 Lawrence Brody, Robert G. Alexander and Gary L. Flotron

All Rights Reserved
Synopsis

1.1 Introduction .................................................................................................................................................. 10

[1]  Summary of the 2009 Article ....................................................................................................................... 10

[2]  The Scope of this Article – Advanced Planning Considerations ..................................................... 12


[4]  An Introduction to the Beneficiary Defective Inheritor’s Trust (“BDIT”) - The Ultimate Structure to Protect Wealth ........................................................................................................ 15

[a]  Creating the “Ideal Plan” ............................................................................................................................... 16

[b]  Description and Design of the BDIT ............................................................................................................. 17


[8]  The Cash Value BDIT is a Better Life Insurance Trust ................................................................................. 31

1.2 Funding the Cash Value BDIT – An Overview of Private Split-Dollar and Premium Financing Arrangements ............................................................................................................. 33

[1] Introduction ............................................................................................................. 33


[3] Summary Description of Split-Dollar Arrangements .............................................. 37


[a] The Standard Endorsement Method ........................................................................ 40

[5] The Loan Regime ...................................................................................................... 44

[6] Premium Financing Arrangements .......................................................................... 47

[7] Critical Planning Note with Respect to Funding the CVBDIT with Private Split-
Dollar and Premium Financing Arrangements............................................................ 50

1.3 Technical Analysis of Split-Dollar Arrangements .................................................... 51

[1] Introduction to the Final Split-Dollar Regulations .................................................. 51

[2] Effective Date ........................................................................................................... 52

[3] Split-Dollar Arrangements Defined ......................................................................... 54

[4] The Two Mutually Exclusive Regimes ..................................................................... 55
1.4 The Economic Benefit Regime – Applicable Generally to Endorsement Arrangements (and to Narrowly Defined Non-Equity Collateral Assignment Arrangements) ................................................................. 58

1.5 The Loan Regime – Generally Applicable to Collateral Assignment Arrangements .......... 67

1.6 Planning for Post-Final Regulation Arrangements .................................................................. 72
[2] The Economic Benefit Regime ................................................................. 74

[a] Non-equity Arrangements .................................................................. 74

[b] Equity Arrangements ........................................................................ 75

[c] Other Tax considerations .................................................................. 76

[3] The Loan Regime .............................................................................. 78

[a] Hybrid Loans .................................................................................... 80

[b] Additional Loan Regime Issues .......................................................... 81

[4] The Decision Tree ............................................................................ 82

1.7 Illustration of How to Structure a Successful CVBDIT Split-dollar Arrangement - PLR 200910002 ................................................................................................. 84

1.8 Technical Analysis of Premium Financing Arrangements .................. 92

[1] Introduction .......................................................................................... 92

[2] The Final Split-Dollar Regulations ....................................................... 93


1.9 The Grantor Trust Rules

[1] Income Taxation of the Trust and the Grantor (Inheritor/Beneficiary) During the Grantor’s (Inheritor/Beneficiary’s) Lifetime ................................................................. 100

[2] Income Taxation of the Trust and Beneficiaries after the Grantor’s (Inheritor/Beneficiary’s) Death ........................................................................................................ 102

[3] Income Tax Consequences on the Termination of the Trust’s Status as a Grantor Trust [Either at the Grantor’s (Inheritor/Beneficiary’s) Death or During His or Her Lifetime] ............................................................................................ 103


[a] Original Issue Discount Rules ........................................................................ 113

[b] Income Tax Treatment of Accrued OID during the Inheritor/Beneficiary’s Life .................................................................................................................. 114

[c] Accrued OID as Income In Respect Of a Decedent .......................................... 116

[5] Planning the Grantor Trust Status of the Trust ................................................. 117

[6] The Inheritor/Beneficiary’s Guarantee of Loans to the CVBDIT or Pledge of Assets as Security for Loans to the CVBDIT ................................................................. 119

[7] Inheritor/Beneficiary Guarantees of Third Party Loans to the CVBDIT for the Premium Payments, or Pledges of Assets as Security for Such Loans .......... 128
<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.10</td>
<td>Exit Strategies for Private Split-dollar and Premium Financing Arrangements with a CVBDIT</td>
<td>142</td>
</tr>
<tr>
<td>1.11</td>
<td>Conclusions Regarding Funding the Cash Value BDIT Using Split-Dollar and Premium Financing Arrangements</td>
<td>146</td>
</tr>
<tr>
<td>1.12</td>
<td>The Cash Value BDIT – Modern Portfolio Theory and Life Insurance</td>
<td>147</td>
</tr>
<tr>
<td>[1]</td>
<td>Introduction</td>
<td>147</td>
</tr>
<tr>
<td>1.13</td>
<td>Modern Portfolio Theory</td>
<td>148</td>
</tr>
<tr>
<td>[1]</td>
<td>Introduction</td>
<td>148</td>
</tr>
<tr>
<td></td>
<td>Modern Portfolio Theory</td>
<td>149</td>
</tr>
<tr>
<td>[a]</td>
<td>Systematic Risk</td>
<td>152</td>
</tr>
<tr>
<td>[b]</td>
<td>Unsystematic Risk</td>
<td>154</td>
</tr>
<tr>
<td>[5]</td>
<td>Rebalancing</td>
<td>158</td>
</tr>
</tbody>
</table>
Concluding Comments on MPT ................................................................. 166

1.14 CVBDIT Investment Portfolios – Family Businesses and Life Insurance ......................... 167

1.15 An Overview of the Main Modern Types of Permanent Cash Value Life Insurance Policies and the Assets that Support the Cash Values.................................................... 170

[1] Introduction ........................................................................................................ 170


[3] Universal Life..................................................................................................... 174

[4] Variable Universal Life .................................................................................... 180


1.16 Life Insurance in the Context of a Portfolio......................................................... 188

1.17 Life Insurance as an Asset Class........................................................................ 192

1.18 Building an Efficient Investment Portfolio by Including Life Insurance............... 206

1.19 Building a Life Insurance Policies Portfolio of Different Policy Types ..................... 219

1.20 Conclusions Regarding the Cash Value BDIT, Modern Portfolio Theory and Life Insurance......................................................................................................................... 243
1.1 Introduction

[1] Summary of the 2009 Article

The 2009 edition of the New York University Review of Employee Benefits and Executive Compensation included an article written by Robert G. Alexander, J.D. LL.M., EPLS, AEP and Michael W. Halloran, CLU, ChFC, CFP®, AEP entitled The Cash Value Beneficiary Defective Inheritor’s Trust (The “Cash Value BDIT”): Creating a More Flexible and Comprehensive Wealth Accumulation and Retirement Plan.¹ The article examined how the planning concept the authors’ referred to as the “Cash Value Beneficiary Defective Inheritor’s Trust” (the “CVBDIT”) can provide clients with a more flexible, comprehensive retirement and wealth accumulation plan than traditional retirement and other planning vehicles including tax qualified retirement plans, 401ks, NIMCRUTS and traditional wealth planning trusts. The reason is that a Cash Value BDIT combines 1) the comprehensive wealth accumulation and retirement planning benefits of well-designed cash value life insurance as part of a properly balanced, diversified financial and retirement plan² with 2) the wealth transfer and asset protection features of a

¹ Robert G. Alexander and Michael W. Halloran, The Cash Value Beneficiary Defective Inheritor’s Trust (The “Cash Value BDIT”): Creating a More Flexible and Comprehensive Wealth Accumulation and Retirement Plan, NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION ¶7 (2009). This Section 1.01 has been abstracted, revised and edited from major portions of the original 2009 article with the permission of the authors of that article.

² Independent insurance consultant Richard M. Weber (Pleasant Hill, CA) provided valuable insights, advice and guidance with respect to the concept of cash value life insurance as a separate uncorrelated asset class and generously allowed the authors to incorporate portions of the white paper he co-authored with Christopher Hause into the 2009 article: Richard M. Weber and Christopher Hause, Life Insurance as an Asset Class; A Value-added Component of an Asset Allocation, copyright 2008 (unpublished manuscript on file with the authors).
multi-generational Beneficiary Defective Inheritor’s Trust (“BDIT”). The authors demonstrated that if properly coordinated, the combination of cash value life insurance with a BDIT can provide clients with a more flexible wealth accumulation and retirement plan because they will have more options with respect to accessing retirement funds during lifetime (often on a tax-free or tax-deferred basis) than may be available with traditional plans, enhanced opportunities to accumulate more wealth, significant opportunities to plan leveraged income tax strategies, and the ability to protect wealth from transfer taxes, divorcing spouses and creditors forever. The authors also illustrated how the enhanced planning features of a Cash Value BDIT will allow clients to maintain control over their wealth both during their lifetime and at death, allow clients to compound and protect wealth on a multi-generational basis, provide flexibility to alter the client’s planning in order to react to changed circumstances in the future, and minimize (and often eliminate) financial, tax and legal risks.

Alexander and Halloran concluded that the Cash Value BDIT is, perhaps, the ultimate opportunity to protect, preserve and dramatically grow family wealth and allow clients (and eventually their families for multiple generations) access to accumulated wealth for

---

3 The Beneficiary Defective Inheritor’s Trust (“BDIT”) was created by Attorney Richard A. Oshins (Las Vegas, Nevada) in the mid-1970’s. Attorney Oshins provided invaluable insights, advice and guidance to Alexander and Halloran in the preparation of their 2009 article, including his generous permission and encouragement to incorporate into that article both planning concepts and significant portions of materials originally published under his name.

4 Alexander & Halloran, supra note 1, at 4.
retirement and other purposes on a tax-advantaged or tax-free basis without disturbing the client’s beneficial enjoyment of the transferred property.\(^5\)

[2] The Scope of this Article – Advanced Planning Considerations

The purpose of this article is to build on the concepts presented in the 2009 article and examine in detail two additional, critically important advanced planning considerations with the Cash Value BDIT:

1. Appropriate planning techniques to adequately fund the life insurance premiums necessary for a successful Cash Value BDIT by utilizing private split-dollar and premium financing strategies. These materials were prepared by Attorneys Larry Brody and Robert G. Alexander who are solely responsible for their content.

2. An in-depth analysis of how to manage wealth within the Cash Value BDIT incorporating modern portfolio theory and life insurance (expanding on the original studies by Weber and Hause). These materials were prepared by Gary L. Flotron and Robert G. Alexander who are solely responsible for their content.\(^6\)

However, prior to examining these two topics in detail it is essential that the reader understand the foundational concepts presented in the 2009 article. Without being

\(^5\) Id. at 42.

\(^6\) Attorney Larry Brody did not participate in the preparation of these materials nor did he give any advice, review, edit or make any comments to the authors regarding these materials. The content (including the opinions, methods and conclusions expressed therein) are the sole responsibility of Gary L. Flotron and Robert G. Alexander. By inclusion of these materials in this article Attorney Brody does not necessarily endorse or express any approval (express or implied) of the content, methods and conclusions of these materials.
grounded in these concepts the reader may find it difficult to successfully navigate through and thoroughly understand the topics presented in this article. Therefore, the following section is a comprehensive summary of the original article, including an explanation of:

1. the two essential components of comprehensive wealth accumulation and retirement planning;
2. the Beneficiary Defective Inheritor’s Trust (“BDIT”) - the ultimate structure to accumulate and protect wealth;
3. how to construct an efficient, comprehensive wealth accumulation and retirement plan by including cash value life insurance; and
4. the Cash Value BDIT (“CVBDIT”) – combining cash value life insurance with the BDIT.


Maximizing efficient, comprehensive wealth accumulation and retirement planning has two major components: 1) accumulating wealth in tax efficient financial vehicles, and 2) protecting wealth by owning and managing it in the most efficient tax and legal structures. One of the major thesis of the original 2009 article is that the proper
coordination of cash value life insurance with a BDIT may be the most flexible, comprehensive and efficient structure to accomplish both of these goals. Quoting from well know experts in the wealth planning profession, the authors stated that harnessing the power of efficient, tax-free compounding perhaps is the most important concept in financial and estate planning, a concept that includes both income tax free and wealth transfer tax free compounding:\footnote{Id. at 5-6.}

Recently a concept that has received significant attention in the wealth and retirement planning community is the importance of cash value life insurance in modern, comprehensive wealth accumulation and retirement planning. The reason is obvious, cash value life insurance takes advantage of the single most important concept in financial and retirement planning—income tax free compounding. At the 2009 43\textsuperscript{rd} Annual Philip E. Heckerling Institute on Estate Planning, nationally known estate planning attorney Jonathan Blattmachr stated that the most important concept in financial planning is income tax free compounding. In the context of wealth transfer planning, he opined that income tax free compounding is more important than getting 30\% valuation discounts, or using GRAT’s and other advanced wealth shifting techniques.\footnote{See also: JONATHAN G. BLATTMACHR, WEALTH PRESERVATION AND PROTECTION FOR CLOSELY-HELD BUSINESS OWNERS (AND OTHERS) 132-138 (Libby Publishing Incorporated 1993); and Blattmachr, Creative Uses of Life Insurance in Estate and Financial Planning, 44\textsuperscript{th} NAEPC Annual Conference (2007).}

Interestingly, during the mid-1970s both Professor Casner and Professor Cooper opined that the transfer tax free, multi-generational trust was the most important planning technique to erode or completely avoid the transfer tax system because a properly designed dynasty trust can provide clients and their families with transfer tax free wealth compounding in perpetuity.\footnote{Hearings before the House of Ways and Means Comm., 94\textsuperscript{th} Cong., 2\textsuperscript{nd} Sess. Pt. 2 1335 (1976) (statement of Prof. A. James Casner).} Despite the imposition of the Generation

\footnote{COLUMBIA LAW REVIEW 161 (March 1977, reprinted in 1979 to reflect the Revenue Act of 1979 by the Brookings Inst.). References hereunder will be made to the Brookings Inst. version.}
Skipping Transfer Tax ("GSTT")\textsuperscript{11}, one of the theses of this article is that the dynastic Beneficiary Defective Inheritor’s Trust ("BDIT") may be the best vehicle currently available to minimize or eliminate the effect of the transfer tax system due to the nature of its transfer tax-free compounding, income tax leveraging and the fact that in most instances a skilled practitioner can leverage or finesse the GSTT exemption limitation ($3.5 Million – 2009). Although not advanced by Professors Casner and Cooper, a perpetual BDIT is also the best vehicle to 1) avoid family wealth diminution from creditors and 2) provide additional wealth shifting opportunities by means of the BDIT design feature known as the income “tax burn”.\textsuperscript{12}

[4] An Introduction to the Beneficiary Defective Inheritor’s Trust ("BDIT") - The Ultimate Structure to Protect Wealth\textsuperscript{13}

The Beneficiary Defective Inheritor’s Trust ("BDIT") undoubtedly is one of the most powerful estate, tax and asset protection strategies available to planning professionals.\textsuperscript{14}

\textsuperscript{11} IRC Chapter 13, §§2601 through 2664.

\textsuperscript{12} The term “tax burn” refers to the transfer tax free shifting of wealth to the Cash Value BDIT resulting from the primary trust beneficiary (the “Inheritor/Beneficiary of the BDIT) personally paying the income tax on income earned by the trust. These payments do not result in taxable gifts to the trust or the trust beneficiaries. Rev. Rul. 2004-64. When the trust beneficiary pays income tax on phantom income, he/she is “burning up” his/her assets not held in trust.

\textsuperscript{13} Alexander & Halloran, supra note 1, at 6-9.

Creating the "Ideal Plan"\textsuperscript{15}

The BDIT enables clients to implement an ideal comprehensive wealth, retirement and asset protection structure because it includes all of the client’s potential desires and goals and maximizes the lifetime control, use, enjoyment and management of the client’s wealth. In the authors’ experience the “bundle of rights” that a knowledgeable client desires to include in his/her wealth accumulation and retirement plan (if these are attainable) will consist of all the following:

1. the opportunity for income tax deferred (and preferably tax-free) wealth compounding;

2. the ability to access the income from his/her property until his/her death;

\textsuperscript{15} Alexander & Halloran, supra note 1, at 9-10.
3. the ability to have his/her assets available for his/her use and enjoyment until his/her death;

4. the right to decide who will receive his/her property at his/her death or during lifetime if the client decides to give the property away;

5. the power to determine in what form and when his/her beneficiaries ultimately will inherit the accumulated wealth;

6. the right to manage, control and use his/her wealth until death;

7. the ability to protect his/her wealth from creditors, including divorcing spouses, in perpetuity;

8. the opportunity for income tax benefits and estate tax savings;

9. the ability to keep the client’s wealth outside the wealth transfer tax system in perpetuity, and

10. the ability to “rewrite” the plan in order to react to changed circumstances.

A properly structured BDIT will allow clients to achieve all ten (10) of these goals with essentially no financial, tax and legal risk. The reader is referred to Exhibit A for a diagram of the BDIT structure.

[b] Description and Design of the BDIT.
**Exhibit A**

**BDIT SCHEMATIC**

**WEALTH PROTECTION**

Solely because assets are placed into an appropriate trust by someone else, and the beneficiary never adds assets to the trust, except for full value, as long as they are kept in trust, these assets have benefits that do not, and cannot, exist if the same assets were owned outright.

**BDITS are forever sheltered:**

1. From all estate, gift and GST taxes;
2. From the beneficiary’s creditors (including divorcing or dissident spouses);
3. From probate and incapacity headaches and delays; and
4. From certain income taxes after the death of the original beneficiary.

**Beneficiary Defective Trust**

Because the original beneficiary is taxed on the trust income, the beneficiary’s estate will be “tax burned,” i.e., depleted by income tax paid on trust income. This, in effect shifts the beneficiary’s personal wealth tax-free into the Beneficiary Controlled Trust (“BDIT”) away from transfer tax and creditors, without gift or GST tax consequences, and with no economic risk because the beneficiary is in control of the trust.

**CONTROL**

Without exposing the trust assets to estate taxes and creditors, the trust beneficiary can have substantial controls.

The original primary beneficiary and each successive primary beneficiary are in control (at the proper time) subject to amendment by the exercise of the power of appointment by the preceding generation.

**Administrative Control:**

1. The original primary beneficiary is the Investment Trustee.
2. The Independent Trustee makes all distributions (if any) and makes other tax sensitive decisions.
3. The primary beneficiary can fire and replace the Independent Trustee with another Independent Trustee, with or without cause. Independent does not require a corporate fiduciary, nor a confrontational relationship; it could be a "best friend".

**Dispositive Control:**

1. The right to use the trust-owned assets (rent-free if desired).
2. The primary beneficiary can essentially re-write the trust. This enables the primary beneficiary to adjust for changes in tax laws, trust laws, family dynamics, etc.

---

Parent or Other Third Party creates trust and contributes $5,000 in cash; no other gifts are made to the trust by anyone Trust Creator is the Grantor of the Trust for:
- Transfer Tax Purposes
- Creditor Rights Purposes
- But Not Income Tax Purposes

**BDIT**

Irrevocable; Fully Discretionary; GST Exempt;
Beneficiary has limited power of appointment
* * * *
Beneficiary given limited time power to withdraw the original gift; Beneficiary is therefore the “Owner” of the Trust for Income Tax Purposes
* * * *
Beneficiary – Investment Trustee
Independent Trustee – Distribution Trustee

Unless otherwise directed by exercise of beneficiary’s power of appointment (“re-write power”) upon death of beneficiary.

Trust for Surviving Spouse (if desired) and Descendants
* * * *
Surviving Spouse - Investment Trustee
Independent Trustee – Distribution Trustee
* * * *
Income Taxed to Trust Unless Distributed

Unless otherwise directed by exercise of power of appointment (“re-write power”) upon death of surviving spouse divided equally for each family branch.

At the death of each child, that child’s trust is “recycled” a generation down, subject to the power of appointment.
Essentially, the BDIT is a third-party settled trust designed: (1) to give the client (who is both a trustee and the initial primary beneficiary of the trust) control and beneficial enjoyment of trust property such that the client can use and manage the trust assets without compromising the trust’s ability to avoid transfer taxes at the client’s death, and (2) to protect the trust assets from the client’s creditors. After the death of the client (the primary beneficiary), control of the trust passes to subsequent primary beneficiaries, often on a per stirpes basis, subject to change through the exercise of a special power of appointment by the client. In addition to receiving control of the trust, the subsequent primary beneficiaries also receive the benefits of trust-owned property such as: (1) transfer tax avoidance, (2) creditor protection, including protection from a divorcing or separated spouse, and (3) potential income tax savings, including state income tax savings if the trust situs is a state with no state income tax.

The critical concept empowering the BDIT is the axiom that assets received by gift or inheritance from a third party and retained in a properly structured trust are protected from unnecessary exposure to the client’s “predators”, including

---

16 Pursuant to IRC §2041, a special power of appointment is the power to appoint property on any terms or conditions to anyone other than the power-holder himself/herself, the power-holder’s creditors, the power-holder’s estate or the creditors of the power-holder’s estate. Of particular importance to the BDIT strategy is that the special power of appointment held by the Inheritor/Beneficiary prevents the possibility of inadvertent gift tax consequences when the Inheritor/beneficiary sells his or her assets to the BDIT.

17 The following are examples of states with no individual income tax: Florida, South Dakota and Nevada. Also, the following are examples of states that impose no income tax on trust income: Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming.
the IRS (unnecessary income and wealth transfer taxes), judgment creditors, a divorcing spouse, disgruntled family members and business partners. In fact, assets held in trust are more valuable than assets owned outright because “a person can receive more rights in a trust than he can obtain by owning property outright, provided that the transfer to the trust is funded by a third party. Since a transferor can confer more rights and benefits by making transfers in trust than giving the property outright, it would also be reasonable to conclude that virtually all significant gifts and bequests should be made in trust and that the term of the trust should be as long as permitted under the law.”

Consequently, a client’s assets should be retained in the trust to enable the beneficiary to obtain more benefits than the beneficiary could obtain with outright ownership. This can be accomplished by selecting the primary beneficiary of the trust (hereinafter sometimes referred to as the “Inheritor/Beneficiary” of the BDIT) as the controlling trustee (a “Beneficiary Controlled Trust”). The primary beneficiary, as trustee of the trust, can be given virtually identical rights in the trust property as he or she would have with outright ownership. In addition, the trust can offer insulation from creditor and divorce problems, as well as estate tax protection that does not result from outright ownership. Thus, the failure to hold and manage wealth in a properly designed trust is often a critical and very costly mistake. The primary beneficiary

18 Oshins, R., supra note 14, at 27-11.
can be given all of the following rights “in trust” that could also be given with outright ownership: (1) the right to access the income, (2) the right to access the principal subject to a broad ascertainable standard, (3) the right as trustee to manage and control the property, (4) the right to use the property, and (5) the right to transfer the property during life and to determine who will receive the property after the beneficiary’s death.\(^{19}\)

In essence, these bundles of rights (which are incorporated into the Cash Value BDIT) are the functional equivalent of outright ownership.

A standard third-party, discretionary trust becomes “beneficiary-defective” when it is drafted so that a single primary beneficiary of the trust (one person, the Inheritor/Beneficiary) is treated as the owner of the trust for all income tax purposes pursuant to the IRC’s grantor trust rules.\(^{20}\)

Specifically, pursuant to IRC §§678(a) and (b) and 671 the general rule is that a person other than the grantor is treated as the owner of the trust income if that person has the power to withdraw trust corpus or income pursuant to a Crummey power of withdrawal and the power is allowed to lapse within the “five or five” exceptions of IRC §§2514(e) and 2041(a)(2). If the Crummey power is given to only one primary


\(^{20}\) Under the grantor trust rules, a person (the “grantor”) who transfers property to a trust and retains certain powers or interests is treated as the owner of the trust property for income tax purposes. As a result, the income and deductions attributable to the trust are included in the grantor’s income to the extent of the “owned” portion of the trust. IRC §§671-679.
beneficiary (the Inheritor/Beneficiary of the BDIT), the Crummey power is allowed to lapse as to that beneficiary and the trust otherwise is not treated as a grantor trust as to the original trust grantor, the primary beneficiary (the Inheritor/Beneficiary) will be considered the grantor of the trust for all income tax purposes. The lapsed Crummey power (1) requires the primary beneficiary to pay the income taxes on the income generated by the trust\(^{21}\) and (2) also permits the beneficiary to engage in transactions with the trust income tax free.\(^{22}\) Significantly, this also allows trust assets to grow income and wealth transfer tax-free, which compounds the multi-generational accumulation of wealth in the trust.\(^{23}\)

With respect to the primary beneficiary (Inheritor/Beneficiary), a BDIT combines the benefits of a traditional intentionally-defective grantor trust (IDGT)\(^{24}\) created

\(^{21}\) IRC §§671, 678.


\(^{23}\) At the 2009 43\(^{rd}\) Annual Philip E. Heckerling Institute on Estate Planning, nationally known estate planning attorney Howard Zaritsky stated that because of the power of tax-free compounding, generally, all irrevocable trusts should be grantor trusts. This increases the benefits of everything else the client wants to do. The following is an illustration of the power of transfer tax free wealth compounding using a multi-generational dynasty trust: if the client dies at age 89 with a total accumulated wealth in the Cash Value BDIT of $1,428,956, the wealth transfer tax free value of the trust (assuming a growth rate of 6\% and 30 years between generations) at the end of one generation will be $8,289,268; at the end of two generations the total value of the trust will be $47,609,338; and at the end of three generations the total value of the trust will be $273,443,518.

\(^{24}\) An intentionally defective grantor trusts is an irrevocable trust intentionally drafted so that all of the trust income either is taxed to the trust grantor or a third party. IRC §§671-679. For a sample of the many excellent discussions of planning and drafting techniques with IDITs, see Michael D. Mulligan, Sale to a Defective Grantor Trust: An Alternative to a GRAT, Est. Planning (Jan. 1996); Fred Nicholson, Sale to a Grantor Controlled Trust: Better than a GRAT? Tax Mgmt. Memorandum (Feb. 22, 1996); H. Allan Shore and Craig T. McClung, Beyond the Basic SUPERFREEZE – An Update and Additional Planning Opportunities, Taxes (Jan. 1997); Michael D. Mulligan, Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note – An End Run Around Chapter 147, 32 U. Miami Philip E. Heckerling Inst. On Est. Plan. ¶115 (1998); Steven J. Oshins, et. al, Sale to a Defective South Dakota Dynasty
for others with the enhanced wealth, transfer tax and asset protection advantages of a trust created and funded by a third party for the benefit of the beneficiary.

Because of the enhanced planning benefits available through a BDIT, particularly the control of the trust and the access to and enjoyment of the trust property by the client [who is the primary beneficiary (Inheritor/beneficiary) of the trust], many clients who otherwise are reluctant to do comprehensive planning or make significant *inter vivos* wealth transfers now can enjoy the benefits of advanced wealth and asset protection planning with minimal personal, financial and tax risk.


---

A properly designed BDIT will allow clients to successfully achieve each of the attributes listed in Section 1.1[4] above and create what the authors believe may be the ideal comprehensive wealth accumulation and retirement plan (hereinafter the “Ideal Plan”).

By combining the BDIT with a tax-free capital accumulation investment such as cash value life insurance, planners can dramatically increase a client’s ability to accumulate and protect wealth provided that the “cost” to obtain this type of treatment is not too severe. For most estate owners, the cost to purchase the life insurance component of this planning strategy is negligible relative to the many significant benefits which can be obtained, principally the ability to allow the investment component of cash value life insurance to grow income tax free. However, keep in mind that tax-free compounding is somewhat exponential, and, therefore, usually a sufficient amount of time is necessary to achieve significant growth in the investment component. Fortunately, in addition to the traditional benefit of the death component of the cash value life insurance product, the death benefit feature also creates both a hedge and a windfall against the premature death of the insured in which event there will not have been a sufficient amount of time for the investment component of the insurance policy to grow significantly. Exhibit B below illustrates the relationship over time between policy cash value and death benefit.

As a result of the limitations on traditional qualified retirement planning, establishing and funding a Cash Value BDIT may be the simplest and most economical retirement planning alternative available for the employer/client.
Exhibit B

Increasing:
income
tax deferred cash
value – available for
use and outside the
estate

Decreasing:
need
for estate tax liquid-
ity during “burn” (&
net amount at risk
outside estate)

Decreasing Net
Amount at Risk

Increasing Cash Value

Now

Estate accessible Es-
tate tax free “Tax
Burn” insurance
+
A FIXED component
of an investment port-
folio outside the es-
tate

Future

Derived from “Life Insurance as an Asset Class” by Richard M. Weber, MBA, CLU and Christopher Hause, FSA, MAAA © 2009 Ethical Edge Insurance Solutions, LLC. For further information contact Dick@EthicalEdge.biz

Used by Permission.
Life insurance companies in recent years have shied away from illustrating the use of cash value life insurance as a “private pension plan” because of overly-aggressive and inappropriate policy illustrations and marketing techniques. However, the use of cash value life insurance as a viable alternative to traditional qualified retirement plans is a well-accepted and important practice in the financial planning community. In a college textbook first published in 1959 and still being published and used today as a standard textbook in life insurance courses, renowned insurance professor Dr. Dan M. McGill, PhD, CLU (Professor Emeritus at The Wharton School of the University of Pennsylvania) wrote that:

Life insurance policies can be an important source of supplemental retirement income funds. The policy proceeds can obviously be an important source of funds for the surviving spouse. These funds can supplement any other source of retirement income available from corporate pensions, IRAs, other qualified plans, investments, and Social Security.

Life insurance can even provide supplemental retirement funds to the insured individual. This can be accomplished by utilizing the cash value of the life insurance prior to the insured’s death. Some policies, such as universal life policies, allow partial withdrawals of cash value amounts without terminating the policy itself. Under any life insurance policy having a cash value, the policy-owner can always gain access to the funds by either taking out a policy loan or surrendering the policy for the entire cash surrender value.²⁶


²⁶ DANIEL M. McGILL, McGILL’S LIFE INSURANCE, 4TH EDITION 214 (Edward E. Graves Ed., The American College 2002).

²⁷ Alexander & Halloran, supra note 1, at 15.
A second major thesis in the original article is that many individuals who are building a comprehensive wealth accumulation and retirement planning portfolio should seriously consider the value of including lifetime uses of cash value life insurance in a well-balanced plan. There can be an important synergy of investment plus cash value life insurance that can serve at least as well as a properly balanced plan focused on passing wealth to the next generation and/or a plan focused on providing retirement income that does not include cash value life insurance, all with potentially less volatility and market valuation risk.

Based on the study by Weber and Hause, the original article examined the concept of modern portfolio theory ("MPT") and the importance of cash value life insurance as a separate, uncorrelated asset class\(^28\). However, in concert with Weber and Hause, the authors noted that in the context of this discussion, before delving to a comprehensive analysis of various planning strategies, it is very important to keep in mind that the focus of the discussion on MPT, asset diversification and comprehensive wealth accumulation and retirement planning is not about the efficacy of portfolio investments vs. life insurance; rather the purpose of the discussion is to illustrate a possible synergy

\(^{28}\text{Id. at 10-13.}\)
of assets that can produce more total “accumulated wealth value”, potentially with more net income, and less market value adjustment risk.


The Weber and Hause white paper provides a detailed analysis of the concept of cash value life insurance as a separate uncorrelated asset class and then demonstrates how to construct an efficient, comprehensive wealth and retirement plan by using cash value life insurance. Weber and Hause analyze various wealth accumulation and retirement planning strategies including utilizing strategies of buying term insurance and investing the difference, strategies focusing solely on the cost of term insurance vs. cash value insurance, strategies focusing on accumulated wealth and death benefit planning and strategies focusing on planning for retirement income. The Weber and Hause study concluded that regardless of whether the client’s strategy is to 1) buy term and invest the difference or 2) combine an investment strategy with or without cash value life insurance, the lifetime use of cash value life insurance synergized with a portfolio of investments can provide a higher net-after-tax retirement income and provide a higher total “accumulated wealth value” with less volatility than using an investment portfolio by itself.

29 The term total “accumulated wealth value” as used throughout this article refers to the total compounded rate of return of the investment portfolio (if any) plus the life insurance death benefit (if any). In their white paper, Weber and Hause refer to this term as the “legacy value”.

30 Alexander & Halloran, supra note 1, at 21-22.
In the original 2009 article Alexander and Halloran conducted their own independent financial analyses of the mathematics of utilizing cash value life insurance as an important component in comprehensive wealth accumulation and retirement planning. Their independent study corroborated the results of the Weber and Hause white paper, and independently demonstrated that the Cash Value BDIT strategy will produce more total “accumulated wealth value” for the client than either the pure retirement plan or other planning alternatives such as a NIMCRUT. The differences between the Alexander and Halloran analyses and the Weber and Hause analyses relate to the fact that the Weber and Hause analyses are based on a combined total “accumulated wealth value” consisting of an investment portfolio and the life insurance death benefit, whereas the Alexander and Halloran analyses focuses on the cash value build-up in the life insurance policy. Regardless of the differences, both analyses demonstrate the powerful wealth accumulation and retirement planning value of the Cash Value BDIT vs. other traditional planning techniques. The reader is referred to Exhibit C below for a summary comparison of the comprehensive planning advantages and disadvantages of qualified retirement plans, NIMCRUTs, and the Cash Value BDIT.

The original 2009 article then analyzed the planning value of cash value life insurance, including the tax-free build-up in a policy that qualifies as a life insurance policy under IRC §7702, the cost of moving into an income tax free accumulation vehicle, advanced

---

31 Id. at 22-25.
Exhibit C

**QRPs v. NIMCRUTs v. CVLI**

I. The most important concept in wealth planning is tax exempt and tax deferred wealth accumulation.

II. From an income tax perspective, the three primary vehicles to accomplish those goals and their features are:

A. Qualified retirement plans –
   1. Tax deferral – not exempt.
   2. Tax at ordinary income rates – often converts capital gain into ordinary income to the recipient.
   3. I.R.D. – subject to both income and estate tax.
   4. Non-alienation – prohibits transfer to escape the estate tax.
   6. Contributions and withdrawals – too much; too soon; too little; too late problems.
   6. Administrative and legal costs.
   7. Non-discriminatory.

B. NIMCRUTs –
   1. Tax deferral – not exempt
   2. Four tier rule – worst (ordinary income) is distributed first.
   3. 10% rule eliminates younger clients and compresses potential accumulation period.
   4. Administrative and legal costs.
   5. Fully discriminatory.

C. Cash Value Life Insurance (“CVLI”)
   1. Tax exempt access to the investment fund.
   2. Can access the fund on a temporary basis, e.g., college, and restore the fund by paying back the loan. This option is not available with QRPs or NIMCRUTs.
   3. Tax-free or deferred accumulation grows exponentially, thus in order to best achieve the benefits estate owner must survive and not withdraw for a long period of time. Client risks early death with QRP and NIMCRUT. With CVLI, the policy matures upon early death, making the undertaking economically successful as to the survivors.
   4. Estate planning strategies, e.g., split-dollar, dynastic trusts enable the proceeds to be transfer tax exempt, yet be available to the client.
   5. Income tax – basis step-up at death.
   6. No administrative or legal costs.
   7. Fully discriminatory.

Used by Permission.
transfer tax planning with cash value life insurance, accessing the cash value, and the CVBDIT as a better life insurance trust.

[8] The Cash Value BDIT is a Better Life Insurance Trust

The Cash Value BDIT can be used as an enhanced version of a traditional, funded irrevocable life insurance trust (ILIT). Although the BDIT can buy life insurance on the life of anyone on whom the trust has an insurable interest, generally, the life insurance will insure the life (lives) of one (or more) of the trust beneficiaries including the person who is the Inheritor/Beneficiary of the BDIT. However, remember that if the life insurance is owned on the life of the Inheritor/Beneficiary, two adjustments must be made in the BDIT design in order to avoid estate tax inclusion under IRC §2042:

1) all decisions with respect to life insurance insuring the life of the Inheritor/Beneficiary must be made by a non-insured trustee. Generally, planners should use an independent trustee to make these decisions; and

2) the insured (the Inheritor/Beneficiary) cannot have a power of appointment or any other “tax sensitive” powers over the life insurance or its proceeds.

Until there is adequate cash flow in the Cash Value BDIT to pay premiums (and fund the installment note if the Inheritor/Beneficiary enters into an installment sale with the

\[32 \text{id. at 37-38.}\]
Cash Value BDIT, which is often a significant purpose of the Cash Value BDIT strategy)  
the premium funding strategy either will involve using a donor/donee split-dollar 
arrangement or a premium financing transaction either with the insured or with a third-
party lender loaning money to the trust to provide a source of premiums. These issues 
are discussed in in detail in Sections 1.3 through 1.10 below.

BDIT

In the 2009 article Alexander and Halloran make the following conclusions.

1) Without question cash value life insurance is an important, but often 
overlooked, component in modern wealth, retirement, tax and asset protection 
planning because it takes advantage of the single most important concept in 
financial and retirement planning - income tax free compounding. Also, cash 
value life insurance may be viewed as an important, uncorrelated, separate asset 
class which, pursuant to the principals of Modern Portfolio Theory, should be 
considered as part of any diversified, well balanced investment portfolio.

2) The dynastic BDIT is, perhaps, the best wealth transfer and asset protection 
technique available both to compound wealth transfer tax-free in perpetuity and 
to asset protect clients’ wealth and the wealth of their descendants forever.

33 Alexander & Halloran, supra note 1, at 41-42.
3) Cash value life insurance owned by a BDIT will allow the beneficiary/insured to access policy cash values often on a tax-free basis and will significantly expand and compound the value of the assets owned by the trust.

4) The use of dynastic BDIT planning properly coordinated with cash value life insurance, traditional wealth shifting techniques and premium financing techniques can provide dramatic opportunities to create a family “wealth pool” which will benefit clients and their descendants in perpetuity.

5) The Cash Value BDIT is, perhaps, the ultimate opportunity to protect, preserve and dramatically grow family wealth and allow clients (and eventually their families for multiple generations) access to accumulated wealth for retirement and other purposes on a tax-advantaged or tax-free basis without disturbing the client’s beneficial enjoyment of the transferred property.

1.2 Funding the Cash Value BDIT – An Overview of Private Split-Dollar and Premium Financing Arrangements

[1] Introduction

Until there are sufficient assets in the Cash Value BDIT (“CVBDIT”) to generate the cash flow necessary to pay the insurance premiums required to fund the appropriate cash value life insurance policy, premium payments most likely will be planned using either a private split-dollar arrangement or a premium financing arrangement. Because the CVBDIT transaction cannot involve any planning arrangement utilizing gifts to the trust
(other than the initial gift of $5,000 by the third party settlor of the trust), traditional methods of funding irrevocable trusts by means of gifting cannot be used without destroying the income, estate and generation skipping tax planning built into the CVBDIT.\(^{34}\) Consequently, annual exclusion gifts, gifts utilizing the $1 million lifetime applicable exclusion amount, gift transfers of existing policies, GRAT funding techniques and other creative funding techniques with gift tax consequences (whether or not a gift tax is actually paid) are not appropriate techniques to fund a Cash Value BDIT. However, the Cash Value BDIT typically is created as part of an integrated wealth transfer and asset protection plan in which the client (who is the primary beneficiary of the CVBIT and usually referred to in this article as the “Inheritor/Beneficiary”) sells income producing assets properly structured in discountable, pass-through entities such as S-corporations, family limited partnerships (“FLPs”) and family limited liability companies (“FLLCs”) to the CVBDIT in exchange for an installment note. If the transaction is planned properly, cash flow from the sale of the discountable entities will be sufficient to pay interest on the installment note, and, hopefully, there will be sufficient cash flow remaining after the interest payments to pay the premiums on the life insurance policy insuring the life of the primary beneficiary (Inheritor/Beneficiary).\(^{35}\) However, if there is insufficient cash flow to fund the insurance premiums, or, if the transaction does not involve the sale of assets to the CVBDIT, planners must look for

---

\(^{34}\) For citations to complete technical analyses of the BDIT see supra note 14.

\(^{35}\) See Oshins, R. supra note 14 for illustrations of cash flow projects with respect to note sales to the BDIT.
other techniques to fund the insurance premiums which do not involve gifts to the trust. Fortunately, properly structured private split-dollar and premium financing arrangements are excellent techniques to provide the funding necessary for a successful Cash Value BDIT transaction in situations where the CVBDIT does not have sufficient cash flow to fund the life insurance premiums.

Historically split-dollar life insurance plans, which have been around from many years, have been arrangements between employers and employees or corporations and shareholders. More recently, split-dollar arrangements have been used in the context of family wealth transfer planning where the arrangement is between family members, family members and an irrevocable trust, between two trusts, or between a trust and a partnership. Private split-dollar arrangements frequently are used in wealth transfer planning when a large life insurance policy is purchased and the annual premium payment will create a large taxable gift. In these situations, the private split-dollar arrangement will reduce the amount of the gift to a small fraction of the total premium. The primary benefit of these types of arrangements is that the life insurance proceeds are kept outside of the insured’s estate and the arrangement minimizes the amount of the gift that must be made each year to the traditional irrevocable trust in order to fund the premium payments.
The 2003 Split-Dollar Final Regulations

In 2003 the IRS published Final Regulations detailing a set of complex rules governing both new split-dollar arrangements created after September 17, 2003 and older split-dollar arrangements that are “materially modified” after September 17, 2003. The Final Regulations also govern private premium financing arrangements, which, under the Regulations, are treated as private split-dollar arrangements. Interestingly, it appears that the Final Regulations create new and better planning opportunities for both private split-dollar and premium financing arrangements that are used for purposes of wealth transfer planning. As further authority for these planning opportunities, there have been a series of private letter rulings in which the IRS has approved private split-dollar arrangements such as those discussed in this article. As a final observation, keep in mind that the Final Regulations indicate that IRS Notice 2002-8 will have continued application to private split-dollar arrangements. Notice 2002-8 made it clear that the tax principles governing employment split-dollar arrangements can be applied to certain types of private split-dollar arrangements. Consequently, equity split-dollar

38 See Ltr. Ruls. 9636033, 9745019, 200728015, 2007747011, 200822003, 200825011, 200848002, 200851013, 200910002 and 200925003.
arrangements involving donor/insureds and donee/trusts that are established after September 17, 2003 are treated as loans between the donor and the trust, and the trust will have to pay adequate interest on the loans or be subject to the interest-free loan rules of IRC § 7872 and §§ 1271-1275.

[3] Summary Description of Split-Dollar Arrangements

Essentially, a split-dollar life insurance arrangement is an agreement established by two parties for the purpose of splitting the premium costs and benefits (the cash value and death benefit) of a cash value life insurance policy. Pursuant to the Final Regulations, private split-dollar arrangements will be governed by one of two mutually exclusive tax regimes: (i) the economic benefit regime or (ii) the loan regime. The key to determining which regime applies to a particular arrangement is to properly identify which party to the arrangement owns (or is treated as owning) the policy. As a general rule, the economic benefit regime applies if the donor is the owner of the insurance policy. This is referred to as the “endorsement method”. The loan regime will apply when the

40 “An equity split-dollar arrangement is one in which one party receives an interest in the policy cash value (the ‘equity’) disproportionate to that party’s share of the premiums. That party also usually receives the benefit of current life insurance protection under the arrangement. The owner of a life insurance contract under an equity split-dollar arrangement is usually treated as providing economic benefits to the nonowner, and both parties must fully and consistently account for that economic benefit.” ZARITSKY, HOWARD M. AND STEPHAN R. LEIMBERG, TAX PLANNING WITH LIFE INSURANCE; ANALYSIS WITH FORMS (2nd ed. 2009 & Supp. 1 2010). Z§6.05[2][2][c][iii] Treas. Reg. § 1.61-22(d)(2). This treatise provides an excellent in-depth explanation of split-dollar insurance.

41 Part of this paragraph [3] has been abstracted, revised, and edited from Michael F. Amoia, Kristen E. Simmons and Robert C. Slane, Utilizing Private Split Dollar in Estate Planning, NAEPC Journal of Estate & Tax Planning (June 2009) at http://www.naepc.org.journal, at p.2. Hereinafter this article will be referred to as “Amoia”. 
donee (such as a trust) is the owner of the insurance policy. This is referred to as the “collateral assignment method.”

Noted life insurance experts Howard M. Zaritsky and Stephan R. Leimberg summarize private split-dollar arrangements as follows:

Private split-dollar life insurance is an arrangement...between a donor (often the insured or the insured’s spouse or an entity such as an FLP or LLC), and a donee (often adult financially mature children or an irrevocable life insurance trust [or a CVBDIT] for one or more generations), whereby the donor pays all or a portion of the premium on a life insurance policy, and reserves a right to recover the donor’s premium payments from the cash surrender value, if the policy is cancelled, or at the insured’s death from the death benefit....

On the insured’s death, the donor typically receives a portion of the proceeds equal to the amount of premiums the donor has paid. The donee [the trust] is named beneficiary and receives the balance of the proceeds. The objective of the private split-dollar is to provide the donee [the trust] with the benefit of insurance protection at a tax cost equal to a fraction of the premium otherwise payable. The cost of this inexpensive coverage is a reduction in the amount payable at the insured’s death [to the trust].
Generally, a split-dollar arrangement can be established in either of two ways: the “endorsement method” or the “collateral method”. Under the endorsement method [generally taxed under the economic benefit regime as detailed in the Final Regulations], the donor buys and owns the policy. The donee names the beneficiary and agrees to reimburse the donor for the donor’s share of the premiums. Under the collateral assignment method [generally taxed under the loan regime as detailed in the Final regulations], the donee is the original purchaser and owner of the policy and pledges its cash surrender value as security for the donor’s premium payments. The gift tax consequences of a split-dollar arrangement do not, however, depend on the form of the arrangement, but rather on the substance of the details. 42


The economic benefit regime 44 divides a life insurance policy into two parts: (i) the term insurance value of the life insurance death benefit, which is referred to as the “economic benefit” of the policy, and (ii) all of the other rights in the insurance contract, including cash value and surrender rights. Consequently, one party to the split-dollar

42 Zaritsky & Leimberg, supra note 40, at § 3.02[2][e].

43 Significant portions of this Section [4] have been abstracted, revised, and edited from Amoia, supra note 41, at 2-4.

44 Treas. Reg. § 1.61-22(b)(2).
arrangement is responsible for the “cost of insurance” and the other party pays the balance of the premium. Generally, the non-owner will be taxed on the amount of the policy cash value to which he or she has current access. In addition, the non-owner will be taxed on any dividends, withdrawals, partial surrenders and specified loans which he or she receives directly or indirectly. 45

Under the “economic benefit” private split-dollar arrangement, the premium payor’s gift tax consequences are based upon the “economic benefit” or term cost of the life insurance policy. Most economic benefit regime split-dollar arrangements will limit the donee (trust) to the amount of current insurance protection. If not, any “equity” buildup in the cash value of the policy belonging to the donee (trust) will be taxable immediately either as income or as a gift.

The economic benefit regime can be structured in either of two ways: (i) the standard endorsement method or (ii) the non-equity collateral assignment method.

[a] The Standard Endorsement Method

Under the standard endorsement method, the premium payor owns the life insurance policy and rents the coverage to the non-owner. Because there is a significant concern that this arrangement will cause estate tax inclusion if the insured is the premium payor, this method is rarely considered in a private split-

45 Treas. Reg. § 1.61-22(d)(e).
dollar arrangement unless the insured’s spouse is the payor and the successor owner is not the insured.

Under the standard endorsement method, the most significant economic benefit to the donee is the cost of current insurance protection which is a term premium factor published by the IRS in the 2002-4 Internal Revenue Bulletin.46 Until further guidance is provided, Notice 2002-8 applies47. This notice states that the interim government table 2001 may be used to value current life insurance protection of a single life.48

For split-dollar arrangements entered into prior to January 28, 2002, the taxpayer may use, as an alternative, the current published premium rates charged by the insurance company issuing the split-dollar policy for a one year term life insurance premium available to all standard risks if lower than Table 2001. The phraseology of Notice 2002-8 would appear to be a grandfather provision [to guard] against future changes by the IRS. However, many insurance companies have ceased publishing the old alternative [one year term life]... rate table.

46 Treas. Reg. § 1.61-22(d)(3).
For split-dollar arrangements entered into after January 27, 2002, the alternative term rate of the insurance carrier may still be used but the IRS reserves the right to change or abolish the alternative term valuation rate. For these post-January 27 [2002] arrangements, the insurance carrier’s rate must meet two additional requirements: the availability is known to persons who apply for term insurance coverage from the insurer and the insurer regularly sells term insurance at such rates to individuals who apply for term insurance through the insurer’s normal distribution channels. 49

Even though the general rule provides that the identity of the contract owner will dictate which regime applies to the split-dollar arrangement, the Final Regulations create an exception to the general rule if the arrangement is in the form of a non-equity collateral assignment. 50 In this type of split-dollar arrangement, the donee (which is usually an irrevocable life insurance trust) is the owner of the contract and the only benefit provided to the donee/trust is the death benefit because the donee/trust must repay the donor the greater of the

49 Id. at 5.

50 “A non-equity split-dollar arrangement is one in which one party provides the other with current life insurance protection, but no interest in the policy cash value. The nonowner in a nonequity arrangement is taxable with respect to the economic value of the value of the pure term insurance coverage, less any amounts contributed by the nonowner to the premium costs”. Zaritsky & Leimberg, supra note 40, at ¶6.05[2][c][ii]. Treas. Reg. § 1.61-22(d).
policy’s cash value or the premiums paid. Consequently, the donor is deemed to be the owner of the policy for the sole purpose of applying the split-dollar tax rules and the donee/trust may be listed as the policy owner.\textsuperscript{51} Importantly, as a general rule, with respect to this type of split-dollar arrangement the donor is not deemed to be the owner of the policy for purposes of determining incidents of ownership under IRC § 2042. In a non-equity collateral assignment arrangement, the non-premium payor (the donee/trust) legally owns the policy and assigns back to the premium payor (donor/insured) an interest in the policy equal to the greater of the policy cash values or the total premiums paid. If the insured dies, the death benefits first are used to pay the donor the greater of the i) policy cash values or ii) the total premiums paid, which are required to be paid to the premium payor (donor) or his or her estate, and the remaining death benefits are paid to the policy owner’s (donee/trust) beneficiary, usually the trust itself.

A non-equity collateral assignment split-dollar arrangement will be considered as either (i) a contributory plan or (ii) a non-contributory plan. If the arrangement is a contributory plan, the donee (trust) will pay the economic benefit of the donor from the donee/trust’s current assets. In the context of a traditional irrevocable trust, the trustee of the trust will pay the economic benefit portion of the premium with current assets that either have been gifted or sold to the

\textsuperscript{51} Treas. Reg. 1.61-22(c)(1)(ii)(A)(2).
trust. If the donee (trust) pays the economic benefit cost of the insurance, this payment will be considered income to the donor, unless the arrangement is between a grantor and a grantor trust for income tax purposes, in which case there will be no income tax consequence.\textsuperscript{52}

In contrast, a non-contributory plan is a non-equity collateral assignment arrangement in which the donor pays the premium in its entirety. In this case, the donor makes an indirect gift to the donee (trust) which may or may not qualify for the gift tax annual exclusion under IRC § 2503(b). However, this is a very unsatisfactory arrangement with respect to the CVBDIT because the CVBDIT must never involve any gift transfers to the trust (and no gift tax consequences to the Inheritor/Beneficiary or any other party to the trust) except for the $5,000 initial gift by the Settlor to the trust.

A detailed, technical discussion of the economic benefit regime is provided in Section 1.4 below.

[5] The Loan Regime\textsuperscript{53}

Treas. Reg. § 1.61-22(b)(3)(i) states that any split-dollar arrangement that is not taxed under the economic benefit regime will be taxed under the loan regime; this is the


\textsuperscript{53} Significant portions of this Section [5] have been abstracted, revised and edited from Amoia, supra note 41, at 4-6.
default category under the Final Regulations. This rule includes those arrangements traditionally described as “equity collateral assignment split-dollar” arrangements\(^{54}\). For purposes of the loan regime, Treas. Reg. § 1.7872-15 uses the same definition of a “split-dollar arrangement” as set forth in Treas. Reg. § 1.61-22 dealing with the economic benefit regime. Critical to this regime is the section of the Final Regulations which states that a split-dollar arrangement exits when (i) payment is made, directly or indirectly, by the non-owner to the owner (or directly to the insurance company), (ii) expectation of repayment, with or without interest, to the non-owner is reasonable, and (iii) such repayment is to be made from or secured by policy cash values or the death benefit.\(^{55}\)

If the loan is a below market rate interest rate loan, then IRC § 7872 applies. If a sufficient rate of interest is paid, then IRC§ 7872 and Treas. Reg. § 1.7872-15(e) do not apply. As a result, there are no gift or income tax consequences if the loan specifies an interest rate that is at least equal to the applicable federal rate (“AFR”) in effect under IRC §§ 1274(d) and 7872(t)(2).

In a traditional loan regime arrangement, the donor will be the grantor of an intentionally defective irrevocable life insurance trust (“IDILIT”) and the donee will be

\(^{54}\) Equity collateral assignment split-dollar arrangements are defined supra note 40.

\(^{55}\) Treas. Reg. § 7872-15(a)(2) states: In a private split-dollar arrangement, the children, grandchildren or a trust will be considered the “owner” of the life insurance policy and borrower(s). In turn, the grantor is considered the “non-owner” and will take a collateral assignment against the policy. A strict collateral assignment is not considered an incident of ownership for §2042. However, the amount of the loan will be included in the lender’s gross estate.
the trust. In this arrangement, the donor will pay the premiums for the insurance policy, and the payment of the premiums will be treated as a loan to the trust. The trust then either will pay interest on the loan, or the amount of unpaid interest will be imputed as a gift by the grantor/donor to the trust/donee. As discussed in Section 1.8 below, there are several ways that the loan arrangement between the donor/grantor and the donee/trust can be structured.

The Final Regulations provide that if a loan regime split-dollar arrangement is not a below-market loan as defined by IRC § 7872 and Treas. Reg. § 1.7872-15(e), it is governed by the general rules governing debt instruments and original issue discount. However, if the split-dollar loan is a below market loan described under IRC § 7872(c)(1), then the loan is recharacterized as a loan bearing interest at the applicable federal rate ("AFR") with imputed transfers consistent with the general provision of IRC § 7872. As a result, the amount by which the AFR exceeds the stated interest is deemed to have been transferred from the lender to the borrower as a gift and then paid back to the lender as interest income. This is referred to as the "foregone interest". Note, however, the income tax consequence can be eliminated with the use of a grantor/grantor trust arrangement.56

Under the Final Regulations, most collateral assignment split-dollar arrangements now will be treated as loans subject to IRC § 7872. The endorsement split-dollar

56 See Rev. Rul. 85-13 and the discussion at Section 1.9 below.
arrangement may measure the economic benefit by the term premium, but the equity will be subject to income/gift taxes unless it is owned by donor or other premium payor. The tradeoff under the Final Regulations is clear; under loan regime split-dollar arrangements, the equity buildup is not subject to income/gift taxes, but the required interest rate must be charged. Although the economic benefit regime split-dollar arrangement may continue to measure current economic benefit by the normally lower term premium, the premium payor should own all of the cash value and other rights in the policy in order to prevent income/gift taxes to the trust/donee. Finally, keep in mind that under the Final Regulations almost all premium loans will fall under the loan regime split-dollar arrangement. However, economic benefit regime (endorsement method) split-dollar arrangements will not be treated as premium loans.

A detailed, technical analysis of the loan regime is provided in Section 1.8 below.

[6] Premium Financing Arrangements

A premium financing arrangement “is a series of loans to an irrevocable trust in order to fund a substantial life insurance policy. The lender may be a bank, a family business, the insured or a family member”\(^{58}\). Although funding the premium payments with loans may avoid the problem of taxable gifts, under the final split-dollar Regulations almost all

---

\(^{57}\) Significant portions of this Section 6 have been abstracted, edit and revised from Jansen, supra note 48, at 24-32.

\(^{58}\) LEE SLAVUTIN ET AL., PPC’S GUIDE TO LIFE INSURANCE STRATEGIES §5.05.1 (11th ed. 2009).
premium loan arrangements will be governed by the loan regime split-dollar rules.\textsuperscript{59} However, economic benefit regime (endorsement method) split-dollar arrangements will not be treated as premium loans. A premium financing arrangement used to fund large premium payments which otherwise would create taxable gifts is an alternative to private split-dollar arrangements. Premium loans are used to create the cash flow necessary to pay the life insurance premiums, replacing the gifts of the premiums to the life insurance trust or third party owner. The loan is paid back during the insured’s life or from the death proceeds.

Premium financing arrangements are analogous to the old collateral assignment equity split-dollar arrangements. Pre-Final Regulations private arrangements generally were structured as follows. The insured (donor) paid the premiums and the donor/insured and the donee/trust had a collateral assignment in favor of the donor up to the amount of the premiums paid. The donee/trust owned the equity cash value of the policy and paid an annual term premium. Keep in mind that for grandfathered arrangements there are no authorities which have determined whether or not the equity constitutes additional income to the donee/insured and a gift to the donee/trust.\textsuperscript{60}

Under the Final Regulations the premium financing arrangement is taxed under the loan regime.\textsuperscript{61} The insured (or a third party) loans the premiums payments to the

\textsuperscript{59} Treas. Reg. § 1.7872-15(a)(2); Jansen, supra note 48, at 27.

\textsuperscript{60} See Rev. Proc. 2002-8, 2002-1 C.B. 398.

\textsuperscript{61} Treas. Reg. § 1.7872-15(a)(2).
donee/trust, and the insured/donor has a collateral assignment up to the amount of the loan. The donee/trust owns all of the cash value equity in the policy. The donee/trust pays the AFR to the donor/insured. The advantage of the loan regime is that the cash value equity is not subject to income and gift taxes. The disadvantage of the loan regime is that the donee/trust must pay the higher AFR rather than the lower term rate.

There are several other important issues to keep in mind with premium financing arrangements, include the following. First, the loan must be a “real” loan as provided in Treas. Reg. § 1.7872-15(a)(4)(i); certain “sham” interest provisions will be disregarded. Second, if the premium loan involves a variable life insurance policy, using the policy as security for the loan could subject the lender to the margin loan limits and registration requirements of the Federal Reserve Board.62 Third, the arrangement may be subject to the reporting requirement of Regulation U.63 Fourth, there are estate tax issues for loans from family corporations or family partnerships to life insurance trusts; however with properly drafted irrevocable life insurance trusts and entity governing agreements there should be neither any direct incidents of ownership in the insurance policy and, therefore, estate tax inclusion under IRC § 2042, nor any prohibited powers under IRC §§ 2036,2038 and 2041. Fifth, if the insured or another family member loans the premium payments to the trust, as security for loan(s), the arrangement must provide for a collateral assignment against the death proceeds or the policy cash value. Sixth, if

62 12 C.F.R. Section 221.2 et al.

63 12 C.F.R. Section 221.3 et al.
the trust assets are a source of income to pay the note interest, the IRS might argue that
the note is not a bona fide debt; rather it might be construed as a non-qualified retained
interest which is disregarded under IRC § 2702 with the result that the loan proceeds
will be treated as a gift to the trust. In order to avoid the IRC § 2702 problem the trust
should have sufficient additional assets (other than the life insurance policy) to provide
both adequate security for the note payments and sufficient cash flow to make the
required interest and principal payments as they become due. Seventh, with both
private split-dollar and premium financing arrangements an “exit strategy” is needed to
unwind the structure and, under the economic benefit regime (endorsement method),
have the trust purchase the policy from the owner, or, under the loan regime (collateral
assignment method), pay off the lender. This issue is discussed in more detail in Section
1.10 below.

A detailed, technical discussion of premium financing arrangements is provided in
Section 1.8 below.

[7] Critical Planning Note with Respect to Funding the CVBDIT with
Private Split-Dollar and Premium Financing Arrangements

It is absolutely critical that readers keep in mind the following planning points with
respect to funding the CVBDIT with either private split-dollar or premium financing
arrangements. The split-dollar arrangement must be a contributory arrangement,
which means that each year the BDIT must, from its own funds, contribute the
economic benefit portion of the premium. Therefore, initially the trust independently
must be funded with assets sufficient to make these payments. As explained throughout this article, this funding may involve the Inheritor/Beneficiary selling assets for fair market value to the trust for an installment note with guarantees used in place of the traditional 10% “seed money” which usually is gifted to the trust in the traditional note sale to an intentionally defective irrevocable trust (“IDIT”). With the BDIT there never can be any gifts (intentional or unintentional) to the trust by anyone other than the initial $5,000 gift to the trust by the original settlor. Gifts to the BDIT (intentional or unintentional) by anyone other than the original settlor will destroy the tax planning build into the BDIT. As an alternative, consider initially funding the BDIT by means of an independent loan from the Inheritor/Beneficiary on an interest accrued basis. In a private premium financing arrangement, the arrangement must accrue interest at the AFR and pay the accrued interest with the principal at the end of the term so that the Inheritor/Beneficiary is not deemed to have made a gift to the trust. In either case, it is absolutely critical that the arrangement is structured so that the Inheritor/Beneficiary never is deemed to have made a direct or even an indirect gift to the trust.

1.3 **Technical Analysis of Split-Dollar Arrangements**

[1] Introduction to the Final Split-Dollar Regulations
The final Treasury Regulations\textsuperscript{64} (sometimes hereinafter referred to as the “Regulations”) governing split-dollar arrangements were issued on September 12, 2003, and became effective on September 18, 2003. These Regulations provide a detailed set of rules applicable to new split-dollar arrangements entered into after September 17, 2003 and split-dollar arrangements that were created on or before September 17, 2003 that are “materially modified” after September 17, 2003. The Final Regulations set forth detailed and complex rules governing (i) the definition and taxation of split-dollar arrangements, provide guidance on the issues of what constitute an arrangement “entered into” (which may be applied to determine whether an arrangement was “entered into” before January 28, 2002, for purposes of Notice 2002-8\textsuperscript{65}, which doesn’t define that term under the Notice) before the effective date of the Final Regulations, and (ii) what might (or might not) be a “material modification” to a pre-Final Regulation arrangement – technically, what would not be considered a material modification.

[2] Effective Date

The Final Regulations apply only to split-dollar life insurance arrangements entered into after September 17, 2003, or “materially modified” thereafter. For these purposes, an arrangement is “entered into” on the latest of:

\textsuperscript{64} Treas. Regs. §§ 1.61-22, 1.83(e), 1.83-6(a)(5), 1.301-1 (q) and 1.7872-15.

\textsuperscript{65} Id.
1) the date the policy subject to the arrangement is issued;

2) the effective date of the policy subject to the arrangement;

3) the date the first policy premium is paid;

4) the date the parties enter into the agreement; and

5) the date the arrangement satisfies the definition of a split-dollar arrangement. The result of this provision will be to postpone the date on which an arrangement can be considered as “entered into.”

The Regulations also apply to any arrangement which is “materially modified” after September 17, 2003. The Regulations contain a “non-exclusive” list of non-material modifications; however, given the nature of the items listed, it appears that only minor, ministerial changes will fall within the definition. For example, permitted modifications include a change from monthly to quarterly premiums, a change required to permit the policy to continue to qualify as life insurance, or a change in the interest rate for a policy loan. The only “substantive” item on this list is a non-discretionary change made pursuant to a binding commitment between the parties. The Explanation to the Regulations also exempts any change made solely to comply with the safe harbor provisions of Notice 2002-8. Given the fact that the preamble to the first set of Proposed Regulations requested comments on whether an IRC § 1035 exchange of the policy should be considered a material modification, its absence from the list of non-material changes and the nature of the other items indicates a policy exchange could be
considered a material modification. In fact, it has been reported that the omission was intentional; Treasury was apparently worried about “creative” policy designs they could not anticipate.

As noted above, for those arrangements entered into before the effective date of the Final Regulations (and not materially modified thereafter), prior law, as provided in Notice 2002-8, will govern. The basic rulings which have traditionally governed split-dollar arrangements were revoked, as of September 18, 2003, as obsolete; taxpayers can, however, continue to rely on their provisions, as provided in Notice 2002-8 for pre-Final Regulation arrangements.

[3] Split-Dollar Arrangements Defined

The Regulations define a split-dollar arrangement as one between an “owner” and a “non-owner” of a life insurance contract, pursuant to which either party pays all (or a part) of the premiums on the policy, at least one party is entitled to recover all or a portion of those premiums, and the recovery is to be made from or is secured by the proceeds of a policy. Reverse split-dollar arrangements probably do not fall within this definition, since, typically, neither party’s interest is characterized as a return of premiums; accordingly, Notice 2002-59\(^\text{66}\) remains the authority on those arrangements.

\(^{66}\) 2002-2 C. B. 481
Loans used to pay premiums that are secured by the policy (premium financing arrangements) are included in this broad definition, although, in most cases, as long as interest is paid at the AFR, or the parties are not related, the general tax rules governing loans, and not the special split-dollar loan rules, will apply. However, as described below, there are special rules for loans which provide for adequate interest where the lender is “to pay” the interest to the borrower, and special documentation requirements for non-recourse loans, both of which could apply to third party lender transactions.

[4] The Two Mutually Exclusive Regimes

The Regulations provide two mutually exclusive regimes for taxing split-dollar arrangements entered into (or materially modified) after September 17, 2003 – either the so-called economic benefit regime\(^{67}\) or the so-called loan regime.\(^{68}\) The distinguishing criteria to determine the appropriate regime is the ownership of the policy: “Generally, the loan regime (collateral assignment method) will be used when a donee is the owner of the insurance contract. Conversely, the economic benefit regime (endorsement method) will be applied if the donor is the owner of the insurance contract.”

\(^{67}\) Found generally in the Regulations under IRC § 61.

\(^{68}\) Found generally in the Regulations under IRC § 7872.
The Regulations provide guidance on the taxation of both equity and non-equity split-dollar arrangements, and, by their terms, apply for purposes of federal income, employment and gift taxes. The Regulations specifically analyze three types of split-dollar arrangements: employment related arrangements; corporate shareholder arrangements; and donor/done arrangements. Partner/partnership split-dollar and other variations of split-dollar arrangements are not specifically addressed, but the Regulations appear to be drafted to apply to all types of arrangements which meet their broad definition. For purposes of the Cash Value BDIT transaction, the important issues are those regarding federal income and gift taxation and the analysis of donor/donee split-dollar arrangements.

[5] Policy Ownership

Under the Final Regulations which regime will apply to an arrangement will be dependent solely on which party owns (or is treated as if it owns) the policy.

The Regulations provide detailed guidance on how to determine which party owns the life insurance contract, but the Regulations “reserve” the issue of ownership of a policy by a partnership. In general, the person named as owner in the contract is treated as the “owner” for these purposes. If there are true co-owners of a policy (as shown on the policy), such as with a joint-survivorship policy, then, subject to an anti-abuse rule where there is any sharing of interests in the policy, if each co-owner holds all of the rights in its undivided interest in the policy, each co-owner is essentially treated as owning a separate policy (which would not be treated as subject to a split-dollar
arrangement); otherwise the first listed party is the owner. For shared ownership arrangements, the order of listing of the owners will give the parties a choice of which regime to use. A non-owner is any person other than the owner who or which has any direct or indirect interest in the contract.

Under a special rule, any non-equity arrangement (one providing for repayment of the full cash value to the premium provider) involving a donor/donee split-dollar arrangement, will treat the donor as the policy owner for these purposes, regardless of actual policy ownership, meaning that these types of collateral assignment arrangements always will be governed by the economic benefit regime. If such an arrangement is “modified,” the Regulations provide that if the donor is not the actual owner of the policy (as would be the case in a collateral assignment arrangement), the donor is treated as having transferred the policy to the donee, with the tax consequences relating to policy transfers described below. The Regulations specifically provide that a change from non-equity to an equity arrangement will be a modification for this purpose; whether a “replacement” of the arrangement with a split-dollar loan would be a “modification” is not clear.

However, despite these rules relating to ownership of policies, the Explanation to the Regulations provides that a gratuitous transfer of a policy to a third party (such as an irrevocable life insurance trust) will continue to be determined under general gift tax theories, regardless of who is treated as the policy owner under the Regulations, and that inclusion of policy proceeds in an insured’s gross estate will continue to be
determined under IRC § 2042, presumably, regardless of who is treated as the policy owner under the Regulations.


The loan regime\textsuperscript{69} generally applies under a split-dollar arrangement when the non-owner makes a payment directly or indirectly to the owner that a “reasonable person” would expect to be repaid and which is to be made from or secured by a policy, and, accordingly, would typically apply to collateral assignment arrangements. The economic benefit regime, the traditional split-dollar concept regime\textsuperscript{70}, applies to a split-dollar arrangement that is not a split-dollar loan, and generally will govern the taxation of endorsement arrangements. In addition, as discussed above, because the donor is deemed to be the owner of the policy in those non-equity split-dollar arrangements, the economic benefit regime will apply to those arrangements regardless of policy ownership. Finally, another special rule, which seems repetitive, requires the economic benefit regime to apply to a donor/donee arrangement if the donor is the owner (or is treated as the owner) of the policy.

1.4 The Economic Benefit Regime – Applicable Generally to Endorsement Arrangements (and to Narrowly Defined Non-Equity Collateral Assignment Arrangements)

\textsuperscript{69} Described in detail below at Section 1.5.
\textsuperscript{70} Described in detail below at Section 1.4.
[1] Introduction

For a split-dollar arrangement taxed under the economic benefit regime, the owner (donor) will be treated as providing an annual benefit to the non-owner (donee) in an amount equal to the “value of the economic benefits” (note that the final word in this phrase is intentionally plural) provided under the arrangement, reduced by any consideration paid by the non-owner for the benefits. The value of the economic benefits equals the sum of (1) the cost of current life insurance protection, (2) the amount of policy cash value to which the non-owner has “current access” (as defined in the Regulations, and as discussed below), and (3) any other “economic benefits” not otherwise described that are provided to the non-owner.


The amount of “current life insurance protection” is the total policy death benefit, reduced by (1) the amount payable to the owner, and (2) the value of any policy cash value taxable to the non-owner (or paid for by the non-owner). Thus, because policy equity generally is taxed currently, based on current access to policy values, in order to avoid double taxation of those amounts to the non-owner, it is not included in the calculation of current life insurance protection. The amount of the non-owner’s current life insurance protection will be “multiplied by the life insurance premium factor

\[ \text{multiplier} = \frac{1}{1 + \text{premium factor}} \]

\[ \text{premium factor} = \frac{\text{current policy cash value}}{\text{current life insurance protection}} \]

\[ \text{current policy cash value} = \text{policy cash value} \times \text{current access factor} \]

\[ \text{current access factor} = \frac{\text{current policy cash value}}{\text{total policy death benefit}} \]

71 As discussed in Section [3] below.
designated or permitted in guidance published in the Internal Revenue Bulletin” – presumably, additional tables to be re-published periodically to arrive at the value of the benefit. In a non-equity arrangement, current life insurance protection will constitute the entire benefit provided to the non-owner.

[3] Current Access to Policy Values

In an equity arrangement, in addition to the value of the current life insurance protection, any cash value to which the non-owner has “current access” will be treated as paid to the non-owner by the owner. A non-owner is considered to have “current access” to policy cash values to which (1) the non-owner has a current or future right, and (2) are currently directly or indirectly: either (a) accessible by the non-owner, (b) inaccessible to the owner (as would be the case in a “restricted” controlling shareholder arrangement), or (c) inaccessible to the owner’s general creditors either under the agreement or under applicable law, such as state laws protecting policy values from claims of the owner’s creditors.

Thus, even if the arrangement satisfies the definition of “access” because, for example, the cash value is not accessible by the owner, it will not be treated as having been transferred to the non-owner unless the non-owner is entitled to that cash value (either currently or in the future) under the arrangement, that is, unless it is an equity arrangement.
The Explanation to the Regulations provides that the term “access” is to be construed broadly, and includes any direct or indirect right of the non-owner to make a withdrawal from the policy, borrow against the policy, or totally or partially surrender the policy. In addition, the non-owner has current access if the non-owner can anticipate or assign, pledge or encumber the policy cash value, or if the policy cash value is available to the non-owner’s creditors. Policy cash value is inaccessible to the owner if the owner does not have the full rights to policy cash value normally held by an owner of a policy; policy cash values are inaccessible to the owner’s creditors if those creditors cannot, for any reason (including applicable state creditor protection law), effectively reach the full policy cash value in the event of the owner’s insolvency. This provision will require determining which law applies to the arrangement, and the results will change if that law changes; in addition, it is unclear what this provision means when applicable law exempts only a portion of policy cash values from claims of the owner’s creditors.

The Explanation to the Regulations makes it clear that state creditor protection laws insulating life insurance policies from claims of the owner’s creditors will cause the policy cash values to be treated as currently accessible to the non-owner (on the stated theory that the constructive receipt rules applicable to deferred compensation should apply), assuming the arrangement satisfies the first criteria (i.e., that the non-owner has a current or future right to the policy cash value, that is, it is an equity arrangement).

For this purpose, policy cash values are to be determined without regard to surrender or similar charges (despite the fact that the surrender value is all the non-owner could
actually realize by accessing policy values), and any “artifice or device” used to understated the amount of policy cash values to which the non-owner has current access will be disregarded. Finally, the Explanation (but not the Regulations) notes that in some cases (such as an equity arrangement with a not-for-profit entity\textsuperscript{72}), even if the non-owner does not have “current access” to policy cash values, other Code provisions may require inclusion of those cash values in income at an earlier time, again, on the stated theory that equity split-dollar is a form of deferred compensation.

[4] Valuation Date

Both for purposes of calculating the policy death benefit and the policy cash value, the value as of the last day of the owner’s taxable year will apply, unless the parties agree to use the policy anniversary date as the valuation date (as was suggested in comments to the Proposed Regulations).

[5] Amounts Received Under the Contract

The Regulations provide the general rule that under the economic benefit regime, any amount received under a life insurance contract subject to a split-dollar arrangement, to the extent provided directly or indirectly to the non-owner, is treated as though paid by the insurer to the owner and then by the owner to the non-owner. IRC § 72 will govern taxation of the amount to the owner, and the subsequent distribution from the owner.

\textsuperscript{72} Governed by IRC § 457.
to the non-owner will be governed by the rules determined by the relationship of the parties (e.g., as a gift). The amount treated as distributed to the non-owner under this provision will be the amount deemed to be received by the owner, reduced by amounts included in the non-owner’s income as a result of the arrangement or treated as a gift to the non-owner in a donor/donee situation, or otherwise treated as a distribution to the owner, other than such amounts attributed to current life insurance protection (to the extent such amounts previously have not been used to offset the tax effects of a distribution).

Generally, under IRC § 72 a policy loan is not treated as a policy distribution unless the policy is a modified endowment contract. As to the owner, this rule continues to apply to economic benefit regime arrangements. However, if a non-owner in such an arrangement receives the proceeds of a “specified policy loan”, the proceeds of that loan first will be treated as having been transferred to the owner (again, as a non-taxable policy loan) and, second, then having been transferred from the owner to the non-owner (as compensation, a gift, or whatever result is dictated by the relationship of the parties). A specified policy loan is defined as one with respect to which (1) the proceeds are distributed directly to the non-owner, (2) the non-owner would not be expected to repay, or (3) “the non-owner’s obligation to repay the loan to the owner is satisfied or is capable of being satisfied upon repayment by either party to the insurance company.” Presumably, if loan proceeds received by a non-owner are not received in conjunction with a “specified policy loan,” they will not be treated as an “amount received under a life insurance contract” and, therefore, not automatically treated as a
distribution to the non-owner. For example, it should be possible for an employer to use the proceeds of a policy loan to make a further loan to an employee without having the entire loan principal be treated as compensation.

[6] Other Tax Consequences

The Regulations provide guidance on each party’s “investment in the contract” in economic benefit regime split-dollar arrangements.

Generally, the Regulations indicate that no amount paid by the non-owner of the policy and no amount included in the non-owner’s gross income as an economic benefit will give the non-owner any “investment in the contract” for purposes of IRC § 72 on the theory that only one person can have an investment in a policy. However, the owner will be treated as having an investment in the contract to the extent of its premium payments.

In addition, any amount paid by a non-owner directly or indirectly to the owner for any economic benefit will be includable in the owner’s gross income and the owner’s investment in the contract on the theory stated in the Explanation that the owner is “renting” the death benefit to the non-owner and the contributory amount is “rent.” It also appears that in a donor/donee situation where the donee is a grantor trust for income tax purposes, and the trust is created by the donor, the grantor trust rules of

---

73 Under IRC § 72(e).
74 That is, any contributory amount.
Rev. Rul. 85-13 will apply to disregard this income. Even if the donee is not a grantor trust, it is difficult to see how income will be generated in such a non-compensatory relationship.

Finally, as the prior split-dollar rulings have held, the Regulations provide that no premium payment and no economic benefit includable in the non-owner’s gross income is deductible by the owner unless the policy is transferred by the owner and the policy cash value is then includable in the transferee’s income.


The Final Regulations essentially provide that the policy death benefit proceeds will be excluded from the income of the owner and non-owner only to the extent the payment “matches” the manner in which the death benefit was allocated for purposes of calculating the current life insurance element of the economic benefit. However, the non-owner’s share will be excluded from income under IRC § 101 only to the extent the non-owner actually paid for or actually took into account that portion of the benefit. In an equity arrangement, to the extent payment to the non-owner represented “equity,” it will not be excluded from income under IRC § 101. 75 However, the non-owner’s basis in that equity (as a result of the non-owner having been taxed on it) will offset that income. Nevertheless, in spite of these provisions, the Regulations do not purport to amend either the IRC § 101 or the § 72 Regulations.

75 As provided in the Regulations.
Transfers of the Policy

The Regulations provide that a transfer of a life insurance policy, or an undivided interest therein (as defined), from the owner to the non-owner occurs only when the non-owner becomes the owner of the entire contract or the undivided interest. An undivided interest is defined as an “identical fraction or percentage interest or share in each right, benefit, and obligation of the policy.” Unless and until ownership of the contract is changed in this way, the initial owner will continue to be treated as the owner of the policy and, presumably, the arrangement will continue to be treated as a split-dollar arrangement for all tax purposes.

When a policy, or undivided interest in a policy, is transferred by an owner to a non-owner, for all tax purposes the owner and non-owner must take into account the excess of the fair market value of the life insurance policy, over the sum of (1) the amount paid by the non-owner to obtain the policy, and (2) to the extent not previously applied for tax purposes, the economic benefit of the arrangement actually taken into account by the parties, or paid for by the non-owner, but specifically excluding the current life insurance element of the economic benefit. For this purpose, the fair market value of a policy generally is determined by its cash value (here, the Regulations use the phrase “cash value,” without the word “surrender,” presumably intentionally, but without comment or explanation) plus the value of all other rights under the policy (whether or not guaranteed) – whatever those are – other than current protection.
The IRC § 83 and §301 Regulations were amended to include this provision for transfers of policies subject to split-dollar arrangements in those contexts; the Proposed Regulations would have applied this rule to all transfers of policies (whether or not subject to a split-dollar arrangement) under IRC §§ 83 or 301. However, for gift tax purposes, the normal gift tax rules\textsuperscript{76} will continue to define the fair market value of policies for gratuitous transfers; note that this rule explicitly is not applicable if, because of the unusual nature of the policy, the reserve doesn’t approximate replacement cost. These policy transfer rules will apply only to transfers of policies under arrangements entered into after September 17, 2003.

1.5 The Loan Regime – Generally Applicable to Collateral Assignment Arrangements

Under the loan regime, the owner (donee) is treated as the borrower and the non-owner (donor) is treated as the lender under a split-dollar loan arrangements. If a payment is made directly or indirectly by the non-owner to the owner, and if the payment is a loan under general principles of federal tax law (or even if it is not, if a reasonable person would expect the payment to be repaid in full to the non-owner), and the repayment is to be made from or secured by either the policy’s death benefit or its cash surrender value, then the payment creates a split-dollar loan. The Regulations specifically provide that even if, in the early years of

\textsuperscript{76} Treas. Reg. § 25.2512-6(a), which uses the traditional “replacement cost” rule, based on the interpolated terminal reserve formula.
the arrangement, the cash value of the policy is less than the cumulative loans, so long as a reasonable person would expect the loan to be repaid in full, the non-owner’s payment creates a split-dollar loan.

If a payment made under a split-dollar loan is non-recourse (as most are), the Regulations treat the loan as a loan that provides for contingent payments (increasing the complexity of calculating the tax consequences and testing for the adequacy of interest), unless the parties to the arrangement provide a written representation with respect to the loan that indicates that a “reasonable person” would expect all payments under the loan to be made. The phrase “non-recourse” is not defined in the Regulations – it is not, for instance, clear if a recourse loan to a trust with no assets other than the policy would be treated as non-recourse for this purpose.

Subject to future IRS rules, the Regulations require that certain representations must be attached to both parties’ tax returns for each year such a loan is made. As noted above, if a third party loan is determined to be non-recourse, this requirement will need to be complied with to avoid treating the loan as one that provides for contingent payments.

The provisions of IRC § 7872 that will apply to a split-dollar loan arrangement are summarized above. In general, the results of the below market interest provisions of the Regulations applicable to split-dollar loans are consistent with IRC § 7872 and the Proposed and Temporary Regulations issued thereunder, although there are some important differences. For instance, the compensation and gift loan de minimus rules of IRC § 7872 will not apply to split-dollar loans, and loans payable at death, which would have been term loans under IRC § 7872, will be hybrid loans under the split-dollar Regulations.
The Regulations provide that the borrower cannot deduct interest on a split-dollar loan,77 and that no amount received by the lender as a loan repayment at the death of the insured is excludable from the lender’s income under IRC § 101. In addition, the Regulations make it clear that if the effect of a split-dollar loan is attributable to the relationship between either the lender or the borrower and a third party, the indirect below market split-dollar loan will be structured as two or more successive (back-to-back) below market loans, each with its own tax (income or gift) consequences.

Split-dollar demand loans initially are defined in the Regulations as only those payable on demand of the lender; split-dollar term loans are all other split-dollar loans.

Consistent with IRC § 7872, for a split-dollar demand loan, the foregone interest is treated as having been paid, and repaid, annually, measured by the (from time to time) short-term AFR. However, for a split-dollar term loan, the present value of the entire foregone interest (measured as the difference between the present value of all payments to be made under the loan and the amount of the loan) is treated as having been paid, and repaid, on the day the loan is made – that is, all up-front. The AFR for the term of the loan is used to measure the present value of the payments to be made under the loan. There are a series of rules in the Final Regulations for determining the “term” of a split-dollar term loan; generally it is the maturity date. However, if there are options exercisable under the loan, the exercise or non-exercise of which could affect the yield and/or the term, the parties are deemed to exercise, or

77 Because of IRC §§ 163 and 264.
not exercise, the options in a manner that produces the smallest yield and, if the yield is the same, the longest term.

The Regulations reclassify two types of split-dollar term loans as what could be called “hybrid” term/demand loans. These types of loans include split-dollar loans payable on the death of an individual (or last survivor of a group of individuals). These “hybrid” loans are treated as split-dollar term loans for purposes of determining whether the loan provides for a sufficient interest; however, if it does not, the foregone interest is treated as transferred and retransferred annually, like a split-dollar demand loan. The rate used to determine the amount of foregone interest on such a hybrid loan each year is the AFR, based on the term of the loan, rather than the blended annual short-term rate.

Gift term loans also are treated as demand loans under similar rules; however, this rule only applies for income tax purposes and not for gift tax purposes. This means that in every case they will be impractical. Apparently, the same is true for the gift element in hybrid loans under the Regulations (those payable at death), also making them impractical.

Special rules apply to loans payable at an individual’s death which treat the loan as reissued as a demand loan if the original term is exceeded. However, split-dollar term loans payable at the later of a term certain or death of an individual or at the later of a term certain or termination of employment do not receive this special treatment.

The most significant provision of the Regulations relating to split-dollar loans is the one that disregards stated interest on a loan if “all or a portion of the interest is to be paid directly or
indirectly by the lender (or a person related to the lender).” The most troublesome aspect of this rule is that there is no apparent provision that would exclude the lender’s payment of the borrower’s interest obligation from the borrower’s income, so that the borrower appears to be taxed on both the imputed income under IRC § 7872 and the actual income from the bonus arrangement – an implausible result.

A “facts and circumstances” test will be used to determine if the interest is “to be paid” by the lender; unfortunately, there is no definition in the Regulations of the phrase “to be paid.”

In addition, although not described in these examples, in a donor-donee arrangement, if the facts and circumstances show that the donor intended “to pay” the interest to the donee (as a gift), as is common in donor-donee premium financing arrangements, the loan will become subject to IRC § 7872. It is unclear how a less formal arrangement might be treated, such as one in which a donor makes occasional gifts to the donee of the interest due or one or more larger gifts which are unrelated to the interest due.

The other significant new provision of the Regulations applicable to split-dollar loans treats stated interest that is waived or forgiven by the lender as transferred from the lender to the borrower and back to the lender (as interest) from the borrower (as would be expected), but this amount is increased by a deferral charge, which is equal to the underpayment of tax interest penalty, and which also is treated as transferred and retransferred between the borrower and the lender.

78 Converting it to a loan governed by IRC § 7872.
1.6 Planning for Post-Final Regulation Arrangements

[1] Introduction

Planning for post-Final Regulation split-dollar arrangements will have to begin 1) by deciding whether to measure the ongoing benefit provided by the arrangement under the economic benefit regime (measuring the benefit by term costs) or under the loan regime (measuring the benefit by the foregone interest), and then, 2) by deciding whether to try to give the employee or donee an interest in policy cash values without tax.

Generally, for younger insureds and for survivorship policy arrangements, the economic benefit regime will be preferable (at least initially), while in the current, historically low interest rate environment, the loan regime will be preferable for older insureds with single life policies. Where providing an interest in policy cash values to the donee without tax is important, only the loan regime will allow the employee or donee to have an interest in the cash values without tax. However, unlike the economic benefit regime, the loan regime will treat each premium payment as a new loan, with a new interest rate, determined at the time each premium is paid. In addition, the benefit under the loan regime is cumulative, meaning that the combined interest on all outstanding loans will be the measure of each year’s benefit.

When an economic benefit arrangement becomes uneconomic (for instance, at the first death in a survivorship arrangement), conversion to a split-dollar loan or replacement
with a premium financing arrangement could be considered. If the arrangement is a non-equity collateral assignment arrangement, whether that conversion will be a modification of the arrangement which will treat the policy as having been transferred to the donee (and the potential tax consequences of that transfer) will have to be taken into account. However, even if such a change were considered a modification treated as a transfer of the policy, the note given by the employee or donee should off-set any taxable transfer.

**Critical Planning Point** – As stated in Section 1.2[8] supra, with either private split-dollar or premium financing arrangements it is absolutely critical that readers keep in mind the following planning points with respect to funding the CVBDIT. The split-dollar arrangement must be a contributory arrangement, which means that the each year the BDIT must, from its own funds, contribute the economic benefit portion of the premium. Therefore, initially the trust independently must be funded with assets sufficient to make these payments. As explained throughout this article, this funding may involve the Inheritor/Beneficiary selling assets for fair market value to the trust for an installment note with guarantees used in place of the traditional 10% “seed money” which usually is gifted to the trust in the traditional note sale to an intentionally defective irrevocable trust (“IDIT”). With the BDIT there never can be any gifts (intentional or unintentional) to the trust by anyone other than the initial $5,000 gift to the trust by the original settlor. Gifts to the BDIT (intentional or unintentional) by anyone other than the original settlor will destroy the tax planning build into the BDIT. As an alternative, consider initially funding the BDIT by means of an independent loan
from the Inheritor/Beneficiary on an interest accrued basis. In a private premium financing arrangement, the arrangement must accrue interest at the AFR and pay the accrued interest with the principal at the end of the term so that the Inheritor/Beneficiary is not deemed to have made a gift to the trust. In either case, it is absolutely critical that the arrangement is structured so that the Inheritor/Beneficiary never is deemed to have made a direct or even an indirect gift to the trust.


Once that initial decision has been made, for arrangements where economic benefit treatment is desired, the next decision will be whether the arrangement should be structured as an equity or a non-equity arrangement.

[a] Non-equity Arrangements

If the arrangement is a donor/donee non-equity arrangement, it can be documented under the collateral assignment method and the economic benefit regime will be used to measure the benefit to the donee. Since the Regulations calculate policy equity for this purpose disregarding policy surrender and other similar charges, as well as any other device used to minimize cash values, the arrangement will have to provide that the donor will be entitled to the greater of its premium advances or the policy cash value, disregarding surrender of other similar changes. However, since this will be a non-equity arrangement, a rollout using only policy values isn’t possible; a rollout will require funds of the owner
not derived from the policy. This means that third party arrangements will require early and, hopefully, leveraged trust funding to allow for a rollout when economic benefits are no longer advantageous. This will increase the gift tax “cost” of third party split-dollar arrangements, compared to pre-Final Regulation arrangements.

[b]   Equity Arrangements

On the other hand, if the arrangement is an equity arrangement, or if it is other than a private arrangement, the donor, or other premium provider will have to be the actual owner of the policy and the arrangement will need to be documented under the endorsement method in order to use the economic benefit regime. However, given the extremely broad definition of the phrase “access” in the Final Regulations for equity arrangements, it is not likely that many post-Final Regulation equity arrangements will be planned so that they will be taxed under the economic benefit regime, especially those that are third party owned, and, perhaps, they only will make sense when the donee is given actual, current access to pay the tax out of policy values. That is, even if the donee’s actual access to the policy cash values in a post-Final Regulation equity endorsement arrangement is restricted, and even if the donor’s access to policy cash value is not restricted, the fact that state creditor protection law will prevent the owner’s creditors from accessing the policy cash values (as is true to some extent in nearly every state), then so long as the donee ultimately will be
entitled to that cash value, this will be enough to provide the donee with current “access” to the equity under the Regulations, taxing the donee on the equity on a current basis. In addition, there are the non-tax issues to consider relating to the use of the endorsement method such as exposure of the policy to the owner’s creditors, subject to state law.

[c] Other Tax considerations

However, under the Final Regulations, in an endorsement economic benefit regime arrangement, there are a number of additional tax consequences that need to be considered. In the first place, any amount received under the life insurance policy by the donee during the arrangement is treated as though paid by the insurer to the donor and then re-transferred to the donee either as income or a gift, preventing tax-free access to policy cash values by the donee in the form of policy loans or withdrawals.

In another change from prior law, the Regulations provide that any amount contributed under an economic benefit regime arrangement by the donee is taxable to the donor and is not included in the donee’s investment in the contract. This issue will have to be taken into account before deciding to use the contributory approach for post-Final Regulation endorsement arrangements. As discussed above, however, in a donor/donee arrangement, since there is no compensatory element to the relationship, it seems that the income creation rule for contributory arrangements should not apply, and in a grantor trust
arrangement (such as the Cash Value BDIT), cannot apply. Finally, in another change from prior law, the Regulations provide that the donee’s beneficiary will receive the life insurance proceeds to which they are entitled under the arrangement income tax free under IRC § 101 only to the extent the donee either paid for or took the economic benefit cost of the arrangement into income. Thus, parties will have to be careful with the tax reporting of split-dollar arrangements, so that, for example, an employee does not fail to include the economic benefit in his or her income, risking loss of the ultimate tax-free receipt of his or her share of the death benefit.

Finally, the Regulations provide that in an endorsement arrangement, if the policy or an undivided interest in the policy is transferred from the donor to the donee, the transferee has to take into income the fair market value of the life insurance policy, reduced by any amount paid by the transferee to obtain the policy and any equity on which the transferee had previously been taxed. For purposes of this provision, the fair market value of the policy is determined by its cash value (apparently not its cash surrender value) plus the value of “all other rights” under the policy which are not reflected in policy cash values (whatever those are), and amounts paid for insurance protection are ignored.
However, if the transfer is by gift, the usual interpolated terminal reserve formula approximation of replacement cost as provided in the IRC § 2512 Regulations will govern the fair market value of the policy.79

[3] The Loan Regime

If, on the other hand, it makes sense to initially measure the benefit from the arrangement by interest rates rather than term costs, or, if providing access to policy cash values to the donee without tax is critical, then the arrangement should be treated initially under the loan regime. This will require using a collateral assignment, equity split-dollar arrangement, a loan arrangement which states adequate interest (paid annually or accrued and paid with the loan principal) or an interest-free loan arrangement. As noted above, even for arrangements initially treated under the economic benefit regime, at some point a switch to the loan regime may make sense such as when economic benefits are no longer advantageous and/or when policy cash values begin to exceed the cumulative premiums advanced; again, note the “modification” issue in any such switch.

If the parties expect that the borrower will use the borrower’s own funds to actually pay interest, then in any arrangement in which the parties want loan treatment, the first choice likely will be to use a loan which provides for adequate interest (based on the applicable federal rate), either paid annually, or, if it makes economic sense to do so,

79 Subject to the exception described above.
accrued and paid with the principal at the insured’s death or other term of the loan. If the loan provides for interest to be accrued, while there will be no tax consequences to the borrower, the lender will have interest income annually, under the original issue discount rules, and over time, the loan principal plus accrued interest will become more and more of the policy death benefit, leaving less for the policy beneficiary. This arrangement has the economic effect of a non-equity arrangement in returning more of the death benefit to the premium provider. This especially is an issue in a donor-donee arrangement, since those increased values will be includible in the donor’s estate.

However, even those split-dollar loans that state adequate interest are still subject to certain provisions of the Regulations which are applicable to split-dollar loans. For example, as noted above, if the loan is non-recourse (an undefined term), the parties will have to attach statements to their respective tax returns each year a loan is made under the arrangement, to prevent the loan from being treated as providing for contingent payments under the IRC § 7872 rules. The parties to a split-dollar loan which provides for adequate interest will want to avoid that risk by attaching those statements. In addition, as discussed, if interest on a split-dollar loan that provides for adequate interest is forgiven by the lender, the forgiven interest will be taxed and a deferral charge will apply.

80 Unless the lender was the grantor of the grantor trust which was the borrower, based on the concepts of Rev. Rul. 85-13, supra.
For any loan in which interest is stated and the parties either expect that the lender may provide the funds for the interest or regularly forgive interest payments, the parties risk triggering the new provision of the Regulations applicable to split-dollar loans that treats a loan where interest is to be paid at the applicable federal rate as a below market loan, subject to IRC § 7872. As discussed above, there is no definition of the phrase “to be paid,” and the Final Regulation indicate that a facts and circumstances test will be used to determine whether the parties intended that the lender pay (was “to pay”) the interest to the borrower. As also noted above, perhaps the most troubling aspect of that provision is that in a gift context, the lender will have made a gift of the interest and also will have made a gift loan under IRC § 7872. While gifts unrelated to the interest arguably should not trigger this provision, it will be a facts and circumstances test.

[a] Hybrid Loans

Accordingly, to avoid the risks stated above, rather than use a loan that states interest, it might make sense to use one of the two types of “hybrid” IRC § 7872 loans provided in the Regulations, as described above. By using either a below-market interest compensatory term loan or a below market interest loan repayable at the insured’s death, the parties will be able to lock-in an interest rate (an advantage in times of low interest rates), but the deemed payment and repayment of interest will occur annually, requiring testing for the adequacy of interest once, at the outset, and treating the imputed interest as transferred on
an annual basis. The other type of hybrid loan, a gift term loan, will not be useful, because it will be treated as a “true” term loan for gift tax purposes, bunching the gifted interest over the term of the loan in the initial year of the loan on a present value basis. In addition, as noted above, the gift element of either of the hybrid type loan arrangements described above likely will not receive hybrid treatment for gift tax purposes, making them impractical as well.

In fact, it may be that using one of those two types of “hybrid” term loans will make more sense for income tax (but not gift tax) purposes than using a loan which provides for adequate interest. For a loan which provides adequate interest that is paid annually, in addition to avoiding the risk of having it treated as a below market loan because the lender is “to pay” the interest, or having a deferral charge apply if the lender were to forgive the interest, as discussed above, the interest actually will need to be paid each year, on a non-deductible basis. For either of the “hybrid” term loans described above, no interest payments need to be made, the interest rate will be locked-in for the expected term of the loan, and the interest will be treated as transferred annually. In addition, it will be cheaper for the borrower to be taxed on the interest rather than paying it on an after-tax basis.

[b] Additional Loan Regime Issues
In addition to measuring the benefit to the donee by the foregone interest and avoiding any issue as to the taxation of policy cash values for the policy owner, using the loan regime has other consequences which must be considered.

In the first place, as noted above, each year’s premium advance is a separate loan, with its own interest rate (fixed or variable), so that over time interest is being paid on, is accruing on, or is being taxed based on all of the cumulative premiums advanced. Under the economic benefit regime, the benefit is measured by term costs, which are premium-insensitive and non-cumulative. Secondly, except in a grantor trust arrangement (such as the Cash Value BDIT), the lender will have interest income from the arrangement, either actually received, treated as received under the OID rules, or treated as retransferred from the borrower. Only in a compensation-related arrangement will the lender have an offsetting compensation deduction. In addition, while term costs are predictable (since they are based on published tables), the interest rate on existing demand loans or on future term loans will depend on the general level of interest rates in the future. Finally, interest in a loan regime is paid to the lender and is not added to the policy.

[4] The Decision Tree

Going forward, the choices clients and their advisors will have to make in deciding how to use split-dollar arrangements are shown in the following Decision Tree.
Exhibit D
DECISION TREE FOR POST-FINAL REGULATION SPLIT-DOLLAR ARRANGEMENTS
To Measure the Benefit By:

Term Costs
Use Economic Benefit Regime

Equity Arrangements

Premium Provider entitled to premiums advancement

Non-Equity Arrangements

Premium provider entitled to greater of premiums advanced or cash value

Endorsement arrangements

Donor - Donee Collateral Assignment Arrangements

Other Endorsement Arrangements

Term costs currently taxed, unless contributed (contribution is income to premium provider unless an Inheritor / Beneficiary Trust)

Term costs currently taxed, unless contributed (contribution is income to premium provider unless an Inheritor / Beneficiary Trust)

Interest is forgiven for principal at term, reducing the death benefit

Interest is treated as transferred / retransferred annually

Interest is treated as transferred / retransferred annually; note the issue of whether these are gift term loans for gift tax purposes.

Interest Rates
Use Loan Regime

Loans with AFR Interest

Interest paid annually

Interest Accrued

The lender has annual interest income

Short term AFR, changes annually

AFR fixed for term of loan

Below Market Interest Loans

Demand loans

Term loans

Hybrid loans

Gift term loans

Loans payable at the insured’s death

AFR fixed for term of loan

Interest is treated as transferred / retransferred annually, for income, but not gift tax purposes.

Term costs currently taxed, unless contributed (contribution is income to premium provider unless an Inheritor / Beneficiary Trust)

Equity taxed currently based on access, surrender charges ignored

©2010 Larry Brody
All Rights Reserved.

Used by Permission.
1.7 Illustration of How to Structure a Successful CVBDIT Split-dollar Arrangement - PLR 200910002

The IRS has been fairly generous to taxpayers when ruling on the consequences of both pre and Final Regulation private split-dollar arrangements. Of particular importance is recently issued PLR 20091002 which provides planners with a detailed illustration of how to structure a successful private split-dollar arrangement between an insured and an irrevocable trust such as the CVBDIT. In the PLR the IRS ruled that the payments by the grantors of an irrevocable life insurance trust of part of the premiums on a second-to-die life insurance policy held by the trustee were not taxable gifts as a result of a family split-dollar arrangement between the grantors and the trust. The ruling also held that the grantors held no incidents of ownership over the trust’s policy. Therefore the only portion of the proceeds that would be included in the grantors’ gross estates would be the amount actually payable to the estate of the survivor as an amount receivable by an executor under IRC § 2042(1). The following is a detailed summary of PLR 20091002; the facts of this ruling easily can be adjusted to the CVBDIT strategy.

Settlor A and Settlor B, who were married, created an irrevocable trust (the “Trust”) under the terms of which the trustee was required to distribute trust income annually to a class of beneficiaries consisting of the Settlors’ living issue (but excluding their children). Each member of the class was given a non-cumulative power to withdraw their share of any contributions to

---

81 See supra note 38.
the Trust. The trustee also was given the discretion to distribute trust corpus to a member of the class to provide for the beneficiary's health, education, support, and maintenance. If a member of the class died survived by issue, the surviving issue became members of the class. The Trust was to terminate on the later of the death of the last surviving Settlor, or when the number of class members equaled 40. In no event was any trust established under the Trust instrument extended beyond the applicable rule against perpetuities. Upon termination, the corpus was to be divided into as many equal shares as there were then living children of the Settlors and deceased children of the Settlors who left issue then surviving.

Each share created on account of a living or deceased child of the Settlors was to be further divided into as many equal shares as there were then living children of the said child and deceased grandchildren who left issue then surviving. Each share created for a grandchild that was age 35 at termination was be distributed outright. If a grandchild was not age 35, then the share was to continue in trust for the grandchild. If a deceased grandchild was survived by issue, then the grandchild's share was to be distributed outright, per stirpes.

The terms of the Trust specifically precluded either Settlor from acting as a trustee. Further, the Settlors retained no powers or authority over the Trust, Trust property, or the administration of the Trust.

The Trust purchased a second-to-die life insurance policy on the lives of Settlor A and Settlor B and proposed to enter into a split-dollar life insurance agreement (the “Agreement”) with the Settlors. Under the Agreement, during the joint lives of the Settlors the Trust was to continue to own the policy and pay an amount equal to the insurance company’s current published
premium rate for annually renewable term insurance generally available for standard risks. After the death of the first Settlor, the Trust was to pay an amount equal to the lesser of: (i) the applicable amount provided in Notice 2001-10, 2001-1 C.B. 549, or subsequent IRS guidance; or (ii) the insurer's current published premium rate for annually renewable term insurance generally available for standard risks. The Settlors were required to pay the balance of the premiums.

Under the Agreement, the Trust collaterally assigned the following rights to the Settlors: (i) if the Agreement terminated on the death of the survivor of Settlor A and Settlor B, then upon the death of the survivor, the right of the survivor's estate to receive the greater of the cash surrender value of the policy or the cumulative premiums paid by the Settlors; and (ii) if the Agreement terminated during the lifetime of Settlor A and Settlor B, or the lifetime of the survivor, then within sixty (60) days of termination, the right to receive from the Trust an amount equal to the greater of the cash surrender value of the policy, or the premiums paid by Settlor A and Settlor B, to the extent the Trust had other assets. Under the Agreement, all incidents of ownership over the policy (including the sole right to surrender or cancel the policy, and the sole right to borrow or withdraw against the policy) were vested in the Trustees of Trust.

The IRS was asked to rule on two issues: (i) whether the payments by Settlor A and B of the premiums pursuant to the Agreement would result in a gift or a deemed gift to the Trust by Settlor A and B under IRC §§ 2501 and 2511; and (ii) whether the insurance proceeds payable to the Trust would be includible in the gross estate of either Settlor A or B under IRC § 2042.
As to the first issue, the IRS ruled as follows. Treas. Reg. § 1.61-22(b)(1) provides that a split-dollar life insurance arrangement is any arrangement between an owner and a non-owner of a life insurance contract that satisfies the following criteria: (i) either party to the arrangement pays, directly or indirectly, all or any portion of the premiums on the life insurance contract, including a payment by means of a loan to the other party that is secured by the life insurance contract; (ii) at least one of the parties to the arrangement paying premiums is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract; and (iii) the arrangement is not part of a group-term life insurance plan described in IRC § 79.

Treas. Reg. § 1.61-22(b)(3)(ii)(B) provides that § 1.61-22(d) through (g) applies (and § 1.7872-15, addressing split-dollar loans does not apply) to any split-dollar life insurance arrangement where the arrangement is entered into between a donor and a donee (for example, a life insurance trust and the donor is the owner of the life insurance contract (or is treated as the owner of the contract under Treas. Reg. § 1.61-22(c)(1)(ii)(A)(2))].

Treas. Reg. § 1.61-22(c)(1) provides, in general, that with respect to a life insurance contract, the person named as the policy owner of such contract generally is the owner of such contract.

Treas. Reg. § 1.61-22(c)(1)(ii)(A)(2) provides that a donor is treated as the owner of a life insurance contract under a split-dollar life insurance arrangement that is entered into between a donor and a donee (for example, a life insurance trust) if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in § 1.61-22(d)(3).
Treas. Reg. § 1.61-22(d)(1) provides in part, that in the case of a split-dollar life insurance arrangement subject to the rules under § 1.61-22(d) through (g), economic benefits are treated as being provided to the non-owner of the life insurance contract. The non-owner (and the owner for gift and employment tax purposes) must take into account the full value of all economic benefits described in §1.61-22(d)(2), reduced by the consideration paid directly or indirectly by the non-owner to the owner for those economic benefits. Depending on the relationship between the owner and the non-owner, the economic benefits may constitute a payment of compensation, a distribution under IRC § 301, a contribution of capital, a gift, or a transfer having a different tax character.

Treas. Reg. § 1.61-22(d)(2) generally provides that the value of the economic benefits provided to a non-owner for a taxable year under the arrangement equals: (i) the cost of current life insurance protection provided to the non-owner determined under § 1.61-22(d)(3); (ii) the amount of policy cash value to which the non-owner has current access within the meaning of § 1.61-22(d)(4)(ii) (to the extent such amount was not actually taken into account for a prior taxable year); and (iii) the value of any economic benefits not described above provided to a non-owner (to the extent not actually taken into account for a prior taxable year).

Treas. Reg. § 1.61-22(d)(3)(i) provides, in part, that the amount of current life insurance protection provided to the non-owner for a taxable year (or any portion thereof in the case of the first year or the last year of the arrangement) equals the excess of the death benefit of the life insurance contract (including paid-up additions thereto) over the total amount payable to the owner (including any outstanding policy loans that offset amounts otherwise payable to the
owner) under the split-dollar life insurance arrangement, less the portion of the policy cash value actually taken into account under §1.61-22(d)(1) or paid for by the non-owner under §1.61-22(d)(1) for the current taxable year or any prior taxable year.

Treas. Reg. § 1.61-22(d)(3)(ii) provides that the cost of current life insurance protection provided to the non-owner for any year (or any portion thereof in the case of the first year or the last year of the arrangement) equals the amount of current life insurance protection provided to the non-owner [determined under § 1.61-22(d)(3)(i)] multiplied by the life insurance premium factor designated or permitted in guidance published in the Internal Revenue Bulletin.

Treas. Reg. § 1.61-22(d)(4)(ii) provides in part, that for purposes of § 1.61-22(d), a non-owner has current access to that portion of the policy cash value to which, under the arrangement, the non-owner has a current or future right that currently is directly or indirectly accessible by the non-owner, inaccessible to the owner, or inaccessible to the owner's general creditors.

The IRS ruled that under Treas. Reg. § 1.61-22(c)(1)(ii)(A)(2), A and B will not be treated as the owners of the Policy, because under the terms of the Agreement, the only economic benefit that will be provided under the split-dollar arrangement is current life insurance protection. Under the terms of the Agreement, the Trust will pay the portion of the premium equal to the cost of current life insurance protection and Settlor A and B will pay the balance of the premium. Settlor A and/or B (or the estate of the survivor) will be entitled to receive an amount equal to the greater of the policy cash surrender value or premiums paid on early termination or at the death of the survivor. The IRS concluded that the payment of the premiums by Settlors
A and B, pursuant to the terms of the Agreement, will not result in a gift by Settlor A and B under IRC § 2511, provided that the amounts paid by the Trust for the life insurance benefit that the Trust receives under the Agreement is at least equal to the amount prescribed under Notice 2001-10.

The IRS also concluded that, if some or all of the cash surrender value is used (either directly, or indirectly through loans) to fund the Trust's obligation to pay premiums, Settlor A and B will be treated as making a gift at that time.

The IRS expressed no opinion concerning the federal gift tax consequences between A and B of the second-to-die policies.

As to the second issue the IRS ruled as follows. IRC § 2042(1) provides that the value of a decedent's gross estate shall include the proceeds of insurance policies on the decedent's life receivable by the decedent's estate.

IRC § 2042(2) provides that the value of a decedent's gross estate shall include the proceeds of all life insurance policies on the decedent's life receivable by beneficiaries other than the executor of the decedent's estate, to the extent that the decedent possessed at his death any incidents of ownership exercisable either alone or in conjunction with any other person. An incident of ownership includes a reversionary interest arising by the express terms of the instrument or by operation of law only if the value of such reversionary interest exceeds five (5) percent of the value of the policy immediately before the death of the decedent.
Treas. Reg. § 2042-1(c)(2) of the Estate Tax Regulations provides that “incidents of ownership” is not limited in its meaning to ownership of a policy in the technical legal sense. Generally, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy.

The IRS ruled that under Agreement and the collateral assignment, neither Settlor A nor B held any incidents of ownership in the policy. As noted above, all incidents of ownership in the policy, including the power to change the beneficiary, the power to surrender or cancel the policy, the power to assign the policy or to revoke an assignment, and the power to pledge the policy for a loan or to obtain from the insurer were vested in the Trustee of the Trust. Accordingly, the IRS concluded that the proceeds of the policy payable to the Trust will not be included in the gross estate of the second to die of A and B under IRC § 2042(2). The portion of the proceeds payable to the estate of the survivor of A and B will be included in the gross estate of the second to die of A and B under IRC § 2042(1).82

Except as specifically set forth above, the IRS expressed no opinion concerning the federal tax consequences of the foregoing transactions under any other provisions of the Code or Regulations.

1.8 Technical Analysis of Premium Financing Arrangements

[1] Introduction

While the facts of individual situations of premium financing will vary, in a typical transaction, the proposed insured, as grantor, will create an irrevocable life insurance trust to become the owner of a new policy on his or her life (or on the lives of himself or herself and his or her spouse on a survivorship basis). The insurance trust will pay all or a portion of the premium payments due on the policy with funds borrowed from an unrelated third party such as a commercial lender (although in some variations the loan could be from the insured, the insured’s spouse or other family member, or a family business entity such as a FLP or LLC). For purposes of this example, the loan will be from an unrelated third party. The trust will pay interest on the loan, annually in advance, usually with funds received directly or indirectly from the grantor/insured, either as part of the initial trust funding or as annual gifts; the principal of the loan will be repaid at the end of the term of the loan or at the insured’s death. The grantor/insured will guarantee the third party’s loans to the trust and/or pledge assets as security for its loans.

Under a typical variation, the grantor will lend the funds to his or her grantor trust to allow the trust to pay premiums on the policy owned by the trust, with interest paid annually or accrued, in either case at the AFR, and the principal paid at the insured’s death. Keep in mind the complex issues involved if the trust’s interest obligation to the grantor is to be paid, directly or indirectly, by the grantor, under the final split-dollar
Regulations, discussed below. In some transactions, both of the insureds in a survivorship policy will loan the premiums to their trust, and in others, the grantor’s loan will be made with the proceeds of a third party loan to the grantor. Finally, the lender in these situations might be a related entity (such as a controlled corporation or a family limited partnership for family limited liability company) or the grantor’s employer.

**Critical Planning Point** - Throughout the discussion of private premium financing in the following sections of this article, it is absolutely critical that readers keep in mind the following planning points. In a private premium financing arrangement, the arrangement must accrue interest at the AFR and pay the accrued interest with the principal at the end of the term so that the Inheritor/Beneficiary is not deemed to have made a gift to the trust. It is absolutely critical that the arrangement is structured so that the Inheritor/Beneficiary never is deemed to have made a direct or even an indirect gift to the trust.

[2] The Final Split-Dollar Regulations

The final split-dollar Regulations\(^{83}\) define a split-dollar arrangement as one between an “owner” and a “non-owner” of a life insurance contract, pursuant to which either party pays all (or a part) of the premiums and at least one party is entitled to recover all or a portion of those premiums and that recovery is to be made from or is secured by the

\(^{83}\) Treas. Reg. § 1.61-22(b).
proceeds of a policy. Loans used to pay premiums that are secured by the policy (premium financing arrangements) are included in this broad definition, although, in most cases, so long as interest is paid (or accrued) at the AFR, the general tax rules governing loans, and not the special split-dollar loan rules of the Final Regulations, will apply. However, as described below, there are special rules for loans with interest paid at the AFR where the lender is “to pay” the interest to the borrower, where the required interest is forgiven, and special filing requirements for non-recourse loans, all of which could apply to premium financing transactions (especially those where the grantor, his or her spouse, or a controlled entity is the lender).

If a payment made under a split-dollar loan is non-recourse, the Regulations\textsuperscript{84} treat the loan as a loan that provides for contingent payments (increasing the complexity of calculating the tax consequences and testing for the adequacy of interest), unless the parties to the arrangement provide a written representation with respect to each loan that indicates that a “reasonable person” would expect all payments under the loan to be made. The word “non-recourse” is not defined in the Regulations; it is not clear if it is broad enough to mean a recourse loan to a trust with no assets other than a policy. Subject to future IRS rules, the Regulations require that such a representation must be attached to both parties’ tax returns for each year such a loan is made. If a loan is determined to be non-recourse, this requirement should be complied with in order to

\textsuperscript{84} Treas. Reg. § 1.7872-15(j).
avoid treating the loan as one that provides for contingent payments (which increases the AFR needed to avoid the application of § 7872 to the arrangement).

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

Although not set forth specifically in the examples in the Regulations, in a donor-donee arrangement, if the facts and circumstances show that the donor is “to pay” the interest to the donee (as a gift), as is common in donor-donee premium financing arrangements, the loan will be subject to IRC § 7872.

85 Converting it to a loan governed by IRC § 7872.
Thus, it is unclear how a less formal arrangement might be treated, such as one in which a donor makes occasional gifts to the donee of the interest due, or one or more larger gifts which are unrelated to the interest due in a given year (but which are invested and used, over the years, to pay the interest).

The other significant new provision of the Regulations\(^88\) applicable to split-dollar loans which applies to premium financing treats stated interest that is waived or forgiven by the lender as transferred from the lender to the borrower, increased by a deferral charge equal to 3% over the underpayment of tax interest penalty.

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

For any loan in which the parties either expect that the lender will forgive the interest or otherwise may be treated as providing the funds for the interest, if interest is stated, the parties risk triggering the new provision of the Regulations applicable to split-dollar loans that treats a loan where interest is to be paid at the applicable federal rate as a

\(^{88}\) Treas. Reg. § 1.7872-15(h)(iii).
below market loan, subject to IRC § 7872. As discussed above, there is no definition of the phrase “to be paid,” and the Regulations indicate that a facts and circumstances test will be used to determine whether the parties intended that the lender was “to pay” the interest to the borrower. As noted above, perhaps the most troubling aspect of that provision is that in a gift context, the lender will have made a gift of the interest and also will have made a gift loan under IRC § 7872. While compensation or gifts which are clearly unrelated to the interests should not trigger this provision, there is no certainty that they will not, since it will be a facts and circumstances test.

[3] Income Tax Deduction for the Interest Payments

There are two possible hurdles to deductibility of the interest payments. First, under IRC § 264, no deduction is allowed for indebtedness to purchase or carry a life insurance policy if it is part of a systematic plan to borrow all of the cash value of the contract. This rule may be avoided, but to do so will require that means other than loans be used to fund a substantial portion of the premium payments in the early years of the policy, which may reduce the attractiveness of the strategy.

The other, and possibly more significant hurdle, is that under IRC § 163 no deduction is allowed for personal interest. The deduction will be allowed only if the interest qualifies as investment interest,89 and then it will be allowed only to the extent of the taxpayer’s net investment income. “Property held for investment” is defined as property which

89 That is, is related to “property held for investment”.

97
produces income of a type described in IRC § 469(e)(1), or non-passive activity income. There is very little guidance on the issue of whether life insurance is an “investment,” so that the interest on a loan to acquire a personal life insurance policy will be deductible, if at all, as investment interest. In any event, the investment element of a life insurance premium, if any, probably will be limited to that portion of the policy premium which is in excess of the current cost of the life insurance protection; the interest allocable to that portion of the premium only will be the portion of the interest which might be considered investment interest.

Whether a deduction is allowed should not be dependent upon whether the interest payments are made directly by the grantor or indirectly by the trust (using the funds gifted by the grantor). Since the interest payments will not be the grantor’s obligation, making those payments directly should not provide any benefit.

[4] The Income Tax Effects of the Transaction on the Grantor, the Trust, and the Trust Beneficiaries

The way in which the trust, the grantor of the trust and the beneficiaries of the trust are taxed for income tax purposes is dependent upon whether the trust (or a portion of the trust) is classified for income tax purposes as a “grantor trust” or a “non-grantor trust.”

If the grantor (or a third party under IRC § 678) is treated as the owner of all or a portion of a trust (i.e., the trust is a grantor trust such as a BDIT), the grantor (Inheritor/Beneficiary of the BDIT) must include in his or her personal income tax
computation all items of income, deductions and credits against tax attributable to the
portion of the trust for which the individual is deemed to be the owner. IRC § 671
provides in pertinent part: “Where it is specified in this subpart that the Grantor or
another person shall be treated as the owner of any portion of the trust, there shall
then be included in computing the taxable income and credits of the grantor
[Inheritor/Beneficiary] or the other person those items of income, deductions, and
credits against tax of the trust which are attributable to that portion of the trust to the
extent that such items would be taken into account under this chapter in computing
taxable income or credits against the tax of an individual.” If the grantor
(Inheritor/Beneficiary) is deemed to be the owner of the entire trust, then all income,
deductions, and credits generated by the trust flow through to the grantor
(Inheritor/Beneficiary). Remember, with the BDIT, the Inheritor/Beneficiary is treated
as the trust grantor for all income tax purposes.\(^90\)

If all or a portion of a trust is not treated as a grantor trust because the grantor
(Inheritor/Beneficiary) is not treated as owning all or a portion of the trust, the trust, or
that portion of the trust, is taxed as a non-grantor trust. Non-grantor trusts, unlike
grantor trusts, are treated as separate taxable entities for income tax purposes. The
income earned by a non-grantor trust is allocated between the trust itself and the
beneficiaries of the trust by allowing the trust to deduct some amounts distributed to

\(^{90}\) IRC §§671 and 678.
the beneficiaries. Taxable income for a non-grantor trust consists of gross income minus deductions and is generally computed in the same manner as for an individual.\textsuperscript{91}

1.9 \textbf{The Grantor Trust Rules}

\textit{[1] Income Taxation of the Trust and the Grantor (Inheritor/Beneficiary) During the Grantor’s (Inheritor/Beneficiary’s) Lifetime}

As discussed above, how the trust will be taxed for income tax purposes during the grantor’s (Inheritor/Beneficiary’s) lifetime is dependent upon whether the trust, or a portion of a trust, is treated as a grantor trust or a non-grantor trust. If the trust is treated as a grantor trust, all items of income, deductions and credits against tax attributable to the trust flow out to the grantor (Inheritor/Beneficiary). Remember, the CVBDIT is a grantor trust as to the Inheritor/Beneficiary for all income tax purposes. If the trust is a non-grantor trust, the trust is taxable on the income that is not distributed to the beneficiaries in accordance with the rules for complex trust discusses above.

There are several advantages to the CVBDIT being a grantor trust as to the Inheritor/Beneficiary. First, the Inheritor/Beneficiary will be able to retain any income tax deduction which would otherwise be available for any interest payments made by

\textsuperscript{91} IRC § 641.
the CVBDIT with respect to money borrowed against the policy. However, see the discussion above regarding the deductibility of any such payments.

Secondly, since a grantor (Inheritor/Beneficiary) and his or her grantor trust (the CVBDIT) are treated as the same taxpayer for income tax purposes, transactions between them are ignored for income tax purpose.\(^{92}\) This result will allow the CVBDIT to buy appreciating assets from the Inheritor/Beneficiary on an installment basis without recognition of gain by the Inheritor/Beneficiary and without taxation of interest on the installment note. However, the Inheritor/Beneficiary will continue to be taxed on income earned by the CVBDIT and on any gains realized on sales of trust assets. This result also will allow the trust to purchase a life insurance policy on the life of the Inheritor/Beneficiary from the Inheritor/Beneficiary himself or herself (or from another trust which is a grantor trust as to the Inheritor/Beneficiary) without gain or application of the transfer for value rules, under the carryover basis exception of IRC § 101(a)(2)(A), or because the transfer is ignored for income tax purposes, or because the transfer is to the insured.\(^{93}\) Such a sale, if it is made at the policy’s fair market value, also will avoid application of the three year “look-back” rule of IRC § 2035, discussed below, because of its exception for transfers for full and adequate consideration. On the other hand, as discussed below, if, on termination for the trust’s grantor trust status the trust has outstanding obligations to the grantor (Inheritor/Beneficiary) or otherwise, termination


of grantor trust status will be treated as a sale of the policy for the debt, potentially triggering gain for the grantor (Inheritor/Beneficiary).

Finally, the grantor’s (Inheritor/Beneficiary’s) payment of an income tax liability generated by income from assets in the trust, which is actually his or her liability under the grantor trust rules, will not be treated as a gift to the trust, which effectively will allow the trust to invest on an after-tax basis, and will have the economic effect of allowing the grantor (Inheritor/Beneficiary) to “add” more assets to the trust for the benefit of the trust’s beneficiaries. Rev. Rul. 2004-64\(^{94}\) held that no gift results from the grantor’s payment of the income taxes on income includible in his or her gross income which is generated by his or her grantor trust (CVBDIT). The revenue ruling holds that when the grantor (Inheritor/Beneficiary) or a grantor trust (CVBDIT) pays the income tax attributable to the inclusion of the trust’s income in the grantor’s (Inheritor/Beneficiary’s) taxable income, the grantor (Inheritor/Beneficiary) is not treated as making a gift of the amount of the tax to the trust beneficiaries, because the grantor (Inheritor/Beneficiary), not the trust, is liable for the income taxes.

[2] Income Taxation of the Trust and Beneficiaries after the Grantor’s (Inheritor/Beneficiary’s) Death

After the grantor’s (Inheritor/beneficiary’s) death, the assets in the trust (the proceeds from the life insurance policy and any other trust property) either will remain in trust or be distributed outright to the beneficiaries, assuming the policy is not a survivorship policy. Because the CVBDIT normally is structured as a dynasty trust, it will not terminate until the end of the maximum period that a trust can remain in existence without violating the applicable state’s perpetuities statute. If the assets are distributed to the beneficiaries, the trust will terminate. However, if the proceeds from the insurance policy remain in the trust, the trust and its beneficiaries will be taxed in accordance with the non-grantor trust rules, discussed above.

[3] Income Tax Consequences on the Termination of the Trust’s Status as a Grantor Trust [Either at the Grantor’s (Inheritor/Beneficiary’s) Death or During His or Her Lifetime]

Because the CVBDIT is drafted as a grantor trust, it will cease to be a grantor trust upon the death of the grantor (Inheritor/Beneficiary), or for some reason grantor trust status is revoked under a power granted in the trust instrument. As a result, the trust will no longer be disregarded for income tax purposes, and, instead, will be treated as a separate taxable entity. With the CVBDIT, it is very unlikely that, for some reason, grantor trust status would be revoked.
As discussed below, on termination of the trust’s grantor status during the grantor’s (Inheritor/Beneficiary’s) lifetime, if the trust then has any outstanding liabilities [to the grantor (Inheritor/Beneficiary) or to a third party], the termination of that status will be treated as a sale of the policy by the grantor (Inheritor/Beneficiary) for the liability. That deemed sale will generate gain, to the extent the outstanding liability exceeds the grantor’s (Inheritor/Beneficiary’s) basis in the policy.

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

On termination of the trust’s grantor trust status during the grantor’s (Inheritor/Beneficiary’s) life, the grantor (Inheritor/Beneficiary) will be deemed to have
transferred to the trust for income tax (but not for gift or GST tax) purposes: (i) the assets in the trust, and (ii) the liabilities of the trust.95

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

However, Treas. Reg. § 1.1001-2(a)(3) provides an exception to this rule when a liability is incurred for purposes of acquiring property and the liability is not taken into account in determining the transferor’s basis in such property [for example, where the loan is

between the grantor (Inheritor/Beneficiary) and his or her trust (CVBDIT)] and thus is ignored for income tax purposes.\textsuperscript{96} Under these circumstances, the assumed liability will not be included in the amount realized by the transferor and therefore will not cause recognition of gain. Note that the exception does not, by its terms, apply to liabilities disregarded for income tax purposes because of the relationship of the lender and the borrower and the implications of Rev. Rul. 85-13 (grantee/grantor trust status); it may be that it was intended to apply to liabilities that were too contingent to be an adjustment to basis.

Example 5 of Treas. Reg. § 1.1001-2(c) illustrates what is deemed to occur on termination of grantor trust status during the grantor’s (Inheritor/Beneficiary’s) life. In the Example, a grantor was considered to be the partner of a partnership in which the grantor trust held an interest. Upon termination of grantor trust status on the renunciation of a grantor trust power, a constructive transfer of the partnership interest to the trust was deemed to occur. The Example concludes that the grantor is required to recognize gain to the extent the allocable share of partnership liabilities assumed by the trust exceeds the grantor’s basis in the partnership interest. Similarly, in \textit{Madorin v. Commissioner},\textsuperscript{97} a grantor transferred to a grantor trust an interest in a partnership that held encumbered assets. The grantor deducted the net losses from the partnership until the trustee renounced a power that had caused the trust to be a grantor trust. The

\textsuperscript{96} Under Rev. Rul. 85-13, above.
\textsuperscript{97} \textit{Id}. 
court held that the grantor was released from his share of the underlying liabilities and recognized a gain to the extent that these liabilities exceeded the basis of the partnership interest.

In applying the general rule of Treas. Reg. § 1.1001-2(a)(1) to a premium financing transaction, on the termination in status of the trust as a grantor trust, the grantor (Inheritor/Beneficiary) will be deemed to have transferred the life insurance policy to the trust in exchange for the trust’s assumption of the loan incurred in connection with the trust’s acquisition of the policy. Under the general rule, the grantor (Inheritor/Beneficiary) will realize income to the extent the liability (i.e., the amount of the loan on termination of the trust’s grantor trust status) assumed by the trust exceeds the grantor’s (Inheritor/Beneficiary’s) basis in the policy. Normally, the grantor’s (Inheritor/Beneficiary’s) basis in the policy will be the total of the premiums paid on the policy, less any non-taxable dividends received (in the case of a participating, whole life policy). However, the IRS has held that basis in a life insurance policy is reduced by the value of the insurance protection provided.98

If the exception of Treas. Reg. § 1.1001-2(a)(3) applies, because the liability (the loan) was incurred in connection with the acquisition of the policy and was not taken into account in determining the grantor’s (Inheritor/Beneficiary’s) basis in the policy – which, again, would appear to be the case with a loan between a grantor

98 Compare the IRS position stated in Ltr. Rul. 9443020 with the holding of Gallun v. Cir, 327 F.2d 809 (7th Cir. 1964).
(Inheritor/Beneficiary) and his or her trust (CVBDIT) - then no income will be realized by the grantor (Inheritor/Beneficiary) on termination of the trust’s grantor trust status, even if the liability deemed assumed by the trust exceeds the grantor’s (Inheritor/Beneficiary’s) basis in the policy.

It should be noted that at least one article has suggested that this exception does not apply to exclude liabilities that were originally incurred by the trust, rather than the grantor, to acquire assets.⁹⁹ Citing TAM 200011005, the article concludes that in order to fall within the exception of Treas. Reg. § 1.1001-2(a)(3), the liability must have been incurred as a result of the grantor’s acquisition of an asset, rather than the trust’s acquisition of the asset. It seems, however, that the factual background described in TAM 200011005 requires a narrower application of the ultimate conclusion reached by the IRS than the article suggests.

In TAM 200011005, the grantor transferred appreciated stock to a grantor trust that was administered as two separate GRATs for a short period, with the grantor trust making annuity payments to the grantor. In order to make the required annuity payments to the grantor, the trustee borrowed money from another trust. On termination of the grantor trust status, the trust disposed of the appreciated stock to remainder trusts for the benefit of the grantor’s nephews. The IRS stated that under Treas. Reg. § 1.1001-2(a), the debts incurred by the grantor trust for purposes of making

---

the annuity payments and secured by the trust assets should be treated as amounts realized by the grantor when the trust ceased to be a grantor trust. The taxpayer argued, in relevant part, that the exception provided by Treas. Reg. § 1.1001-2(a)(3) should apply, because the debt was incurred by reason of the trust’s acquisition of the stock. The IRS disagreed, stating that language of the exception can only be reasonably read to refer to indebtedness incurred in connection with the grantor’s acquisition of the stock. In essence, the debt under these facts was not acquisition indebtedness because neither the grantor nor the trust incurred the debt in order to acquire the stock. Rather, the trust incurred the indebtedness because it held the stock.

The article correctly summarizes the conclusion of TAM 200011005 that the liabilities must have been incurred as a result of the grantor’s acquisition of the stock in order to fall within the intended application of the exception; however, the article fails to discuss the specific facts which lead the IRS to this conclusion in the TAM. Arguably, if the trust had incurred the liabilities in connection with acquiring the stock, the exception would have applied. Applying this reasoning, the liability incurred by the insurance trust for purposes of acquiring the life insurance policy could be the type of acquisition indebtedness contemplated by Treas. Reg. § 1.1001-2(a)(3), and, therefore, under that reasoning, any discharge of that indebtedness resulting from termination of the trust’s grantor trust status would fall within the exception and would therefore not be included in the amount realized by the grantor for income tax purposes.
However, even if the exception contained in Treas. Reg. § 1.1001-2(a)(3) does not apply in the CVBDIT situation, the termination of the trust’s grantor trust status still should not result in a recognition of gain by the Inheritor/Beneficiary, as long as the liability incurred by the trust to acquire the policy does not exceed the Inheritor/Beneficiary’s basis in the policy. The trust’s basis in the policy should equal the premiums it paid to acquire the policy (regardless of the fact that it financed those premium payments) and because the trust is treated as a grantor trust and therefore is considered a disregarded entity for income tax purposes under Rev. Rul. 85-13, above, the Inheritor/Beneficiary’s basis in the policy should be the same as the trust’s basis in the policy. Assuming that the loan proceeds (the liability) equal the premiums paid for the policy (the basis in the policy), the liability associated with the policy and deemed assumed by the trust will be offset by the Inheritor/Beneficiary’s basis in the policy (again, perhaps adjusted, as discussed above); therefore no income should be recognized by the Inheritor/Beneficiary on termination of the trust’s grantor trust status during the Inheritor/Beneficiary’s life.

As discussed above, there is substantial uncertainty and debate among commentators regarding the income tax consequences on termination of grantor trust status as a result of the grantor’s (Inheritor/Beneficiary’s) death, where the trust has outstanding liabilities at that time. As discussed above, the authorities dealing with the income tax
consequences on termination of grantor trust status where the trust has outstanding liabilities only pertain to termination during the grantor’s (Inheritor/Beneficiary’s) life.\textsuperscript{100}

Some commentators view the transfer of assets that is deemed to occur on the grantor’s (Inheritor/Beneficiary’s) death as tantamount to a testamentary transfer of the assets to the trust. Under this theory, a gain-on-death rule is contrary to the rule of IRC § 1001 and, accordingly, no gain should be triggered on the deemed transfer of the assets to the trust upon the death of the grantor (Inheritor/Beneficiary).

On the other hand, the IRS likely will argue, and other commentators believe, that when grantor trust status is terminated by the grantor’s (Inheritor/Beneficiary’s) death, the deemed transfer of the assets to the trust triggers gain to the extent any assumed liability exceeds the grantor’s (Inheritor/Beneficiary’s) basis in the assets transferred, just as in the case of termination of grantor trust status during the grantor’s (Inheritor/Beneficiary’s) life.\textsuperscript{101} Thus, under this analysis, as discussed above, on the grantor’s (Inheritor/Beneficiary’s) death and the corresponding termination of the grantor trust status of the trust, the grantor (Inheritor/Beneficiary) will be deemed to have transferred the life insurance policy to the trust in exchange for the assumption by

\textsuperscript{100} See Treas. Reg. § 1.1001-2(c) Example 5; Madorin v. Commissioner, above; Rev. Rul. 77-402; TAM 200011005.

\textsuperscript{101} See Treas. Reg. § 1.1001-2c) Example 5; Madorin v. Commissioner, above; Deborah V. Dunn & David A. Handler, Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates, above; Fred Nicholson, Sale to a Grantor Controlled Trust: Better Than a GRAT, 37 Tax Management Memorandum 99 (1996), in which the author acknowledges that the reasoning in Treas. Reg. § 1.1001-2(c) and the Madorin case may cause the recognition of gain on the grantor’s death to the extent the deemed transfer of assets subject to a liability exceeds the grantor’s basis in those assets.
the trust of the loan incurred in connection with the acquisition of the policy. Under the
general rule of Treas. Reg. Section 1.1001-2(a)(1), the grantor (Inheritor/Beneficiary) will
recognize gain to the extent the liability assumed by the trust exceeds the grantor’s
(Inheritor/Beneficiary’s) basis in the policy. However, if it is determined that the
exception of Treas. Reg. § 1.1001-2(a)(3) applies, because the liability was incurred in
connection with the acquisition of the life insurance policy and was not taken into
account in determining the transferor’s basis, then no gain will be recognized by the
grantor (Inheritor/Beneficiary) or his or her estate on termination of the trust’s grantor
trust status, even if the liability deemed assumed exceeds the grantor’s
(Inheritor/Beneficiary’s) basis in the policy.

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

[a] Original Issue Discount Rules

When adequate interest (based on the Applicable Federal Rate) is not paid on a debt instrument or when a debt instrument does not require the current payment of interest, interest income is imputed to the holder of the debt or the seller of the property under the original issue discount ("OID") rules.\textsuperscript{102}

Briefly, IRC§ 1273 provides that the amount of OID is equal to the difference between the issue price of an instrument and its stated redemption price at maturity. The term "stated redemption price at maturity" means the sum of all payments due under the debt instrument other than certain qualified interest payments.\textsuperscript{103} In general, holders of debt instruments must include in income the sum of the daily portion of OID determined for each day during the tax year the instrument is held, and the OID rules place the holder of a debt instrument on the accrual method of accounting as to any interest (whether stated or imputed) not paid currently. The basis of the debt instrument in the hands of the holder is increased by the amount of OID that was included in gross income.\textsuperscript{104} Concomitantly, IRC § 163(e) generally allows an interest deduction (to the extent not otherwise disallowed by some other Code provision).

\textsuperscript{102} The "OID" rules of IRC §§ 1272, 1273 and 1274.
\textsuperscript{103} See IRC § 1273(a)(2).
\textsuperscript{104} See IRC § 1272(d)(2).
[b] Income Tax Treatment of Accrued OID during the Inheritor/Beneficiary's Life

If the CVBDIT borrows funds from the Inheritor/Beneficiary, any OID (or deemed OID on a below-market loan) accrued on the loan during the Inheritor/Beneficiary's life will be disregarded for income tax purposes. The OID rules, ordinarily which would apply in this situation to impute interest to the Inheritor/Beneficiary on a current basis, do not apply, under the rationale of Rev. Rul. 85-13, because the trust is a grantor trust.105

In Rev. Rul. 85-13, the IRS held that a grantor trust is disregarded as an entity for income tax purposes, and the grantor is deemed to own the assets of the trust for income tax purposes. In the ruling, the grantor sold appreciated stock to the grantor in exchange for an installment note. The IRS stated that because the grantor is considered the owner of the grantor trust under the grantor trust provisions and, thus, is both the maker and the owner of the installment note, the purported purchase by the grantor trust of the appreciated stock is not recognized as a purchase for income tax purposes. Note that in Rev. Rul. 85-13, above, the IRS refused to follow the contrary decision of the Second Circuit in Rothstein v. United States,106 in which the court considered a transaction

105 See also HENKEL, KATHYRN, ESTATE PLANNING AND WEALTH PRESERVANTION; STRATEGIES AND SOLUTIONS, ¶ 30.11[3](2008).
substantially similar to the facts in the Ruling in which the grantor claimed an interest deduction on the installment note and a loss on the subsequent sale of the stock to the corporation. The IRS disallowed both deductions. The Second Circuit held that although the grantor must be treated as owner of the trust under the grantor trust provisions, this requires only that the grantor include the trust’s items of income, deduction and credits in his or her own computation of taxable income, and that the trust must continue to be viewed as a separate taxpayer. The court, therefore, held that the sale of the trust assets to the grantor in exchange for an installment note was a bona-fide sale and that the grantor acquired a cost basis in the assets.

Similarly, in Ltr. Rul. 9535026, the grantor transferred stock to a grantor trust in exchange for a promissory note paying a market rate of interest for twenty years followed by a balloon payment of principal. The IRS, relying on Rev. Rul. 85-13, determined that in addition to no gain or loss recognition, the grantor trust could not deduct the interest payments and the grantor did not have interest income attributable to the promissory note.107

107 See also Ltr. Rul. 9519029, citing Rev. Rul. 85-13, above, which concluded that no gain or loss will be recognized to the grantor (Inheritor/Beneficiary) or the grantor’s (Inheritor/Beneficiary’s) trust on the transfer of assets by the grantor (Inheritor/Beneficiary ) to the trust to fund the trust, on the transfer of any property from the trust to the grantor (Inheritor/Beneficiary) in payment of any annuity installments, or on the substitution by the grantor (Inheritor/Beneficiary ) of assets of the grantor (Inheritor/Beneficiary) for assets of the trust. See also, the Conference Report, Deficit Reduction Act of 1984, H. Rep’t. 98-861, 98th Cong., 2d. Sess. 1018, in which the conferees clarified that if a taxpayer makes a below-market demand loan to a trust and the loan is treated as a revocable transfer of property for purposes of the grantor provisions, then the grantor trust provisions, and not
Accordingly, under Rev. Rul. 85-13 and subsequent rulings, transactions between an Inheritor/Beneficiary and a CVBDIT are ignored for income tax purposes. Consequently, if the trust owes money to the Inheritor/Beneficiary, there is no debt for income tax purposes since the debt runs both to and from the Inheritor/Beneficiary and cannot represent a true indebtedness. Thus, the Inheritor/Beneficiary will not recognize interest income and the CVBDIT will not be allowed an interest deduction for interest paid on the “disregarded” loan. Moreover, since any debt instruments between the Inheritor/Beneficiary and the CVBDIT are disregarded for income tax purposes, no OID (or deemed OID) can arise during the Inheritor/Beneficiary’s life. Accordingly, no OID (or deemed OID) is accrued or taxed during the Inheritor/Beneficiary’s life on debts between the Inheritor/Beneficiary and the CVBDIT.

[c] Accrued OID as Income In Respect Of a Decedent

Although there appears to be some uncertainty and debate regarding the income tax consequences of OID (or deemed OID) on termination of the trust’s grantor trust status as a result of the grantor’s (Inheritor/Beneficiary’s) death, it appears that pre-death accrued OID (or deemed OID) on a loan (or deferred payment sale) from an Inheritor/Beneficiary to a CVBDIT should not constitute income in respect of a decedent (“IRD”) in the hands of the

IRC § 7872, govern because “it would be anomalous to give effect for tax purposes to a loan made by a taxpayer to himself or herself.”
Inheritor/Beneficiary’s estate or heirs. Treas. Reg. § 1.691(a)-1(b) in general provides that IRD “refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent.” Thus, the term IRD is understood to include items of income that, at the time of death, the decedent had earned or accrued, but not yet received.

As discussed above, the OID rules do not operate during the Inheritor/Beneficiary’s life on debts between the Inheritor/Beneficiary and the CVBDIT for income tax purposes, because the trust, and thus the debt, is disregarded for income tax purposes. Consequently, OID on that disregarded debt is not taxed to the Inheritor/Beneficiary, or deducted by the CVBDIT, during the Inheritor/Beneficiary’s life. Since pre-death OID did not constitute income to the Inheritor/Beneficiary while living, those amounts (the accrued OID) should not constitute IRD in the hands of the Inheritor/Beneficiary’s estate or successors. To do otherwise would tax something after death (the accrued OID) that would never have been taxed had the Inheritor/Beneficiary continued to live.

[5] Planning the Grantor Trust Status of the Trust

Given both the potential advantages and risks associated with the trust’s grantor trust status as described above, careful consideration should be given to that status when
planning and drafting a trust for a particular client. The CVBDIT always is created as a grantor trust as to the Inheritor/Beneficiary. Therefore, when the insured (Inheritor/Beneficiary) is the lender, the CVBDIT’s grantor trust status is extremely beneficial to the Inheritor/Beneficiary because it prevents the insured (Inheritor/Beneficiary) from recognizing the receipt of interest from the trust as income or the recognition of original issue discount as income each year, where interest on the loan is accrued and will be paid at the insured’s death. In addition, the CVBDIT’s grantor trust status is important for other planning reasons such as use of the trust as the buyer in an installment sale of appreciating assets from the Inheritor/Beneficiary which is disregarded for income tax purposes under Rev. Rul. 85-13,\textsuperscript{108} or as the buyer of a life insurance policy from the insured (Inheritor/Beneficiary) in an attempt to avoid both the three year “look-back” rule of IRC § 2035 and the transfer for value rule of IRC § 101(a).

These strategies generally require grantor trust status for the trust, a critical design feature inherent in the CVBDIT. On the other hand, where the lender is a third party, the trust is not likely to own any assets other than the policy during the insured’s lifetime, and the benefits of the CVBDIT are not necessarily important to the client, creating the trust as a non-grantor trust (and therefore not a CVBDIT) will eliminate any risks relating to the termination of the trust’s grantor trust status at the insured’s death, if the liability to the third party is then outstanding, and would have no disadvantages.

In planning situations where the specific benefits of the CVBDIT are not necessarily important to the client, more difficult choices will be raised (i) in situations where the insured is the lender but it seems unlikely that the trust’s obligation to the insured will be repaid before his or her death and (ii) in situations where the trust is involved in premium financing arrangements with third party lenders and the trust is going to be funded with substantial income producing assets during the insured’s lifetime. In either of those cases, the risks associated with grantor trust status if the loan is outstanding at the insured’s death will need to be weighed against the current income tax cost of requiring the insured to report the interest received as income (where he or she is the lender) or losing the opportunity to have the insured pay the income tax on trust-generated income with no gift tax consequences (where the lender is a third party).

[6] The Inheritor/Beneficiary’s Guarantee of Loans to the CVBDIT or Pledge of Assets as Security for Loans to the CVBDIT

Under IRC § 2042(2), the proceeds of a life insurance policy insuring the life of the decedent will be included in the decedent’s estate if the decedent possessed any “incidents of ownership” in the policy on his or her death. “Incidents of ownership” is broadly defined to include all rights to the economic benefits of the policy, such as the right to name or change beneficiaries, the right to surrender the policy, the right to pledge the policy for a loan, or the right to obtain a loan from the insurer against the cash surrender value of the policy.
IRC § 2035(a) provides, in part, that if a decedent makes a transfer of property within three years of his or her death (for less than full consideration) and if, prior to that transfer, the property would have been included in his or her estate under IRC § 2042, the property will be included in his or her estate under IRC § 2035. Thus, if a decedent transfers a policy (or any incidents of ownership in a policy) within three years prior to his or her death (for less than full consideration), the policy proceeds will be included in his or her estate for estate tax purposes.

Accordingly, the first issue to consider is whether the decedent, as a result of guaranteeing the loan, will be deemed to hold any incident of ownership in the policy. So long as the guarantee, either explicitly or under applicable state law, does not give the insured (Inheritor/Beneficiary) any rights to the policy (in the form of subrogation rights, etc.), the Inheritor/Beneficiary should not be deemed to hold any incidents of ownership in the policy as a result of the guarantee, and, therefore, the proceeds of the policy should not be included in his or her estate (assuming, of course, that the trust is properly drafted to prevent the Inheritor/Beneficiary from holding any incidents of ownership). The right to obtain an interest in the policy under subrogation or similar rights provided either under the loan documents or state law (or both) will be an incident of ownership in the policy, and will need to be negated specifically in the documents. This result is supported by a private letter ruling which was issued with respect to a “private” split-dollar arrangement.
In Ltr. Rul. 9745019, the Service considered the implications of a private split-dollar arrangement between a husband and wife as the premium providers and their irrevocable insurance trust, with respect to a policy insuring the lives of the husband and wife, on a survivorship basis. The premium providers initially funded the trust with a cash gift, with which the Trustee purchased and paid for the first premium on a survivorship policy covering their lives. The trust was named as initial owner and beneficiary of the policy.

Under the proposed collateral assignment split-dollar agreement, the Trustee was designated as the owner of the policy. The trust would pay the smaller portion of the annual policy premiums and the insureds would pay the balance of the annual premium. The split-dollar agreement was terminable at will by either the Trustee or the insureds, so long as the value of the trust assets (based on the loan value of the policy) equaled or exceeded the amount to be repaid to the insureds on termination of the arrangement. In all other cases, the agreement could be terminated only by mutual consent of the Trustee and the insureds. These provisions likely were used to prevent any argument that the insureds could force termination of the arrangement and obtain ownership of the policy. The agreement also would terminate upon the bankruptcy of the insureds, failure of the Trustee to reimburse the insureds, failure of the insureds to pay their share of the premiums, or the death of the survivor of the insureds.

If the agreement terminated prior to the death of the survivor of the insureds, the survivor would be entitled to receive an amount equal to the cash value of the policy,
net of the cash surrender value at the end of the initial policy year. Why this limitation was imposed on the insureds’ right of reimbursement also is not clear; it has been suggested that it was included to avoid any issue about the initial gift to the trust being a completed gift in which the insureds retained no reversionary interest. If the agreement terminated as a result of the death of the survivor of the insureds, the estate of the survivor would be entitled to receive an amount equal to the cash value of the policy immediately prior to the survivor’s death, again, less the cash surrender value at the end of the initial policy year.

In order to secure the insureds’ interest in the policy, the Trustee assigned to the taxpayers limited rights under a “restricted” collateral assignment. The only rights assigned to the insureds were the right to receive a portion of the death proceeds payable on the survivor’s death and the right to receive the cash value of the policy if the policy were surrendered by the Trustee. All other rights under the policy were reserved to the Trustee under the collateral assignment.

One of the issues on which the Service was asked to rule was whether the insurance proceeds payable to the trust under the split-dollar agreement would be includible in the gross estate of the surviving insured. As a conclusion, and without any analysis, the Service held that the insureds retained no incidents of ownership in the survivorship policy on their lives. Although the ruling discusses the broad nature of the phrase “incidents of ownership” under the IRC § 2042 Regulations, the ruling goes on to apparently hold that the restricted nature of the collateral assignment to the insureds
was enough to prevent their interest in the policy from rising to the level of an incident of ownership in the policy. This conclusion is similar to the rationale of Ltr. Rul. 9511046, holding a similarly restricted collateral assignment agreement did not create corporate incidents of ownership in a controlling shareholder arrangement which would have seen attributed to the insured under the controlling shareholder Regulations issued under IRC § 2042. Thus, even though the insureds had a security interest in the policy (although with few of the rights which would normally be granted a secured creditor), they were not deemed to hold any incidents of ownership in the policy which would cause its inclusion in either of their estates under IRC § 2042.109

Similarly, the insured’s (Inheritor/beneficiary’s) guarantee of a loan used to pay premiums on a policy on the insured’s life (or pledge of assets as security for such a loan) should not cause inclusion of the policy proceeds in the insured’s (Inheritor/Beneficiary’s) estate under IRC § 2042, so long as the guarantee does not directly grant incidents of ownership in the policy to the guarantor (Inheritor/beneficiary), in the form of subrogation or other similar rights. However, since a guarantee typically includes rights of subrogation, any guarantee agreement must specifically limit these subrogation rights, as they apply to the policy, so that the insured’s (Inheritor/Beneficiary’s) rights in the policy as subrogee are limited to the right to receive a portion of the policy cash value, if the policy is surrendered, or to receive a portion of the policy death benefit upon the insured’s (Inheritor/Beneficiary’s) death. If

109 See also P.L.R.s 200747011, 200822003, 2008250011, and 200848002.
the Inheritor/Beneficiary did become entitled to a share in the proceeds, as subrogee, then that share of the proceeds obviously would be included in the insured’s (Inheritor/Beneficiary’s) estate.

It has been suggested by some commentators that if the trust pledges the policy as security for the loan, which is guaranteed by the grantor (Inheritor/Beneficiary), the grantor (Inheritor/Beneficiary) receives some benefit from the trust’s pledge of the policy (presumably because it is then less likely that he or she will be required to make payments under his or her guarantee) which, they argue, constitutes an incident of ownership in the policy. However, the authors have found no authority for this proposition, and the existing authority seems to suggest otherwise.

As a practical matter, there is no apparent benefit to the grantor (Inheritor/beneficiary) as a result of the trust’s pledge of the policy it owns as security for its own loan. The fact that the “value” of what the Inheritor/Beneficiary may be providing the trust in terms of his or her guarantee may be reduced does not mean that the Inheritor/beneficiary affirmatively receives a benefit as a result of the transaction. However, in some cases, particularly where the acquisition of a policy on the insured’s life (to be owned by a third party such as a CVBDIT) and a subsequent pledge of the policy by the owner as security for a loan to the insured (Inheritor/Beneficiary) by an
unrelated lender is part of an integrated transaction, courts have held the policy was includible in the insured’s estate.\textsuperscript{110} On the other hand, where the transaction is not integrated to the degree it was, for instance, in \textit{Pritchard}, other courts have concluded that where a third party owner of a policy (such as a CVBDIT) pledged the policy as security directly for the insured’s (Inheritor/Beneficiary’s) loan, then since the decision to make the pledge was within the discretion of the third party owner (CVBDIT), and not a right held by the insured (Inheritor/Beneficiary), the insured had no incident of ownership as a result of the pledge.\textsuperscript{111} To avoid any risk of this argument, perhaps a policy owned by a CVBDIT should not be used as security for the insured’s (Inheritor/beneficiary’s) obligations to a third party. Instead, considering structuring the transaction with third party guarantees (and paying a guarantee fee as determined by an independent, third party appraisal) or some other form of third party security arrangement which will not have any possible tax or creditor consequences to the Inheritor/Beneficiary.

The fact that it could be argued that the source of the policy premiums could be coming indirectly from the decedent (Inheritor/Beneficiary) should likewise not cause inclusion of the policy proceeds in the decedent’s estate under IRC § 2042. In Ltr. Rul. 9809032, the Service considered a situation in which the decedent directly loaned funds to an

\textsuperscript{110} See, \textit{Pritchard v. United States}, 397 F.2d 60 (5th Cir. 1968).

irrevocable insurance trust he created, which were used by the trustees to pay the premiums on a policy insuring the decedent’s life which was owned by the trust. The executors of the decedent’s estate requested a ruling that the decedent did not hold any incidents of ownership in the policy for purposes of IRC § 2042(2) as a result of having loaned the funds used to pay the premiums on the policy. The Service noted that under the terms of the trust, the decedent held no incidents of ownership in the policy, nor did he transfer any incidents of ownership in the policy during the three year period prior to his death. Therefore, none of the policy proceeds was included in his estate under IRC § 2042(2). The Service further noted that the fact that the decedent, through loans, had provided the funds for payment of the policy premiums was irrelevant, since “payment of premiums is irrelevant in determining whether a decedent retained any incidents of ownership in the policy proceeds.” The ruling did not discuss whether the insured had retained a security interest in the policy for his loan; if he had, it presumably would have to have been a “restricted” assignment to avoid giving the insured incidents of ownership in the policy.112 For its holding regarding the irrelevancy of payment of premiums in an “incidents of ownership” analysis, the Service in Ltr. Rul. 9809032 cited Estate of Leder v. Commissioner,113 and Estate of Headrick v. Commissioner.114 The primary focus of these cases actually was inclusion of policy proceeds under IRC § 2035 (which, when dealing with life insurance proceeds, obviously requires an analysis of IRC

112 See Ltr. Rul. 9511046, above.
113 893 F.2d 237 (10th Cir. 1989).
114 918 F.2d 1263 (6th Cir. 1990).
§ 2042). They are among those cases in which the Tax Court rejected arguments by the Service, largely made under the IRC § 2035 (which generally included in a decedent’s estate any transfer made within three years of death), that an insured’s direct or, in some cases, indirect, payment of premiums should be treated as a “transfer” subject to IRC § 2035 which, if made within three years of the decedent’s death, would cause the policy proceeds to be included in the decedent’s estate. Estate of Leder was the first case to consider this issue based on the then current IRC § 2035 and the court concluded that as amended, in order for IRC § 2035(d)(1) – now IRC § 2035(a) – to apply to insurance, first IRC § 2042 had to apply to the insurance.

Where the policy originally had been applied for and owned by the insured’s spouse, as in Estate of Leder, the insured never owned (and transferred) the policy, therefore, IRC § 2035 did not apply to cause inclusion of the policy proceeds.

As indirectly supported by its statement in Ltr. Rul. 9809032, the Service seems to agree with this basic analysis – the determining factor in an analysis of whether the proceeds of a policy insuring a decedent’s (Inheritor/beneficiary’s) life are includible under IRC § 2035 is whether the decedent possessed incidents of ownership in the actual policy within the three year period prior to his or her date of death. The fact that he or she may have provided the source of premium payments on a policy on his or her life within that three year period is irrelevant. With respect to guarantees by the insured (Inheritor/Beneficiary), the decedent (Inheritor/Beneficiary) is even further removed from the premium payments, since he or she merely will be guaranteeing a third party
loan used to fund those payments. In Ltr. Rul. 9809032, the Service ruled that a direct loan by the insured to the policy owner in the amount of the premium payments did not cause inclusion of the policy on his life purchased by the borrower in the insured’s estate for estate tax purposes; accordingly, having the insured (Inheritor/Beneficiary) guarantee similar loans should not cause inclusion of those proceeds in his or her estate for estate purposes under IRC § 2042.

[7] Inheritor/Beneficiary Guarantees of Third Party Loans to the CVBDIT for the Premium Payments, or Pledges of Assets as Security for Such Loans

Most commentators would agree that if an individual actually is required to make payments to a lender pursuant to his or her guarantee (or if pledged assets are used to satisfy the loan, the same analysis would apply to the consequences of a guarantee and a pledge of assets as security for a loan, not accompanied by a guarantee) then, assuming the guarantee was not made for adequate consideration, the guarantor’s payment will be treated as a gift to the borrower, less, perhaps, any amounts received by the guarantor from the borrower under the guarantor’s subrogation rights. See the discussion above on the estate tax consequences of subrogation rights under the guarantee agreement. Similarly, if the guarantor gratuitously pays either the loan interest or principal, that also will be treated as a gift to the borrower. The issue which is addressed in this article is whether there is an immediate gift to the borrower when the guarantor merely guarantees the loan (or the pledgor merely pledges assets as
security for the loan). Throughout this discussion keep in mind that in structuring the CVBDIT it is absolutely critical that neither the Inheritor/Beneficiary nor any other person or entity is treated as making a gift to the BDIT (with the exception of the initial gift of $5,000 to the BDIT by the original creator of the BDIT). Any said gifts will destroy the tax planning built into the CVBDIT.\footnote{For a technical analysis of this issue see Oshins, R. supra note 14.}

There is very little authority on this issue; in fact, what little authority there was (with which the authors and most commentators had disagreed) has now been withdrawn. This appears to be an area in which there is an apparent absence of authority, and most of the discussion centers on two letter rulings: Ltr Ruls. 9113009 and 9409018.

In Ltr. Rul. 9113009, the Service took the position that a father’s guarantee of his child’s loan constituted a gift to the child when the guarantee was made. The Service also concluded that if guarantees were outstanding at the father’s death, then because the marital trust created under the father’s estate plan might be required to make payments on a guarantee, the marital trust would not qualify for the marital deduction.

In Ltr. Rul. 9409018, the Service reconsidered some of the issues raised in Ltr. Rul. 9113009 and ruled that the marital deduction would not be disallowed, although presumably it still could be reduced by the estimated “value” of the contingent liabilities under the guarantees if other assets of the estate available to satisfy the guarantor’s potential obligations were valued at less than such amount. The Service withdrew Ltr.
Rul. 9113009, but did not further address the issue of whether the father’s guarantee of the loans would constitute a current gift.

In Ltr. Rul. 9113009, the Service cited Revenue Ruling 84-25\(^{116}\) in support of its position that the gift as a result of the guarantee occurred when the guarantee was made. Revenue Ruling 84-25 held that a gift of an enforceable promissory note occurs when the note is transferred, rather than when the note is paid. The result in Revenue Ruling 84-25 can be distinguished from a personal guarantee, since with a personal guarantee the amount the guarantor will have to pay is contingent and undeterminable. However, in *Estate of Bradford*,\(^ {117}\) which was not cited by the Service, the court ruled that a wife’s substitution of her note for her husband’s note held by a bank was not a gift. In reaching its decision, the court noted that the wife had no current obligation to make payments and made no transfer when she gave her note to the bank. The court found that the fact that the husband may have received some benefit as a result of the transaction was not controlling.

The Service also cited *Dickman v. Commissioner*,\(^ {118}\) in which the Supreme Court ruled that a decedent’s interest-free loans to his son constituted gifts of an amount equal, in effect, to the foregone interest; of course the rule of this case has now been incorporated into IRC § 7872 of the Code. The analysis of *Dickman* to some extent

\(^{116}\) 1984-1 C.B. 191.

\(^{117}\) 34 T.C. 1059 (1960).

reflects one of the problems with the Service’s position that a guarantee should constitute a current gift. The court in *Dickman* focused strongly on the fact that an interest-free loan involves a transfer of assets and that the gift tax applies to transfers; especially if the guarantee is unsecured, it is difficult to find the requisite transfer of property in the making of a guarantee.

The lack of an identifiable transfer makes a complete analysis of the Service’s possible position difficult. For example, assuming for a moment that making a guarantee constitutes a current gift, if a trust beneficiary (such as the Inheritor/Beneficiary) guarantees a trust’s loan, but is the sole income beneficiary and holds a power of appointment over the trust, the “gift” upon making the guarantee will be incomplete, but presumably will become complete upon the beneficiary’s death. This assumes again that the beneficiary has transferred something to the trust, which will somehow be included in the beneficiary’s estate so that the completion of the transfer at the beneficiary’s death could be taxed. However, the authors have found no authority to support the position that making a guarantee is a transfer potentially subject to IRC §§ 2036 or 2038 – presumably the Sections under which the “incomplete gifts” as a result of the guarantees will be taxed at the beneficiary/guarantor’s death. Similarly, the Inheritor/Beneficiary’s guarantee of the trust’s loan should not constitute a retained interest in the trust’s assets (including an insurance policy) under either of these Sections or under IRC § 2042, especially if the Inheritor/Beneficiary does not receive a security interest in any trust assets pursuant to the guarantee. See Ltr. Rul. 9809032, holding that a grantor’s direct loan to his trust did not create an incident of ownership
under IRC § 2042. In addition, if the loan is paid before the Inheritor/Beneficiary dies, then the incomplete transfer would seem to “disappear” since there would be no further obligation on the part of the either the Inheritor/Beneficiary or the Inheritor/Beneficiary’s estate.

The Service’s position stated in Ltr. Rul. 9113009 also is difficult to support because it does not provide a mechanism for valuing the guarantee – certainly a difficult, although perhaps not impossible, task. Valuation presents two basic issues. First, assuming there is a transfer, then, if the value of what is given away cannot be determined, the Service has contended in prior rulings that the gift will be valued and subject to tax when the value can be determined. Therefore, if the guarantee cannot be valued, even if it is a current transfer, it should not be subject to gift tax currently. A second valuation issue is that under the gift tax Regulations, the gift tax is imposed on the value of the property the donor transfers, not the value of what the donee receives. In a guarantee situation, what the donee gets (a loan for which he or she could not otherwise qualify, or a loan with better interest rates) is quite different from what the guarantor theoretically gives away – perhaps the future value of possible payments on the guarantee. Additionally, it fails to adequately address the effect of making payments under a guarantee. Under the Service’s position, since the guarantee would be taxed upon its creation, it should not be taxed again if payments are made on it, since the transfer of the guarantee obligation presumably would be complete.

---

Of course, this contradicts what most practitioners and commentators generally will concede – that payments on a guarantee will be treated as gifts. However, this concession implicitly is premised on finding that no previous transfer has occurred. Nevertheless the Service could contend that one gift occurs when the guarantee is made (assuming they can find a transfer of “property” and can value it) and another occurs if payments are made on the guarantee and the guarantor releases his or her subrogation rights or permits them to lapse. However, it seems unlikely that the Service will concede this point, in which case double-taxation would result. These problems with the Service’s position in Ltr. Rul. 9113009 may be among the reasons the Service has not issued any new rulings or provided any guidance addressing the gift tax treatment of guarantees.

In Revenue Ruling 69-346, the Service ruled on an agreement between a husband and wife which required the wife to transfer one-half of her interest in community property into a trust created under the husband’s will. The agreement was enforceable under state law, and the wife’s obligation to transfer the property occurred after administration of her husband’s estate. The Service held that the taxpayer did not make a gift until the death of her husband, at which time the value of the property transferred was capable of being valued, since the agreement was enforceable under state law at the time of execution, but not capable of being valued until the time of transfer.

120 1969-1 C.B. 227.
However, a 1994 field service advice, which was not released to the public until sometime after 1999, indicates that while the Service had not published any additional rulings on the point, an internal decision had been made (by at least some Internal Revenue Service counsel) not to pursue the theory of there being a gift upon the making of a guarantee (unless, perhaps, when the guarantee was made, all parties fully intended and expected the guarantor to make all payments on the obligation). The field service advice121 involved a situation where an individual had guaranteed certain obligations of a partnership in which he had little or no interest, and of which a trust for the benefit of his children held the largest share of the interests.

One of the issues discussed in the field service advice was whether the giving of his guarantee constituted a gift; the FSA concluded it did not. The FSA discussed Ltr. Ruls. 9113009 and 9409018 and stated that while a guarantee clearly confers an economic benefit upon the borrower, it is not a transaction that has the current effect of depleting the guarantor’s estate – noting that a “gift tax is imposed on the transfer by the donors, not on the receipt by the donee.” The FSA further noted that treating a guarantee as a gift could result in taxing an amount greater than if taxation occurred in the taxpayer’s estate. The FSA also stated that a guarantee could be considered as an incomplete gift, because the donor has not yet parted with dominion and control over any property. In addition, the donor still has subrogation rights, as a result of the guarantee.

121 1994 FSA Lexis 217.
In this particular case, the FSA further concluded that although the taxpayer made payments on the guarantee when the partnership went into bankruptcy, there was no gift because he did not gratuitously make the payment or release his subrogation rights. The Service confirmed this conclusion even though there were no assets of the partnership upon which the taxpayer could enforce his subrogation rights.

Another reason for the absence of any other authority in this area may be due to a similar issue raised in the S-corporation arena. In fact, the Service’s position in the S-corporation area may provide some support for the position that a guarantee is not a current gift.

Shareholders of an S-corporation who are asked to guarantee loans to the S-corporation have long attempted to take the position that their stock or debt basis in the corporation should be increased when they personally guarantee loans to the corporation. Courts, however, almost unanimously have rejected this argument, holding instead that their basis will not be increased until payments actually are made on the loan pursuant to the guarantee. The leading case supporting the proposition that a shareholder could increase his or her basis by the amount of a loan guaranteed by the shareholder is Selfe v. United States.122

In Selfe, the Eleventh Circuit remanded for a determination by the District Court to determine whether the taxpayer’s personal guarantee on a loan to her business would

---

122 778 F.2d 769 (11th Cir. 1985).
increase the basis in her stock where the lender looked to the shareholder for repayment. The shareholder obtained a loan in her name to start her retail clothing business. The business was later incorporated. When the shareholders elected to have the corporation taxed as an S-corporation, the loans originally made to the taxpayer were transferred to the corporation. The shareholder then personally guaranteed the loans and pledged other assets to the bank. Generally, the decision in Selfe has not been followed by the remaining courts. However, the decision in Selfe has been followed where the court determines that the debtor is actually the shareholder. For example, see Bolding v. Commissioner,\textsuperscript{123} holding that an S-corporation shareholder was entitled to increase his basis where the bank loaned funds directly to shareholder, the bank looked to shareholder to repay loans, and proceeds were contributed to corporation; the taxpayer, as debtor, was not asked to “guarantee” loans of the corporation. However, for a decision contra to Bolding, see Nigh, et al. v. Comr.,\textsuperscript{124} holding that S-corporation shareholders were not entitled to increase basis when they were co-makers of loans rather than guarantors.

Commentators have argued that guarantees by S-corporation shareholders of the corporation’s debts should be recognized as a current “economic outlay” and be given a current value so that the shareholder’s basis in the stock or debt of the corporation will

\textsuperscript{123} 117 F.3d 270 (5th Cir. 1997).

\textsuperscript{124} 60 T.C.M. 91 (1990).
be increased. Commentators have offered several methods of valuing the guarantees, although they recognize it is a difficult task.

The article *Shareholder Guarantees of S Corporation Debt: Matching the Tax Consequences with Economic Reality*,\(^\text{125}\) notes the following:

The Internal Revenue Service has recently struggled to develop its position on the valuation of shareholder guarantees. In 1991, the Service surprised the legal community when it issued a private letter ruling stating that a parent’s guarantee of a child’s debt should be considered a gift at the time the guarantee is made. The Service did not indicate in the ruling whether the gift guarantee would be valued at the face amount of the loan or by a different method. When practitioners inquired about the correct application of the private letter ruling, for three years the Service would only respond that it was reevaluating its position on gift guarantees. By the middle of 1993, several members of Congress had become interested in applying a legislative solution to the guarantee issue posed by the Service. Senator Daniel K. Akaka of Hawaii proposed the addition of a subsection to section 2056(b) of the code that would value gift guaranties not on the face value of the indebtedness guaranteed but on the likelihood that the guarantor would be called to

\(^{125}\) 81 Va. L. Rev. 223 (February 1995).
perform on the guarantee (a valuation method). On December 1, 1993, possibly because of the congressional pressure and persistent fear that its position in the gift guarantee area might trigger a new examination of the S corporation shareholder guarantee controversy (which would cause greater overall revenue losses to the Service), the Service withdrew the gift guarantee sections of the December 21, 1990 letter ruling [Ltr. Rul. 9113009] without explanation. (Emphasis added).

Shareholders of S-corporations who guaranteed loans of their corporations must have anticipated using Ltr. Rul. 9113009 as support for their position that guarantees should be given value for basis purposes when made; however, this did not prove to be the case. Consequently, in the gift/guarantee area, the Service’s long-standing argument that guarantees by S-corporation shareholders do not involve a current economic outlay which can be added to basis (and the courts’ acceptance of this argument) should provide strong support for the position that personal guarantees do not involve a current economic outlay/transfer of property by the guarantor for gift tax purposes.

While it would be difficult to argue that someone who guarantees a debt for no consideration should not be treated as making a gift to the debtor if the guarantor actually pays the debt by making good on the guarantee, the discussion in the Virginia Tax Law Review article quoted above seems to support the position that a current gift is not made as a result of a guarantee, unless the guarantor, at the time of making the
guarantee, does not expect the primary obligor to pay the debt (which would be rather difficult to prove).

There are several cases, somewhat similar to those discussed above regarding loan guarantees by S-corporation shareholders in which courts (and the IRS) recharacterized a loan to a corporation, guaranteed by a shareholder, as a loan to the shareholder followed by a contribution by the shareholder to the corporation, as equity. Typically, in these cases, the taxpayer/guarantor was claiming a deduction for amounts paid on the guarantee when the corporation failed to make payments on the loan. Again, in a case similar to that described above, the “ultimate question” in analyzing this issue was whether there is “a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship.”

Although other factors have been cited as relevant in making the determination of whether “debt” should be treated as such, in *Hunt v. Commissioner*, which involved large loans made by parents to children (to enable them to try to “corner” the silver market, among other things), the Court indicated that expectation of repayment was the critical issue in distinguishing loans from gifts in the intra-family context, and

---


127 T.C. Memo 1989-335.
rejected the IRS invitation to focus on certain other characteristics generally deemed material in the corporate-shareholder loan context. The Court stated, in part, that:

Respondent asks us to consider additional factors in determining whether the transfers between Mr. Hunt and the children created bona fide indebtedness. Respondent suggests these additional objective factors are necessary, because of the family relationship, to our determination of whether the transfers created bona fide indebtedness: (1) the source of payments of principal or interest; (2) the status of advances in relation to other creditors; (3) ability to obtain loans from outside lenders; (4) failure of the debtor to pay on the due date; and (5) the risk involved in making advances. These factors are generally applied to transfers between shareholders and their controlled corporations to determine the economic substance of the transfers.

Respondent does not direct us to any intra-family loan cases where any of these factors are explicitly applied. As a general rule we are not persuaded by respondent's arguments that the factors relevant to a determination of whether an advance to a corporation is debt or equity are relevant to our determination here. These cases involve intra-family loans, not advances to a corporation by its shareholders. As petitioners point out, in the debt-equity determination it is beneficial (for tax purposes) for both the shareholder and the corporation to establish debt
at the time the funds are transferred. Thus, both the corporation and the shareholder have INTENT to create debt. In those situations, the Court looks much more closely at objective factors in reaching its decision.

However, in the context of intra-family loans, the focus is much more on the intent of the parties. Unlike the debt-equity cases where the corporation and the shareholders share the same interest in creating debt for tax purposes, in these instances, even though the parties are related, the "lender" and the “borrower” have conflicting interests. In these cases, the children benefit but the parents suffer if the transfers are characterized as gifts. Conversely, if the transfers are characterized as loans, the parents are advantaged but the children risk having substantial income from the relief of indebtedness.

In conclusion, the law addressing the issue of gift/guarantees is quite sparse, and the Service may have strong reasons for abandoning its once-stated position on the gift tax treatment of guarantees. Nevertheless, it is clear that a guarantee provides a benefit to the borrower, even if intangible and not subject to simple valuation (somewhat like the intangible – but valuable benefit – of being born into a wealthy family). Therefore, anyone contemplating guaranteeing a loan should be aware of the Service’s once-stated (then withdrawn) position and the potential consequences resulting from that position being asserted and sustained.

Another possible way to avoid or mitigate this issue would be to have the trust pay the Inheritor/Beneficiary (or better yet, a third party) an arm's length fee (perhaps...
determined by a bank’s letter of credit fee or, better yet, an independent third party guarantee fee appraisal) – that would seem to make the guarantee a business arrangement and therefore non-donative. If the guarantee is provided by the Inheritor/Beneficiary, because the trust will be a grantor trust from the point of view of the guarantor (Inheritor/Beneficiary), the guarantee fee will not be income to the Inheritor/Beneficiary nor deductible by the CVBDIT. If the Inheritor/Beneficiary had to gift the amount of the guarantee to the trust to allow the trust to pay the fee, that amount would be a gift for gift tax purposes which would be disastrous for effective CVBDIT planning.

1.10 Exit Strategies for Private Split-dollar and Premium Financing Arrangements with a CVBDIT

Because the term insurance cost to the trust of the private split-dollar arrangement may become too large, or the loan interest costs to the trust of the premium financing arrangement may become too large, with either arrangement an “exit strategy” to terminate or unwind the arrangement should be planned at the inception of the arrangement. With a typical irrevocable life insurance trust exit strategies might include a GRAT funded with discountable, flow-through entities such as S-corporation stock, interests in a family limited partnership or interests in a family limited liability company. The GRAT will name the irrevocable trust as the remainder beneficiary. When the GRAT terminates, its assets will be distributed to the irrevocable trust providing the trust with enough asset to unwind the split-dollar or premium financing arrangement and also fund future premiums. However, while this strategy may be effective for
the typical life insurance trust, the Cash Value BDIT cannot have assets gifted to it (other than the initial gift by the settlor) without destroying the income, estate and generation skipping tax benefits which are crucial to its success. As alternatives, consider making additional policy loans to the CVBDIT or entering into a fair market value sale of assets to the CVBDIT structured as a traditional installment sale to an IDIT. However, because the CVBDIT cannot have assets gifted to the trust as “seed” money without destroying the income, wealth and generation skipping tax planning built into the CVBDIT, as an alternative consider using guarantees in lieu of the traditional seed money gifted to the intentionally defective trust. Properly structured, this strategy will create a successful exit strategy without the possibility of a gift.

Perhaps the best exit strategy is the arrangement known as “The Side Fund Split-Dollar Solution”™ created by this article’s co-author Larry Brody and Michael D. Weinberg. 128 Essentially the arrangement is a non-equity collateral assignment private split-dollar arrangement between an insured grantor and an irrevocable life insurance trust. The trust is “funded” with sufficient assets other than the life insurance policy in order to assure the full repayment of the grantor’s premium payments. The funding is accomplished by an installment sale of assets to the CVBDIT by the Inheritor/Beneficiary using guarantees in place of the usual gift of “seed” to the trust in order to give the transaction the economic substance necessary for the IRS to treat the transaction as a bona fide sale for adequate and full consideration.129

129 IRC §2036.
Brody and Weinberg suggest, this technique is best described in five steps which are summarized as follows and adopted to the CVBDIT for purposes of this article.\(^\text{130}\)

First, as the irrevocable trust, the insured (Inheritor/Beneficiary) utilizes the CVBDIT created for his or her benefit by a third party settlor that is designed to be a grantor trust as to the insured (Inheritor/Beneficiary). Therefore, the income of the CVBDIT is deemed to be owned by the insured (Inheritor/Beneficiary). The insured (Inheritor/Beneficiary) then “funds” the trust with a certain quantity of cash or other investments (the side fund) to be owned by the trust in addition to the life insurance policy. With a traditional irrevocable life insurance trust this side fund will be furnished by annual exclusion gifts, gifts utilizing the grantor’s $1 million gift tax exemption, and, in appropriate situations, taxable gifts. However, with the CVBDIT, there never can be any gifts to the trust other than the initial gift of $5,000 by the settlor to the trust. Therefore, traditional gifting techniques cannot be used. Rather, the Inheritor/Beneficiary will sell assets to the CVBDIT for fair market value (often on a discounted basis utilizing discountable S-corporation stock, FLPs and FLLCs), typically using guarantees as the “seed” money. The precise amount of the side fund is determined by the expenses that are to be paid from the side fund.

Second, the insured (Inheritor/Beneficiary) enters into a non-employment, non-equity collateral assignment split-dollar arrangement with the trustee. The collateral assignment is executed by the trust in favor of the Inheritor/Beneficiary and filed with the insurer. This arrangement

\(^{130}\) Zaritsky & Leimberg, supra note 41, at §3.02[2][e].
results in the income, gift, and GST taxation of the insured (Inheritor/Beneficiary) under the economic benefit regime, rather than the loan regime.

Third, the insured (Inheritor/Beneficiary) is repaid for his or her split-dollar premium advances from the trust side fund if the arrangement terminates during the Inheritor/Beneficiary’s lifetime, or from the proceeds of the policy if the arrangement continues until the Inheritor/Beneficiary’s death. This feature differs from the traditional split-dollar arrangement in which sufficient premiums had to be paid to enable the ultimate payment of premiums from the cash value of the policy. The side fund does not require that premiums be as large as those required under some older split-dollar arrangements.

Fourth, the trust (CVBDIT) pays the annual term costs to the insured (Inheritor/Beneficiary) from the side fund. This also differs from the traditional split-dollar arrangement in which the trust was usually unfunded and the grantor made gifts to the trust to cover the term cost.

Fifth, any loans outstanding at the termination of the arrangement during the insured’s (Inheritor/Beneficiary’s) life will be repaid from the side fund during the insured’s (Inheritor/Beneficiary’s) lifetime, or from the insurance proceeds at the insured’s (Inheritor/Beneficiary’s) death.

In their summary of this technique authors Zaritsky and Leimberg state:

The authors of this technique note that the use of a non-equity collateral assignment arrangement results in the deemed transfers of relatively small amounts determined under either the Table 2001 costs or, if appropriate, the
actual term costs. In addition, the combined use of an intentionally defective grantor trust [CVBDIT] and a life insurance policy enhances the estate planning uses of installment sales to such trusts, because it provides cash at the insured’s death with which to repay any obligations created on the sale of appreciated assets to the trust.\textsuperscript{131}

1.11 Conclusions Regarding Funding the Cash Value BDIT Using Split-Dollar and Premium Financing Arrangements

As stated in the introduction to Section 1.2, until there are sufficient assets in the Cash Value BDIT to generate the cash flow necessary to pay the insurance premiums required to fund the appropriate cash value life insurance policy, practitioners need to consider planning strategies to fund the CVBDIT that do not involve gifts to the trust, other than the initial gift to the trust by the settlor. As explained in detail in sections 1.2 through 1.10, private split-dollar and premium financing arrangements properly structured to avoid any gifts and unwanted tax consequences to the trust or the Inheritor/Beneficiary may be the perfect techniques to provide the funding for a successful Cash Value BDIT transaction.

\textsuperscript{131} \textit{id.} at S3-37.
1.12 The Cash Value BDIT – Modern Portfolio Theory and Life Insurance

Managing Wealth within the Cash Value Beneficiary Defective Inheritor’s Trust – Incorporating Modern Portfolio Theory and Life Insurance

[1] Introduction

The following Sections of this article will examine and analyze the application of modern portfolio theory (MPT) to the management of wealth contained within the Cash Value Beneficiary Defective Inheritor’s Trust (CVBDIT), including permanent cash value life insurance. A brief history, background and description of MPT will be presented, and CVBDIT investment portfolios, including family businesses and life insurance, will be considered. An overview of the main modern types of permanent cash value life insurance will be presented, as well as the nature of the insurance company assets that

132 The authors gratefully and greatly acknowledge the assistance of independent insurance consultant Richard M. Weber, MBA, CLU, AEP® (Distinguished) of The Ethical Edge, Inc. of Pleasant Hill, California in the preparation of this article. For the past 20 years Mr. Weber has written, lectured and practiced innovated, consumer-oriented processes which apply financial planning and statistical modeling techniques to the evaluation, selection and management of life insurance policies. He has provided invaluable insights, advice and guidance, as well as inspiration, with respect to the issues discussed within this section of the article. Additionally, he has generously granted permission to incorporate into this article significant portions of materials that he has previously published, most significantly the following seminal research white paper with coauthor Christopher Hause, FSA, MAAA, CLU:


No claim is made to original work herein. This article not only contains original material from the authors, but also compilations, summaries, revisions and commentary from other source materials, most of which are cited in the footnotes.
support the cash values contained within the life insurance policies. The academic, scholarly and professional literature on life insurance in the context of a portfolio will be explored. Life insurance as an asset class will be considered and analyzed, plus an examination of the allocation of assets to building an efficient investment portfolio by including life insurance. Finally, the authors will present and analyze the selection of life insurance by applying MPT to create a portfolio of different life insurance policy types, or styles, based on risk tolerances and other preferences of the trustee and the Inheritor/Beneficiary.

1.13 Modern Portfolio Theory

[1] Introduction

The Cash Value Beneficiary Defective Inheritor’s Trust (CVBDIT) is the ultimate wealth management, multi-task vehicle to shield and protect family assets in perpetuity from transfer taxes and creditors, including divorced spouses. Indeed, it behooves a family to house almost all family assets (other than assets retained for personal use) within the trust’s protective wrapper. After assets are transferred to the trust, where, because of the “tax-burn”, they can grow tax-free within the trust, besides the use and enjoyment of the assets by the family (not the ownership by the family but by the trust) the dominant issue becomes the efficient management of the assets contained in the trust.

Efficient management entails managing the assets for the maximization of investment returns on the assets. But how does one accomplish this task? What is maximization of
returns? Are investments concentrated within one or two assets or are investments diversified along a whole spectrum of assets? What about the risks involved with the various investment choices? Can planners maximize returns yet minimize risks?


Fortunately, the answers to these questions, which have plagued investors and portfolio managers as well as trustees for eons, is contained in a body of knowledge that has come to be known as modern portfolio theory (MPT). Originally espoused by Harry Markowitz in 1952, for which he along with Merton Miller and William Sharpe shared a Nobel Prize in 1990, MPT has become the dominant approach to the selection of investments and portfolios. Indeed, the Model Uniform Prudent Investor Act, adopted in some form by the majority of states, provides the standards which professional fiduciaries and trustees must adhere to, and incorporates MPT and a “‘total return’ approach to the exercise of fiduciary investment discretion, as well as risk versus return analysis.”

One of the advantages of using a corporate independent trustee for the CVBDIT along with the Beneficiary/Inheritor as Family Trustee is that such trustee’s firm will have the knowledge and expertise to apply MPT to the portfolio of assets contained

\[\text{\ldots}\]

---

134 www.nobelprize.org/nobel_prizes/economics/laureates/
in the CVBDIT since the corporate trustee is held to the Prudent Investor Act standard that encompasses MPT.

Prior to the advent of MPT, the academic and scholarly literature of economics and finance only accounted for risk in terms of individual investments and securities as opposed to a portfolio of investments or securities as a whole. Risk in an investment was accounted for by either letting “anticipated’ returns include an analysis for risk”....or....”we could let the rate at which we capitalize the returns from particular securities vary with the risk.” Diversification within a portfolio had to do more with the law of large numbers as opposed to diversification by industry, much less diversification by “asset classes” (to be discussed below).

MPT uses mathematical statistics and modeling to derive at an optimal efficient portfolio return given a specific level of risk. A portfolio is optimal when for any given level of return there is no lower risk for the same return, or, conversely, for any given level of risk there is no higher return for the same risk. The curve on a graph of risk and return that describes the set of optimal portfolios is referred to as the “efficient frontier.” The crux of MPT is taking into account how investments or securities, or types of investments or securities, relate to one another, or to a particular market or market indices such as the [Standard & Poor’s 500® Index (S&P 500®)]. As long as there is not a

---

136 Markowitz, supra at note 133, at 77. Markowitz references in footnote 2. J. R. Hicks, Value and Capital, Oxford University Press, New York, New York, 1939, page 126. Markowitz further notes in the footnote that “Hicks applies the rule to a firm rather than a portfolio.”

137 Id. at 77-80.
direct one-to-one correlation, planners can reduce the overall risk of a portfolio by combining investments and securities whose market price or return movement varies differently from one another.

The measurement of how an investment or a security’s return or price movement varies with respect to another investment or security’s return or price movement, or to a particular market movement or market indices, is called covariance. The standardized measurement of covariance is the correlation coefficient. The correlation coefficient has a numerical range from minus one (-1) to plus one (+1). Investments with a correlation coefficient of plus one (+1) are perfectly correlated and, therefore, combining these investments provides no diversification or lowering of the risks of a portfolio. Investments with a correlation coefficient of minus one (-1) move completely in the opposite direction and provide the maximum diversification within a portfolio and reduction of risks. Unfortunately, in the real world correlation coefficients of minus one do not exist and even negative correlations can be rare. Investments with a correlation coefficient of zero (0) have absolutely no relationship with one another, but, theoretically, do reduce the overall risks of a portfolio.\(^{138}\)


While the authors have referred to risk in the discussion of MPT, the authors have not yet defined risk and how risk is measured. Risk is defined as the variability, or degree of uncertainty, of a return, which is commonly measured by the standard deviation of the expected or anticipated return. The standard deviation comprises the total risk of an expected or anticipated return. Total risk with any investment or security, or for that matter portfolio, has two components: systematic risk and unsystematic risk. The important difference between the two components is that systematic risk cannot be eliminated through diversification of a portfolio, whereas, unsystematic risk can be eliminated by diversification of a portfolio (the essence of Markowitz’s MPT).

[a] Systematic Risk

Systematic risk is the risk that cannot be diversified away no matter how many different securities or investments, which have correlation coefficients with one another of less than one (+ 1), are added to a portfolio. It represents the variability of all risky assets due to the effect of macroeconomic variables. These macroeconomic variables include such things as unanticipated changes in the gross domestic product growth rate, inflation, interest rates, money supply and

industrial production. Some macroeconomic factors that are particular types of risks generic to systematic risk include: purchasing power risk, reinvestment rate risk, interest rate risk, market risk and exchange rate risk. Purchasing power risk is the risk caused by inflation, which causes a rise in the general price level. Reinvestment risk is the risk of reinvesting funds, either from sold investments or the income from investments, at a lower rate of return than is being earned by the current investment or portfolio.

Interest rate risk is the risk associated with changes in the general level of interest rates. This risk is particularly of interest for purchasers of bonds or fixed-income securities because of the inverse relationship between interest rates and prices of fixed-income securities, i.e. as interest rates increase (decrease) the price of fixed income securities fall (rise).

Market risk is the broad risk of macroeconomic factors, investment preferences and opinions, political and tax changes that affect all securities in the market. For example, a shift in investor psychological preference away from the stock market would cause a decrease in demand which should result in lowering of the overall prices of equity securities.

Exchange rate risk, or currency risk, is the risk that changes in the exchange rates for the United States and foreign currencies could cause an adverse effect on an investment. For example, when the Euro weakens relative to the dollar, the price of goods manufactured in the United States rises in the European
market causing an adverse effect on businesses that export to Europe. Similarly, for businesses in Europe owned by United States companies, conversions from the Euro to the United States dollar caused a decrease in the income received.

[b] Unsystematic Risk

Unsystematic risk can also be referred to as diversifiable risk, since it is the risk that can be eliminated through diversification. Unsystematic risk describes risk factors that are specific or unique to individual investments. These include such things as a company’s management, business plan, marketing strengths, product line, patents, uniqueness, position within an industry, financial structure, earning capacity, ability to pay interest and dividends, and the industry in which the company operates. The financial risk of a business, in other words how it finances, its assets (the degree of financial leverage), and, the business risk of the company and the industry in which it operates, is especially important. Some other types of unsystematic risks, which can be germane to specific investments, types of investments or investment funds, include default risk, credit risk, political risk, call risk, tax risk and investment manager risk. While the authors will not discuss in detail these types of unsystematic risks, there are two other types of unsystematic risk that are worth noting.

The first is liquidity risk, which is the ability of, or how quickly can, an investment be converted into cash with little, if any, change from the market price, which is generally the price at which the investment last traded. This risk can be
especially acute for closely-held businesses and real estate. Safety of principal is another aspect of liquidity risk.

The second risk, closely aligned with liquidity risk, is marketability risk. Marketability risk is the risk that there is not an active market for an investment. For example, the market for an environmentally contaminated piece of real estate may be non-existent. Similarly, there may not be a market for a single product company with an obsolete product.

Unsystematic risk is minimized by including in the portfolio securities from different industries, preferably industries whose performances are not correlated. The classic example would be owning stock of both a car manufacturer and a manufacturer of bicycles. The idea is that when the cost of either owning or operating an automobile is considered too high demand for automobiles will decrease, thus lowering the return of the car manufacturer stock. However, this will be offset by the increasing demand for bicycles which will cause an increase in the return of the bicycle manufacturer stock.

It does not take that many securities to eliminate unsystematic risk. For example, “some studies have suggested that a well-diversified portfolio can be formed with 10 to 15 large-cap securities selected from different industries.”140

“Studies of mutual funds have shown that four to seven funds in different asset

140 College for Financial Planning, supra 139, Chapter 1 at 17.
classes optimize diversification benefits.”

Because mid- to small-cap stocks have a greater degree of volatility, a great number of securities are needed to achieve the same diversification of a portfolio of large-cap stocks. “A good rule of thumb would be to allocate 25 to 30 mid- or small-cap securities.”

Systematic risk is non-diversifiable. Therefore, systematic risk cannot be eliminated by adding more securities of the same type, such as bonds, to a portfolio of bonds. Adding more bonds will not eliminate purchasing power risk or interest rate risk, both types of systematic risks. However, within the framework of a portfolio of bonds, those risks can be mitigated with the addition of different types of assets, or asset classes (to be discussed below), to the portfolio, such as common stocks. Therefore, by adding common stocks to a portfolio of all bonds, such that the portfolio now contains 50% bonds and 50% stocks, the portfolio’s purchasing power risk is now diminished because over time common stocks outperform inflation.


The underlying tenet of MPT is to create a portfolio that is diversified not only among assets, securities or investments of a similar type but also among assets, securities or

---

141 *Id.* at 17.
142 *Id.*
143 *Id.* at 19.
investments of different types. In practice, MPT starts with dividing investment choices, or portfolio components, into broad categories known as “asset classes” and allocating investment resources among the different asset classes in predetermined percentages that are consistent with the investor’s risk tolerance (to be discussed below).

In Chapter 40 of *The Financial Analyst’s Handbook*, Second Edition, Jeffery J. Diermwier, CFA, describes asset class as “referring to individual securities that are of a common financial form, i.e., common stocks, bonds, real estate, commodities, Treasury bills, and so on.” He goes on to state: “Because substantial empirical evidence has demonstrated that securities of a common financial form perform in a significantly similar fashion, it is logical in a decision hierarchy to group such securities together for purposes of convenience.”

In a similar fashion, the definition of asset class in the 2008 *Morningstar/Ibbotson Yearbook* is as follows: “A grouping of securities with similar characteristics and properties. As a group these securities will tend to react in a specific way to economic factors (e.g., stocks, bonds, and real estate are all asset classes).”

From the examples given in the above definitions, it is obvious that there is considerable agreement that primary asset classes include common stocks (equities), bonds (fixed

---


145 *Id.*

income) and real estate. Additional equity primary asset classes can include preferred stocks; additional fixed income primary asset classes can include mortgages; and money market (cash) can be classified as a primary asset class. Other authors have classified guaranteed annuities as a primary asset class. Later in this paper the authors will explore the concept of permanent life insurance as an asset class.

Primary asset classes are further subdivided into sub-categories. For example, common stock equities can be segregated into large-cap, mid-cap, small-cap and international. Thus, each primary asset class can be diversified and assets allocated to different sub-asset classes. By means of this division of allocated investment resources, total risk of a portfolio can be minimized and returns maximized for any given level of risk tolerance.

The above definitions of asset classes reference assets of “similar characteristics and properties”, or “common financial form.” The definitions go on to say that assets of an asset class “perform in a significantly similar fashion” and “will tend to react in a specific way to economic factors.” This implies that each asset class has different characteristics and properties, and financial forms; and, that the different asset classes will not necessarily perform in a similar fashion or react the same way to economic factors. It also suggests that with respect to one another these asset classes will have a correlation coefficient of less than one (+1), and ideally a negative correlation coefficient.

[5] Rebalancing
In order to maximize a portfolio’s return within a given level of risk tolerance over time, the original portfolio asset allocation percentages, or asset mix, between asset classes need to be maintained unless the investor’s risk tolerance level changes in which case the portfolio will need to be reallocated to properly fit within the investor’s revised risk tolerance level. The process of adjusting the assets within a portfolio to maintain the portfolio’s original asset allocation percentages is referred to as “rebalancing”. Rebalancing needs to be performed periodically in order to maintain the original asset allocation.

The importance of rebalancing can be seen with the following example. Suppose an investor has a risk tolerance level that suggests a portfolio of 60% common stocks and 40% bonds. Assume that the market for common stocks has been good such that stock prices have risen relative to bond prices and the originally invested portfolio now consists of 80% stocks and 20% bonds (based on the market values of the stocks and bonds). While the overall expected return of the portfolio has increased because more of the portfolio is invested in common stocks, the overall riskiness of the portfolio also has increased because as an asset class common stocks have more volatility, or risk, than bonds. Thus, the portfolio has become a more aggressive portfolio and the risk level has increased beyond the investor’s risk tolerance level. Rebalancing this portfolio back to the original asset allocation mix of 60% common stocks and 40% bonds will bring the portfolio back to the investor’s risk tolerance level. This will entail selling common stocks and purchasing bonds to bring the portfolio back to the original asset allocation.
mix. Also, note that this example is a perfect illustration example of selling high and buying low, as common stock prices are high in this market as compared to bond prices.

Similarly, if the prices of bonds have risen relative to common stocks such that the portfolio now consists of 40% common stocks and 60% bonds, the investor would sell bonds and purchase common stocks. Note that with this scenario the portfolio before rebalancing would have a lower overall expected return and the overall riskiness of the portfolio has decreased lower than the level of the investor’s risk tolerance. This is because more of the portfolio is invested in bonds (based on the market values of the stocks and bonds), which have a lower expected rate of return and less volatility, or risk, than common stocks. In this situation the rebalancing will raise both the expected return and the risk of the portfolio back to the level of the investor’s risk tolerance. Again, note that this is another example of selling high and buying low, as bonds are now higher in this market compared to common stocks.

[6] Risk Tolerance

Recall that the purpose of MPT is to derive an optimal efficient portfolio return given a specific level of risk. A portfolio is optimal for any given level of return when there is no lower risk for the same return, or, conversely, for any given level of risk there is no higher return for the same risk. Through the use of quantitative techniques, mathematical statistics and modeling, academicians and practitioners in the financial and investment world have been able to quantify with relative accuracy the expected
returns and risks of various portfolios. However, quantifying an investor’s risk tolerance level has been more elusive.

Naturally, there are many psychological and emotional factors involved in the makeup of an individual’s risk tolerance level. In fact, a whole new area of study called “behavioral finance” has evolved with respect to the psychological factors that motivate financial decisions. “Behavioral finance looks at the emotions, irrational decision-making, and biases that often come into play when individuals invest and handle money.” These factors complicate the quantification of an investor’s risk tolerance, and in many ways risk tolerance level assessment is more of an art than a science.

Generally, the investor’s risk tolerance level is measured either by asking the investor a series of questions or by having the investor complete a risk tolerance questionnaire. The questions are designed to determine the investor’s preference for safety of principal as opposed to potential for appreciation but with the possibility of a loss, current income as opposed to growth in the value of the investment, tolerance for investment fluctuations in value, particularly loss of value, and overall comfort level of

147 In 2002, Daniel Kahneman and Vernon L. Smith shared the Nobel Prize in Economic Sciences for their work in the field of economic psychology and experimental economics. www.nobelprize.org/nobel_prizes/economics/laureates/


the investor with different types of risk. The responses to the questions are than
“scored” and matched to investor type, styles or risk profiles in order to determine an
asset allocation mix (discussed below).

There is no uniform risk tolerance questionnaire or portfolio asset allocation system,
although there are significant similarities in many of the questionnaires and asset
allocation systems. Various investment houses, financial institutions, financial planning
practitioners and investment media have devised their own questionnaires and asset
allocation systems.\textsuperscript{150} A typical asset allocation mix system for six types of investor
styles, or risk profiles, will be presented in the next section.


In designing a portfolio two other factors need to be taken into consideration in addition
to risk tolerance: (1) the investor’s time horizon and (2) the investor’s current financial
situation. An investor with a short time horizon who is concentrating on short-term
goals will be far more concerned with price stability, preservation of capital and liquidity
than an investor with long-term goals who has a longer time horizon. In other words,
the short-term investor is willing to accept the lowest returns in order to gain price

\textsuperscript{150} One such system used by banks, insurance companies and CPA firms is the \textit{Portfolio Allocation Scoring System (PASS)} developed by Dr. William G. Droms, CFA, Powers Professor of Finance and International Business at Georgetown University. See, William G. Droms, “Investment Asset Allocation for PFP Clients,” \textit{Journal of Accountancy}, April 1987, pages 114-118. In addition, many investor risk tolerance, profiles, types or styles questionnaires and asset allocation mixes determined from the questionnaires can be found on numerous websites of investment houses and investment media outlets.
stability. Similarly, an investor who has a decreasing future income, large amounts of
debt or no emergency funds will need to be considerably more conservative and less
aggressive in managing their investments, if they even have any investments to manage,
than an investor who has an increasing amount of income, low amount of debt and has
establish an adequate emergency fund.

Strategic Advisers, Inc., a registered investment adviser and a Fidelity Investments
company, has developed six target asset mixes based on six different investor styles and
risk tolerances.151 They also have calculated the range of annual returns for each asset
mix over the period 1926 – 2009. Exhibit E contains the six different investor styles and
risk tolerances, a brief description for each type of investor, the target asset mix, and
the historical target asset returns and ranges of returns:

Note that as planners move from the Short Term investor to the Most Aggressive
investor the average rate of return increases as does the risk, or volatility, of returns as
measured by the highest one-year return, lowest one-year return, highest five-year
return and lowest five-year return. The investor types demonstrate the risk-return
relationship. Also, note the “smoothing” effect of the highest five-year return and

151 Fidelity Investments, Brochures on Benefits of Asset Allocation, loose pages titled: “Asset allocation,” “Asset
allocation portfolio efficiency,” “Understand your risk tolerance,” “Target asset mixes,” and “Target asset mixed
returns,” Provided by Fidelity Brokerage Services, FMR, LLC, Smithfield, Rhode Island, 2010. Data source for this
material was Ibbotson Associates, 2008 (1926-2009) and various market indices such as the Standards & Poor’s
500® Index (S&P 500®), U.S. Intermediate Government Bond Index, U.S. Treasury bills and the Morgan Stanley
Capital International Europe, Australia, Far East Index.
# Exhibit E

## Asset Allocation Mixes for Six Types of Investor Risk Styles

### Short Term
Investor who seeks to preserve capital and can accept the lowest returns in exchange for price stability.

<table>
<thead>
<tr>
<th>Asset Mix:</th>
<th>100% Short-term investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Return:</td>
<td>3.66%</td>
</tr>
<tr>
<td>Highest One-Year Return:</td>
<td>15.20%</td>
</tr>
<tr>
<td>Lowest One-Year Return:</td>
<td>-0.04%</td>
</tr>
<tr>
<td>Highest Five-Year Return:</td>
<td>11.13%</td>
</tr>
<tr>
<td>Lowest Five-Year Return:</td>
<td>0.06%</td>
</tr>
</tbody>
</table>

### Conservative
Investor who takes an income-oriented approach with some potential for capital appreciation and seeks to minimize fluctuations in market values.

| Asset Mix: | 14% Stocks  
6% International  
50% Bonds  
30% Short-term investments |
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Return:</td>
<td>6.05%</td>
</tr>
<tr>
<td>Highest One-Year Return:</td>
<td>31.06%</td>
</tr>
<tr>
<td>Lowest One-Year Return:</td>
<td>-17.67%</td>
</tr>
<tr>
<td>Highest Five-Year Return:</td>
<td>17.24%</td>
</tr>
<tr>
<td>Lowest Five-Year Return:</td>
<td>-0.37%</td>
</tr>
</tbody>
</table>

### Balanced
Investor who seeks potential for capital appreciation and some growth and can withstand moderate fluctuations in market value.

| Asset Mix: | 35% Stocks  
15% International  
40% Bonds  
10% Short-term investments |
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Return:</td>
<td>7.94%</td>
</tr>
<tr>
<td>Highest One-Year Return:</td>
<td>76.57%</td>
</tr>
<tr>
<td>Lowest One-Year Return:</td>
<td>-40.64%</td>
</tr>
<tr>
<td>Highest Five-Year Return:</td>
<td>23.14%</td>
</tr>
<tr>
<td>Lowest Five-Year Return:</td>
<td>-6.18%</td>
</tr>
</tbody>
</table>

---

Exhibit E – cont.

Asset Allocation Mixes for Six Types of Investor Risk Styles

<table>
<thead>
<tr>
<th>Investor Type</th>
<th>Description</th>
<th>Asset Mix</th>
<th>Average Return</th>
<th>Highest One-Year Return</th>
<th>Lowest One-Year Return</th>
<th>Highest Five-Year Return</th>
<th>Lowest Five-Year Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth</td>
<td>Investor who has a preference for growth and can withstand significant fluctuations in market value.</td>
<td>Asset Mix: 49% Stocks</td>
<td>Average Return: 8.88%</td>
<td>Highest One-Year Return: 109.55%</td>
<td>Lowest One-Year Return: -52.92%</td>
<td>Highest Five-Year Return: 27.27%</td>
<td>Lowest Five-Year Return: -10.43%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>21% International</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>25% Bonds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>5% Short-term investments</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Asset Mix:</strong> 60% Stocks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>25% International</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>15% Bonds</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>0% Short-term investments</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aggressive</td>
<td>Investor who seeks growth and can tolerate wide fluctuations in market values, especially over the short term.</td>
<td>Asset Mix: 60% Stocks</td>
<td>Average Return: 9.51%</td>
<td>Highest One-Year Return: 136.07%</td>
<td>Lowest One-Year Return: -60.78%</td>
<td>Highest Five-Year Return: 31.91%</td>
<td>Lowest Five-Year Return: -13.78%</td>
</tr>
<tr>
<td>Growth</td>
<td></td>
<td>25% International</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>15% Bonds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>0% Short-term investments</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Most</td>
<td>Investor who seeks very aggressive growth and can tolerate very wide fluctuations in market values, especially over the short term.</td>
<td>Asset Mix: 70% Stocks</td>
<td>Average Return: 9.97%</td>
<td>Highest One-Year Return: 162.89%</td>
<td>Lowest One-Year Return: -67.56%</td>
<td>Highest Five-Year Return: 36.12%</td>
<td>Lowest Five-Year Return: -17.36%</td>
</tr>
<tr>
<td>Aggressive</td>
<td></td>
<td>30% International</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>0% Bonds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>0% Short-term investments</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\[1\] Derived from Fidelity Investments, Brochures on Benefits of Asset Allocation, loose pages titled: “Asset allocation,” “Asset allocation portfolio efficiency,” “Understand your risk tolerance,” “Target asset mixes,” and “Target asset mixed returns.” Provided by Fidelity Brokerage Services, FMR, LLC, Smithfield, Rhode Island, 2010. Data source for this material was Ibbotson Associates, 2008 (1926-2009) and various market indices such as the Standards & Poor’s 500® Index (S&P 500®), U.S. Intermediate Government Bond Index, U.S. Treasury bills and the Morgan Stanley Capital International Europe, Australia, Far East Index. Used by Permission.
lowest five-year return as opposed to the highest one-year return and the lowest one-year return.

Most investor types or styles would fit the profiles of Conservative, Balanced, Growth or Aggressive Growth with few investors falling into the category of Short Term or Most Aggressive. It would be particularly unlikely to see assets in a CVBDIT managed for short-term goals. In Section 1.14 below, the authors will discuss portfolio assets within a CVBDIT.

[8] Concluding Comments on MPT

The purpose of the sections above was to provide a general overview and introduce the reader to MPT, if they have not already been familiar with or introduced to the concept. As part of this discussion the authors covered the corollary and complementary topics of risk types and measurement, asset allocation and asset classes, rebalancing, risk tolerance, and asset allocation mixes for six types of investor risk styles. MPT is not as “modern”, or contemporary, as it once was and now has been around for almost 60 years. During that time period a tremendous amount of research has been performed, and continues to be performed, and writings abound on MPT in both the academic and scholarly literature as well as in the practical investment literature and investment media publications. MPT is not without controversy and there are numerous publications and studies that challenge the assumptions behind MPT, particularly the efficient market hypothesis and investor behavior. This general overview has barely scratched the surface on this investment technique that predominates the financial
Further discussion on this comprehensive topic is beyond the scope of this article. The remaining sections of this article regarding the subject of MPT will cover the application of MPT to the investment portfolios within the CVBDIT, the application of MPT to permanent life insurance within the portfolio of assets of the CVBDIT, and the application of MPT and asset allocation models to building an efficient portfolio of permanent life insurance within the CVBDIT.

1.14 CVBDIT Investment Portfolios – Family Businesses and Life Insurance

While some BDITs may consist of diversified portfolios composed mostly of publicly traded securities (or own controlling interests in FLLCs or FLPs that primarily contain such portfolios, or eventually will contain such diversified portfolios as current non-diversified assets are sold or trust owned life insurance proceeds collected), the vast majority of the assets of BDITs consist of family businesses, real estate, and farms and ranches. BDITs are private arrangements and there are no statistics available based on any published study or survey and, therefore, the assertion made above is based on empirical observation and talking with many estate planning practitioners. This is not surprising in that 76.6% of households who have a net worth between $10 and $50 million and 86.6% of households who have a net worth greater than $50 million

own a private business; and part of the main reasons for establishing a BDIT is to transfer to the BDIT appreciating family businesses for the purposes of estate tax and generation skipping transfer tax “freezes,” and asset protection, as noted earlier in this article. Thus, after being transferred to the BDIT the family business can grow in perpetuity free of estate tax and generation skipping transfer taxes, and can be shielded and protected from potential creditors, including divorced spouses, for the benefit of the Inheritor and his or her family and heirs.

As noted by attorneys Richard Oshins, Robert Alexander and Kristen Simmons, the “BDIT can serve as a funded life insurance trust that can own life insurance on the life of any beneficiary, including the Inheritor, provided that (1) a trustee other than the one who is also the insured holds all rights and powers with respect to the life insurance, and (2) the insured beneficiary does not have a power of appointment over the life insurance or its proceeds.”  

Indeed...“The use of the BDIT in combination with life insurance is quite compelling.”  Thus, another common asset of the BDIT portfolio is life insurance, and, in particular, permanent cash value life insurance.

---


155 Id. at 9.

While at first it may seem that having a heavy concentration in family businesses, real estate, or farms or ranches is a breach of fiduciary duty for the trustee(s) of the BDIT under the Uniform Prudent Investor Act [which has been adopted by forty-four (44) states], Section 3 of the Uniform Prudent Investor Act “lends support to families who want to retain heavily concentrated assets by providing that diversification does not have to occur if the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversification.”

There may be some family enterprises that are highly diversified. However, this is an exception to the normal nature of family businesses, and, it is indeed obvious that most family businesses generally are not diversified. Thus, the portfolio of assets within the BDIT contains a tremendous amount of unsystematic risk, particularly business risk, liquidity risk and marketability risk. Generally while these family enterprises provide enormous value to the family, do quite well and are highly successful, the high return comes with a risk that is higher than it would be with a diversified portfolio.

As stated above, the BDIT is an ideal vehicle to own life insurance on the lives of the beneficiaries of the BDIT, including the Inheritor/Beneficiary. The life insurance has the advantages (1) of providing estate liquidity to pay estate transfer taxes on the estate of the Inheritor/Beneficiary with respect to assets that have not been transferred to the BDIT or

consumed by the “tax burn,” and (2) the tax-deferred, and highly possible tax-free, build up of the cash values within the life insurance policy. The remaining question is whether it is possible that the permanent cash value life insurance policy could provide diversification to the family businesses, real estate, and/or farm or ranches portfolio of assets contained within the BDIT and, through a correlation coefficient of less than one (+1) with these family enterprises, lower the risk of the portfolio of family businesses within the BDIT according to Harry Markowitz’s MPT.

The authors will explore that question subsequently; however, first the authors will present an overview of the main modern types of permanent cash value life insurance, as well as the nature of the insurance company assets that support the cash values contained within the life insurance policies. Then the authors will exam the use of life insurance in the context of a portfolio, and the unique aspects of permanent cash value life insurance that possibly could give a positive answer to the above question and qualify permanent cash value life insurance as a unique asset class by itself.

1.15 An Overview of the Main Modern Types of Permanent Cash Value Life Insurance Policies and the Assets that Support the Cash Values

[1] Introduction

While it is beyond the scope of this article to provide a detailed or in depth description of the various types of permanent cash value life insurance and the nature of the assets that support the cash values within permanent life insurance, a very brief overview for
background purposes will be provided. This overview will concentrate on four types of permanent cash value life insurance policies: whole life, universal life, variable universal life and no-lapse secondary guarantee universal life. While the focus will be on single insured policies, the policy descriptions and comments are germane to survivorship or second-to-die policies.

[2] Whole Life

Traditionally and historically permanent life insurance consisted of whole life insurance and endowment policies. Whole life policies have many variations that have been referred to, and include, ordinary whole life and limit-payment whole life. All of these types of life insurance have guaranteed values that include a guaranteed death benefit, guaranteed cash values, and guaranteed premiums and premium payment periods. These policies are issued either by stock life insurance companies (companies which are owned by stockholders), or mutual life insurance companies (companies which are owned by the policy owners).

---

Whole life policies may be issued on either a “participating” or “nonparticipating” basis. Nonparticipating policies primarily are issued by stock life insurance companies, and this version of whole life does not pay any “dividends” to the policy owner. The policy owner does not share in the favorable experience of the insurance company (over and above the “expected” guaranteed investment returns, guaranteed expenses of operation of the company and the policy, and guaranteed mortality experience),159 with respect to higher than expected investment returns, lower than expected expenses of operation of the company and/or lower than expected mortality experience. In other words, the policy owner just receives the guaranteed values of the life insurance policy.160

Almost all whole life policies sold by mutual life insurance companies are participating policies; and “[most] stock life insurance companies offer a choice of both participating and nonparticipating policies.”161 As stated by Dan M. McGill and revised by Edward E. Graves:

“Whole life policies issued on a participating basis anticipate charging a small extra margin in the fixed premium with the intent to return part of the premium in the form of policy owner dividends. This approach allows the insurer to maintain a stronger

159 An old axiom known by all professionals within the life insurance industry and profession is that the three main elements of a life insurance policy consist of investment, or interest, returns, mortality experience and expenses.

160 See Graves, supra note 158 at 4.9.

161 id. at 4.10.
contingency margin and still adjust the cost downward after periods of coverage have been evaluated. Policy owner dividends are based on favorable experience such as higher than expected investment returns or lower than expected expenses of operations and/or mortality.”

Legally, dividends are a return of premium, and are non-taxable until the total dividends received under the policy exceed the policy owner’s basis (essentially the total premiums paid) in the policy. By far, “investment results usually account for the largest proportion of dividends.” However, dividends are not guaranteed and, therefore, can be reduced from previous non-guaranteed dividend projections as occurred in the 1990s. Dividend payments, which generally are declared annually and paid on the life insurance policy anniversary date, can be applied to several different dividend options. The most commonly applied dividend options, and the options most relevant to this discussion, are to receive the dividends in cash, apply the dividend to reduce the next due premium payment, or apply the dividend to purchase what amounts to a single-premium, fully paid-up whole life insurance policy with a cash value equal to the dividend payment and a face amount equal to the amount of life insurance that that cash value will support given the insured’s gender, age at the time of

________________________________________

162 Id. at 4.9.
163 IRC § 72(e)(5); Treas. Reg. § 1.72-11(b)(1).
164 Graves, supra note 158 at 4.10.
165 Id.
payment of the dividend, and risk classification used in the original whole life policy. This later dividend option is referred to as “paid-up additions.” In addition, paid-up addition dividends are subsequently paid (if the insurance company declares dividends, which, of course, are not guaranteed) on the previous paid-up additions, resulting in a compounding affect that is tremendously valuable to the policy owner.

Participating whole life policies are commonly referred to as par whole life, and par whole life policies with the paid-up additions dividend option are the most common, and appropriate, forms of whole life policies contained within the BDIT. Both Richard M. Weber and Christopher Hause (hereinafter sometimes referred to as “Weber and Hause”) and the authors agree with many other well-known life insurance authorities that “[historically], dividend-paying [participating whole life] policies have generally provided greater long-term value than those policies that did not pay dividends [nonparticipating whole life].”¹⁶⁶ All further discussion of whole life policies in this section and throughout the rest of this article will be solely with respect to participating whole life policies with the paid-up additions dividend option.

[3] Universal Life

Non-traditional permanent cash value life insurance policies include universal life, variable universal life, and no-lapse secondary guarantee universal life. The authors will first consider universal life.

¹⁶⁶ Weber and Hause, supra note 2 and 132, at 21.
While whole life insurance has been around for well over 100 years universal life insurance was introduced in the late 1970s. There are several major differences between whole life policies and universal life policies. These differences include the flexibility to increase (with evidence of insurability) or decrease the face amount, increase or decrease the premium, and directly make withdrawals of cash from the policy cash value in addition to taking a policy loan from the cash value of the policy.

One very unique feature of universal life policies is the “unbundling” and detailed itemized accounting of the expense components, including cost of insurance (mortality) and other expenses, crediting rates to the cash value of the policy, and loans and withdrawals from the cash value of the policy. Whole life insurance does not have this “transparency” and operates as a “bundled” package.

Unlike whole life that has a fixed, guaranteed premium payment amount and period of premium payments, the universal life policy premium payment amounts and periods are flexible. In fact, other than a “minimum specified level of first-year premium payments...it is completely up to the policy owner as to how much premium to pay and even whether or not to pay premiums.”167 Thus, the premium is considered “indeterminate” and policies with this premium flexibility feature are referred to as “indeterminate premium” policies. The amount of planed premium that the policy owner decides to pay is referred to as the “funding premium.”

167 Graves, supra note 158 at 5.17.
The guaranteed nature of whole life and universal life, however, are substantially different. Whole life guarantees that as long as the policy owner pays the stipulated guaranteed premium each year until either the inured dies or the policy “matures” or “endows”,168 (generally at age 100169, at which age the face amount of the policy is paid to the policy owner) the face amount, or death benefit, is guaranteed to be paid. Similarly, as long as the premiums are paid when due, there is a guaranteed schedule of cash values in the policy.170 The guaranteed values and the guaranteed premiums are all based on conservative assumptions of guaranteed interest crediting rates, policy expenses and mortality experience that are stipulated in the policy. With respect to the whole life policy, the current interest earnings, expenses and mortality experience of

168 The mortality tables that are the basis for life insurance policies have a maximum assumed age at which point it is actuarially assumed that the insured is dead whether or not the insured is actually dead or alive. If the insured is still alive at that maximum assumed age the policy is said to have matured and the total face amount can be paid to the policy owner. However, unlike the face amount that is paid as a death benefit and is income tax-free [IRC § 101(a)], the face amount plus policy loans, if any, plus dividends received at the maturity of the policy less the policy owner’s basis (premiums paid) is taxable income. Many insurance companies give the policy owner the option to continue the policy and treat it as a paid-up policy, thus avoiding the income taxation. The policy’s face amount would then be paid to the policy beneficiary(s) at the death of the insured income tax-free.

Prior to the Commissioners 2001 Standard Ordinary (CSO) Table of Mortality, the maximum age on all prior CSO Tables of Mortality was age 100. The 2001 CSO Table of Mortality has a maximum age of 120.

The term mature and endow have been used interchangeably in insurance parlance. Endow essentially means to pay off the face amount of the policy. This is not to mean the whole life or universal life policies are endowment policies. Endowment policies act as savings vehicles that pay off the face amount at a specified age, such as age 65, if the insured has not died prior to that age, in which case the face amount would have been paid to the policy beneficiary. Endowment policies while popular in other countries have been eliminated in the United States due to the tax code.

169 This age can vary with whole life and universal life policies. Technically whole life and universal life policies mature at age 100. However, some “whole life” and universal policies mature as early as age 95 and age 98 is not uncommon. In addition, prior to 1990 some insurance companies issued policies to female insureds that matured three years later than those issued to male insureds. Newer whole life and universal policies can mature up to age 120.

170 Enhancements in the policy’s face amount and cash values come from policy dividends, which are not guaranteed.
the insurer generally are superior to the conservative values guaranteed in the whole life policy itself.

There are three factors that are guaranteed with a universal life policy: i) the minimum interest rate to be credited to the cash value, or account value, ii) the maximum expense charges, and iii) the maximum costs of insurance (mortality). After the first year of premium payments at the specified level, as mentioned above, the only guarantees in the policy are the three items specified earlier in this paragraph. This means that while the pricing elements are guaranteed, other than in the first year there are no guaranteed premiums or policy benefits. Thus, the onus and “sufficiency” risk to adequately fund the policy so that the policy stays in force and cash values continue to grow is transferred to the policy owner.

Quite often, the premium funding level in a universal life policy is determined based on the insurer’s current interest crediting rate, expense charges and cost of insurance (mortality) rates. These “current assumptions,” which can, and do change (particularly the interest crediting rate) are not guaranteed, but generally are far more favorable than the guaranteed minimum interest crediting rate, maximum expense charges and maximum cost of insurance. Funding based on the current assumptions can be a sinister proposition, as exemplified with universal life policies sold in the 1980s based on then “current” high interest crediting rates which dropped precipitously in the 1990s. Too many policy owners were then left with drastically underfunded universal life
policies that were destined to lapse and die out before the insured died unless there were dramatic increases in premium funding.

The actual operation and “mechanics” of a universal life policy has been analogized to a pot. Edward E. Graves compares the universal life funding to the operation of a car’s gas tank:

Consider the analogy of an automobile’s gas tank, where premium payments are synonymous with filling the tank. Premium payments (tank refills) can be made frequently to keep the tank nearly full at all times. With that approach the automobile is never likely to run out of gas. The same automobile, however, can operate on a just-in-time philosophy, where premium payments of minimal amounts are made only as frequently as necessary to keep the car from running out of gas. The vehicle operator has full discretion in deciding how to maintain an adequate amount of gasoline in the car. If the operator fails to keep enough gas in the tank, the vehicle may run out of gas and be inoperable until the tank can be refilled. Likewise, under a universal life insurance policy, if the policy cash value is allowed to drop too low (the cash value
is inadequate to cover the next 60 days of expense and mortality charges), the policy will lapse.\textsuperscript{171}

As pointed out by Weber and Hause, the risk shift with universal life policies is “[not] as transparent [or obvious], at least [as was thought] initially, [in that the risk to the policy owner] was that the universal life policy design essentially transferred to the policy owner the sufficiency risk that the policy – based on the requirement that there be at all times a positive balance of paid premiums, credited interest, and debited expenses – would be in force when the insured dies.”\textsuperscript{172}

The universal life policy owner has a choice between two death benefit designs: a level death benefit policy and an increasing death benefit policy.\textsuperscript{173} A level death benefit universal life policy mirrors the design of a whole life policy without dividend enhancements. The increasing death benefit design is a constant amount of the equivalent of level term insurance added to the increasing cash value. Obviously, a greater premium funding level is required for the increasing death benefit design. Naturally, given the flexibility of universal life, the policy owner can switch between the two death benefit options, although evidence of insurability most likely will be required to switch from the level death benefit to the increasing death benefit.

\textsuperscript{171} Graves, supra note 158 at 5.17.

\textsuperscript{172} Weber & Hause, supra note 2 and 132, at 22.

\textsuperscript{173} The level death benefit design may turn into an increasing death benefit due to IRC §7702, which requires that, a certain ratio, or “corridor,” based on the insured’s age is maintained between the cash value and the death benefit.
With the unbundling of the elements of a life insurance policy (and the accounting for the deductions from the accumulated cash values for the cost of insurance, or mortality, for each year), universal life essentially functions as a “buy term and invest the difference” model, with the difference being invested on a tax-deferred basis. Without question universal life initially needs to be funded adequately and then continuously monitored for funding adequacy. It is ideal for those policy owners who will have changing needs and need a flexible insurance vehicle to manage those needs. It is also suitable for those policy owners whose cash flow will vary over the years.

[4] Variable Universal Life

Variable universal life adds an additional element of flexibility to the already flexible universal life. When the policy owner pays the premium on the universal life policy to the insurer, or for that matter any non-variable cash value policy, the excess premium over and above any expense charges and cost of insurance is invested in the “general account” of the insurance company, which backs up the insurance company reserves that back up the cash values of the policy. These general accounts, which are subject to the claims of the insurer’s creditors, are invested primarily in high-grade fixed-income securities. In fact, according to the American Council of Life Insurers 2009 Fact Book, 72% of the assets of life insurers were invested in corporate or government bonds, 11% of the assets were invested primarily in mortgages and real estate, including company occupied real estate, 4% in policy loans, and 10% in miscellaneous assets. Only 4% of
the assets were invested in stocks.\textsuperscript{174} The policy owner has no choice to direct where his or her excess premiums or policy cash values are invested.

With variable universal life the policy owner has the choice (and both the opportunity and responsibility) to direct investments and allocate, reallocate and rebalance his or her premiums and cash values into his or her choice of separate sub-accounts of the insurer, “which are very similar to mutual fund accounts.”\textsuperscript{175} As noted by Weber and Hause, the “the variable universal life policy typically provides a variety of proprietary and non-proprietary mutual fund-like sub-accounts across a spectrum of fixed and equity accounts.”\textsuperscript{176} These “offerings include a number of fixed return accounts, bond accounts, and equity accounts, including small cap, large cap, and international funds.”\textsuperscript{177} The Securities and Exchange Commission (SEC) requires that the separate accounts “not constitute part of the insurance company’s general investment fund and put such assets beyond the claims of its general creditors.”\textsuperscript{178} Thus, the separate accounts for variable insurance products are beyond the reach of the insurance company’s general creditors.

\textsuperscript{175} Weber, \textit{supra} note 158, at 47.
\textsuperscript{176} Weber & Hause, \textit{supra} note 2 and 132 at 22.
\textsuperscript{177} Weber, \textit{supra} note 158 at 47.
\textsuperscript{178} Graves, \textit{supra} note 158, at 5.7.
With variable universal life only two factors are guaranteed: the maximum expense charges and the maximum costs of insurance (mortality). As Edward E. Graves points out:

A variable life insurance policy provides no guarantees of either interest rate or minimum cash value. Theoretically, the cash value can go down to zero, and if so, the policy will terminate. As the SEC pointed out, in order for policy owner’s to gain the additional benefit of better-than-expected investment returns, they also have to assume all of the downside investment risk.179

As observed by Weber and Hause, the “long-term viability of the policy becomes a function of the funding premiums paid and the market returns of the chosen sub-accounts.”180 In order to achieve the maximum benefit from the variable universal life insurance policy, and because of the variability of the investment sub-accounts, the policy needs to be funded to the maximum extent possible.181

179 Id. at 5.6.

180 Weber & Hause, supra note 2 and 132, at 22.

181 If too much cumulative premium is paid into the policy during the first seven years of the policy, or after a change in the policy, the policy may become a modified endowment contract (MEC). The MEC rules affect policies issued after June 21, 1988 and insurers are required to test for MEC status. The insurers will specify the maximum amount of premium that can be paid into the policy without the policy becoming a MEC. While MEC status does not affect the tax-free nature of the death benefit, it does cause any lifetime withdrawals of cash values, including policy loans, to be taxable on a “last in/first out” basis. In other words, distributions from the policy become income taxable on a first dollar basis. In addition, there is also a 10% tax penalty for withdrawals from a MEC policy before the age of 59 ½.
MPT can be applied to the premium investments in the sub-accounts in order to achieve diversification and create an optimal portfolio within those sub-accounts. Of course, similar to pure investment portfolios, in order to maintain the optimal return for a given level of risk, the sub-accounts need to be rebalanced. Fortunately, within the variable universal life insurance policy the rebalancing does not result in capital gains taxes as it does within mutual funds and other investments. MPT needs to be taken in a “total portfolio context.” That is, an investor’s total portfolio of personal investments, retirement plans and variable universal and other cash value life insurance must be considered together.

Variable universal life insurance by far is the most flexible life insurance vehicle. Well known and respected financial planner Ben G. Baldwin, Jr., CLU, ChFC, CFP®, AEP® (Distinguished) considers “variable universal life to be the financial product of the century, a veritable financial Swiss Army knife of financial products, a product that is capable of helping almost everyone.”182


The no-lapse secondary guarantee universal life policy is a universal life policy with a special provision, the secondary guarantee, which guarantees that the death benefit

---

For an excellent discussion and analysis of variable universal life insurance premium funding levels see Baldwin, supra note 158, Chapter 8, at 139-164.

182 Id. at 91.
under the policy will be paid under certain conditions despite the fact that there is no cash value in the policy – “a condition that would normally cause a universal life policy to lapse.” 183 As stated by Richard M. Weber, a no-lapse secondary guarantee universal life policy “will waive the requirement to maintain a positive cash value and will sustain the policy until the death of the insured in spite of the fact that there is no cash value.” 184 Weber goes on to say “[at] least one requirement of a typical secondary guarantee policy is that the specified premium must be paid immediately upon billing.” 185 The contractual provisions to maintain the secondary guarantee provision are very stringent and are enforced strictly. If the conditions of these provisions are not met, the no-lapse secondary guarantee aspect of the policy is null and void. Almost always, one condition is that a specified minimum required premium, or target premium, must be paid on or before the exact due date. In other words there is no grace period with the no-lapse secondary guarantee provision and the policy owner cannot skip premium payments. 186

183 Weber & Hause, supra note 2 and 132, at 23.
184 Weber, supra note 158 at 42.
185 Id.
186 Edward E. Graves notes: “The second approach to the no –lapse guarantee [and less common approach] is intended to allow the flexibility of skipping premiums or paying smaller than target premiums. The criteria for maintaining the guarantee is that the policy cash value must equal or exceed a specified schedule of accumulation. The required schedule is often called a shadow cash value amount. In order to be able to skip premiums and maintain the guarantee, adequate prior premiums will have to be paid to build up the cash value in excess of the required schedule. Failure to maintain a cash value that equals or exceeds the required schedule will negate the guarantee.” Graves, supra note 158, at 5.22.
The no-lapse secondary guarantee feature came about, as noted by Edward M. Graves, because “[the] flexible premium feature on universal life policies has increased the risk that the policy may terminate due to inadequate premium payments.\textsuperscript{187} He further states that “[the] insurers have introduced guarantees that the coverage will stay in force if the actual premiums paid meet the requirement specified in the no-lapse guarantee provision.”\textsuperscript{188} The no-lapse secondary guarantee provision within a universal life policy obviously is a significant departure from the underlying principles of universal life and life insurance policy design in general. Essentially, the no-lapse secondary guarantee provision converts the universal life policy into the guarantee features of whole life without the cash value. Thus, in effect the policy becomes what Richard M. Weber defines as “a [guaranteed] level-premium term to life insurance until death.”\textsuperscript{189} To paraphrase Weber and Hause, the policy has “the reality of the lifetime guarantee but without the typical cash value that would accompany a lifetime policy.”\textsuperscript{190}

While a participating whole life policy with the paid-up additions dividend option has an excellent potential for an increasing death benefit, a “properly” funded variable universal or universal life policy has a good potential, and even a minimally funded universal life has some potential, there is no potential for an increasing death benefit

\textsuperscript{187} Id. at 5.22.
\textsuperscript{188} Id.
\textsuperscript{189} Weber, supra note 158, at 43.
\textsuperscript{190} Weber & Hause, supra note 2 and 132 at 23.
with no-lapse secondary guarantee universal life. Thus, the death benefit remains at
the constant level of the initial face amount of the policy. That means there is no way to
compensate for the purchasing power loss over the years due to inflation.

The primary advantage of no-lapse secondary guarantee universal life is the level, “fixed
guaranteed premium that is substantially lower than that of a whole life policy.”¹⁹¹
Indeed, the no-lapse secondary guarantee universal life policy premium is lower than
the “actual” funding premiums required to sustain a variable universal or universal life
policy to maturity. As implied previously, unlike a participating whole life policy, a
“properly” funded variable universal or universal life insurance policy, there is no, or
very little within the first several years, cash value, or living benefits, in a no-lapse
secondary guarantee universal life insurance policy. Richard M. Weber states “[in] such
policies, it’s unlikely that meaningful cash values will accrue beyond the 10⁰ or 15⁰
year.”¹⁹² Weber and Hause comment:

Because of the significant guarantee of sufficiency, owners should not
anticipate accruing substantial cash values; in fact, the relatively nominal
guaranteed cash value is all that should be expected. While the
guarantees of [no-lapse secondary guarantee] universal life are especially
appealing in times of low credited interest rates, they could lose their

¹⁹¹ Weber, supra note 158 at 43.
¹⁹² Id. at 43.
appeal vis-à-vis non-guaranteed [universal life] competitors when crediting rates in the marketplace exceed 5% or 6.\textsuperscript{193}


As mentioned previously, insurance company general accounts, primarily consisting of high-grade corporate and government bonds, commercial mortgages and real estate, and other fixed-income type investments, support the cash values of whole life, universal life, and no-lapse secondary guarantee universal life (to the extent there is any cash value in the policy) policies. Variable universal life cash values are supported by the separate, mutual fund-like sub-accounts of the insurance company. Although there are minimum guarantees in participating whole life and universal life policies, enhancements to the cash values of the policies over and above the guarantees are based on the performance and investment characteristics of the primarily fixed income general account of the insurer. Similarly, the non-guaranteed results and cash values within variable universal life insurance policies are based on the performance and investment characteristics of the separate, individual mutual fund-like sub-accounts of the policy itself. Thus, if premiums and cash values within a variable universal life policy are allocated to a sub-account that is invested in large-cap stocks, the cash values take on the performance and investment characteristics of a mutual fund invested in large-cap stocks.

\textsuperscript{193} Weber & Hause, supra note 2 and 132 at 23.
1.16 **Life Insurance in the Context of a Portfolio**

The needs, uses of, and the tremendous benefits of permanent life insurance contained within the BDIT have been discussed previously in other sections of this writing and other articles. Rather, in this section the authors will concentrate on i) the use of life insurance as part of an asset allocation mix and ii) on the use of life insurance in the context of an asset within a portfolio. In reviewing the financial, investments and insurance literature, particularly the scholarly and academic literature, the authors found that there only are about two handfuls of articles and manuscripts that deal with life insurance in the context of asset allocation decisions and portfolios. However, all of these writings are extremely theoretical and present advanced mathematical and statistical behavioral models. In addition, all of these writings present the concept of “life-cycle finance,” which attempts to integrate human capital, financial capital, asset allocation and life insurance in decision models considering the riskiness of the human capital in the asset allocation and life insurance decision. Human capital is

---


196 See forward to Ibbotson, et al., supra note 195 at vii for a further description of this concept.
defined as “the present value of the anticipated [future] earnings over one’s remaining lifetime.” 197 Total wealth is defined as being “made up of two parts: our human capital and our financial capital.” 198 “Over our lifetimes, our mix of human capital and financial capital changes. In particular, financial capital becomes more dominant as individuals age so that the lower-risk human capital represents a smaller and smaller piece of the total.” 199 In other words, human capital decreases as individuals age.

Peng Chen, Roger G. Ibbotson, Moshe A. Milevsky and Kevin X. Zhu note that a “unique aspect of an investor’s human capital is mortality risk—that is, the family’s loss of human capital in the event of the wage earner’s death.” 200 They go on to say: “Life Insurance has long been used to hedge against mortality risk.” 201 In the research report Lifetime Financial Advice: Human Capital, Asset Allocation and Life Insurance by the same authors it is noted that:

*Life Insurance is the perfect hedge for human capital in the event of death. Term life insurance and human capital have a negative 100 percent correlation with each other. If one pays off at the end of the year, then the other does not, and*

197 *Id.* at 1.
198 *Id.* at 2.
199 *Id.*
200 Chen et al., supra note 195 at 97.
201 *Id.*
vice versa. Thus, the combination of the two provides great diversification to an investor’s total portfolio. 202

In a similar fashion Stephen A. Buser and Michael L. Smith in their article “Life Insurance in a Portfolio Context” state “that insuring against the loss of a claim on future earnings as a result of the wage earner’s death may be modeled as a portfolio problem in which the return on a life insurance contract is negatively correlated with the return on the claim.” 203

All of the models and analysis in the scholarly and academic literature use one year renewable term insurance; and, as used in the models and shown on the graphical exhibits that accompany the various writings, the insurance is decreasing term insurance. The insurance actually decreases in direct proportion to the decrease in human capital over the wage earner’s or investor’s working lifetime and ceases at retirement.

In the research report Lifetime Financial Advice: Human Capital, Asset Allocation and Life Insurance the authors state that “although numerous life insurance product variations exist—such as term life, whole life, and universal life, each of which is worthy of its own financial analysis—the authors [Ibbotson, et al.] focus exclusively on the most fundamental type of life insurance policy—namely, the one-year, renewable term policy.” 204 The footnote referenced at the end of this quoted last sentence makes the comment: “Although an analysis is beyond the

202 Ibbotson et al., supra note 195 at 29.
203 Buser and. Smith, supra note 195 at 147.
204 Ibbotson et al., supra note 195, at 30.
scope of this monograph, the authors believe that all other types of life insurance policies are financial combinations of term life insurance with investment accounts, added tax benefits, and embedded options.”205 However, with the exception of the book produced by Richard M. Weber and Christopher Hause (to be discussed below), to date no other scholarly authors or practicing financial advisers that the authors are aware of have written on life insurance in an investment portfolio context, other than the use of decreasing term insurance in a theoretical context.

To be fair, at the end of the section stating their theoretical model, the authors of the research report *Lifetime Financial Advice: Human Capital, Asset Allocation and Life Insurance* state that:

> We emphasize at this point that our analysis completely ignores the non-human-capital aspects of insurance purchases. For example, a wide variety of estate planning, business succession, and tax minimization strategies might increase demand for insurance much more than the level we have derived in our models. These aspects are beyond the scope of our analysis.206 (Emphasis added).

It is interesting to note that this is the only scholarly and academic writing were the authors of this article have found this caveat, and the cited authors are to be commended and applauded for making that statement.

205 *Id.*

206 *Id.* at 33.
1.17 **Life Insurance as an Asset Class**

While Stephen A. Buser and Michael L. Smith in their article *“Life Insurance in a Portfolio Context”* treat life insurance as an asset, at least in a subheading in the article, the authors were unaware until the seminal white paper by Richard M. Weber and Christopher Hause (Weber and Hause) of anyone treating life insurance as an asset class within the context of asset allocation and MPT.

Weber and Hause hypothesize that the unique characteristics and properties of permanent cash value life insurance qualify it to be treated as a separate, uncorrelated assets class within the context of MPT. This hypothesis is premised on the analysis by Weber and Hause of the characteristics of permanent cash value life insurance presented below:

1. “The death benefit is cash (itself a major asset class) at the precise time it is needed and without valuation adjustment based on up or down phases of the equity or bond markets.

2. “The living benefits — the cash value — take on the asset class attributes of the policy itself. A universal life or whole life policy’s cash value has the dominant characteristic of a fixed account with a minimum guaranteed [risk free] return. A

---

207 Buser & Smith, supra note 195, at 149.

208 Weber & Hause, supra note 2 and 132.
variable universal life policy’s cash value is itself a portfolio with the opportunity to reflect the asset allocation of the policy owner.

(3) “The unique characteristics of life insurance — income tax deferred accumulation of cash value, income tax-free and possibly estate tax-free death proceeds, the ability to make policy proceeds free from the reach of creditors, the possibility of drawing upon policy cash values to produce significant [tax-free] retirement income, and the inherent leverage of relatively low periodic payments into a capital sum [death benefit] — are attributes that allow a life insurance policy the tendency to be at least uncorrelated against virtually any other asset class.

(4) “The death benefit is based on the event of death — not a market event which in turn can cause a change in value.

(5) “Individuals with sufficient assets to retain portfolio managers are most often buyers of significant amounts of life insurance that are funded with capital rather than budgeted income. Determining from which “pockets” of portfolio investments the premiums should be paid is inherently an activity of asset allocation and re-allocation [rebalancing].

(6) “Permanent life insurance intended for a lifetime can produce at least as favorable a long-term return with less risk within a portfolio of equity and fixed
components than a portfolio without life insurance (a favorable efficient frontier result).”

Thus, given the hypothesis, and based on the above analysis, Weber and Hause come to the conclusion that permanent cash value life insurance is a unique, separate asset class by itself within MPT. As such, permanent cash value life insurance has the ability to diversify, enhance and complement other assets, and asset classes, in an investor’s portfolio, adding to a comprehensive wealth accumulation strategy and/or retirement plan.

In this section the authors (a) will examine and analyze the Weber and Hause arguments, as presented in sub-paragraphs (1) through (6) above, regarding the treatment of permanent cash value life insurance as a unique, separate, uncorrelated asset class, and (b) then relate these arguments to the definitions, characteristics and factors that were described above in the section on “Asset Allocation and Asset Classes.” Recall that the definitions used for asset classes referenced assets of “similar characteristics and properties”, or “common financial form.” Furthermore, the definitions go on to say that assets of an asset class “perform in a significantly similar fashion” and “will tend to react in a specific way to economic factors.” The different asset classes will not necessarily perform in a similar fashion or react the same way to economic factors. That is, with respect to one another the different asset classes will have a correlation coefficient of less than one (+1), and ideally a negative correlation coefficient.

209 Id. at 64-65.
The common and, perhaps, the most unique aspect of all life insurance is the death benefit. No other type of asset, or asset class, can deliver a significant sum of cash, income tax-free with the ability to be free from the claims of creditors, and if arranged properly, estate tax-free, for a relatively small periodic payment, referred to as a premium, at the precise time it is needed. Plus, as Weber and Hause point out in their first argument in sub-paragraph (1), this occurs “without valuation adjustment based on up or down phases of the equity or bond markets.”

The death benefit characteristics of life insurance are pointed out in sub-paragraphs (1) and (4), and the tax aspects and creditor aspects of the death benefit are pointed out in sub-paragraph (3). The death benefit aspect of life insurance is, clearly, a unique, similar characteristic and property, and a common financial form of all types of life insurance, both permanent cash value and term policies. Additionally, all forms of life insurance, with respect to the death benefit, will “perform in a significantly similar fashion.” In sub-paragraph (4), Weber and Hause note that the event of death is “not a market event which in turn can cause a change in value.” Thus, with respect to the death benefit, life insurance will react in the same specific way to economic factors, which is, that it will not react. Finally, the death benefit is triggered by the event of death, which is not correlated with the activity of any other asset or asset class.\footnote{210}{The only possible exception to this rule is the allegedly reported suicides of investors during the Great Market Crash of October 1929.} In fact, the event of death will have a correlation coefficient with all other assets and asset classes of zero (0).
Sub-paragraph (2) of the Weber and Hause analysis addresses the living benefits, or cash values, of permanent life insurance as an asset class. This analysis notes that the cash values within the life insurance “take on the asset class attributes of the policy itself.” Weber and Hause expand on that concept by saying:

A universal life or whole life policy’s cash value has the dominant characteristic of a fixed account with a minimum guaranteed [risk free] return. A variable universal life policy’s cash value is itself a portfolio with the opportunity to reflect the asset allocation of the policy owner.

What this means is that the cash values within a life insurance policy take on the characteristics of the insurance company’s assets that support the cash values. Recall from the discussion in a previous section that the general account of an insurance company (consisting primarily of high-grade corporate and government bonds, commercial mortgages and real estate, and other fixed-income type investments) supports the cash values in whole life and universal life policies. Similarly, the separate, individual mutual fund-like sub-accounts support the cash values in variable universal life policies.²¹¹

However, the cash values within participating whole life, with the paid-up additions dividend option, and universal life policies have two components: a guaranteed component and a non-

²¹¹ While the general account technically supports the cash values in no-lapse secondary guarantee universal life policies, because of minimal cash value in the first 10 or 15 years of the policy, and normally no policy cash value thereafter, no-lapse secondary guarantee universal life policies have been omitted from this part of the discussion and analysis. Because of the guaranteed constant level death benefit and guaranteed level premium, the death benefit portion of the policy takes on the characteristics of a risk-free asset. This aspect of no-lapse secondary guarantee universal life will be discussed and analyzed in a subsequent section presented below.
guaranteed component. The guaranteed cash value increase within whole life policies and the
guaranteed crediting rate within universal life policies have the characteristics of a risk-free asset. That is, part of the cash value has a guaranteed rate of return with the only risk being the extremely unlikely insolvency of the insurer.

The non-guaranteed portion of the cash values of whole life policies is dependent on non-guaranteed dividends. While very heavily dependent on general account investment results, dividends are a return of premium based on favorable investment results, favorable mortality experience and lower expenses.212 Thus, growth in the non-guaranteed portion of whole life policies, while predominately affected by the performance of the general account investments, is also affected, to a lesser extent, by the insurer’s mortality experience and favorable or unfavorable expenses of operation of the company and the policies.213

The non-guaranteed portion of the cash values of universal life policies is primarily dependent on the difference between the current interest crediting rate and the minimum guaranteed crediting rate, which, in turn, is primarily dependent of the investment performance of the

212 See Black, Jr. and . Skipper, Jr., supra note 158 at 39-40 for an excellent discussion on “Experience Participation In Insurance.”

213 These expenses include taxes. Thus, a change in how the life insurance companies or polices are taxed can effect expenses. A prime example of this effect occurred in 1990 with the passage of the DAC (deferred acquisition cost) Tax as part of the Revenue Reconciliation Act of 1990. As commented by Kenneth Black, Jr. and Harold D. Skipper, Jr. in their book Life & Health Insurance, Thirteenth Edition:

“The DAC tax substantially raised the U.S. Life Insurance industry’s federal income taxes. In turn, life insurers have had to make appropriate adjustments in existing and new-product pricing to account for this increase. Interest rate credits, dividends, and other nonguaranteed benefits are somewhat lower than they otherwise would have been.”

Id. at 974.
general account. However, the growth, as planned, in the cash value in universal life policies is effected by the continued use of the current schedule of monthly deductions for expenses and cost of insurance at rates less than the guaranteed maximum rates in the policy. A decrease in the current schedule of expenses and/or cost of insurance will result in lesser amounts deducted on a monthly basis from the cash value in the policy, thereby allowing a larger amount of cash value to grow at the current interest crediting rate. An increase in the current schedule of expenses and/or cost of insurance will, of course, have the opposite effect.\(^{214}\) In other words, unlike, for example, a bank savings account, a universal life policy cash value growth (or total rate of return) is not affected only by the current interest crediting rates alone, but also by the monthly deductions for expenses and cost of insurance.\(^{215}\)

One other important aspect of the cash values of whole life and universal life policies is that, whereas the general account of the insurers are subject to market value adjustments, as the market values of the underlying securities and assets change, the cash values of these policies are not subject to market value adjustments. Thus, once dividends are declared and added to the cash values in a whole life policy, or the current interest crediting rate is credited to the cash values in a universal life policy, subsequent changes to the market values of the underlying general account that supports these cash values do not affect the cash values in these policies.

---

\(^{214}\) See the previous footnote, which is germane to universal life insurance policies, as well as all types of life insurance policies.

\(^{215}\) This is actually true for all types of permanent cash value life insurance policies.
Unlike whole life and universal life policies, in variable universal life insurance policies there is no guaranteed, risk-free like, growth, or guaranteed minimum interest crediting rates for the cash values in the policy. In addition, the cash values in variable universal life policies, unlike whole life and universal life policies, are subject to market value adjustments. The cash values are, therefore, directly affected by the investment performance of the underlying sub-accounts that support the policies. In this way, the cash values in variable universal life policies do take on the characteristics and asset attributes of the underlying sub-accounts that support the policies. From an investment performance standpoint there is a one to one correlation, or a correlation coefficient of one (+1).

However, like its cousin universal life, the growth, as planned, in the cash value in variable universal life policies is effected by the continued use of the current schedule of monthly deductions for expenses and cost of insurance at rates less than the guaranteed maximum rates in the policy. A decrease in the current schedule of expenses and/or cost of insurance will result in lesser amounts deducted on a monthly basis from the cash value in the policy, thereby allowing a larger amount of cash value to grow as the sub-account grows. An increase in the current schedule of expenses and/or cost of insurance will, of course, have the opposite effect. In other words, a variable universal life policy cash value growth, or total rate of return, is not affected only by the rates of return, or market value adjustments, of the sub-accounts alone, but also by the monthly deductions for expenses and cost of insurance.

The unique tax aspects of the living benefits, or cash values, of life insurance are pointed out in sub-paragraph (3) as cited above, and include income deferred accumulation of cash value and
the possibility of drawing upon policy cash values to produce significant tax-free income for retirement or other purposes.

Treating life insurance as a separate and uncorrelated asset class by just considering the investment return, characteristics and attributes of the underlying assets that support the cash values may be a weak argument. After all, considering these factors alone, the “similar characteristics and properties” and “common financial form” all emulate the nature of either a risk-free bank savings account, or the portfolio of assets that make up the general account, or the separate, mutual fund-life, sub-accounts. Furthermore, the cash values of life insurance (when only considering the investment return, characteristics and attributes of the underlying assets that support the cash values) will “perform in a similar fashion,” “will tend to react in a specific way to economic factors” and will have a correlation coefficient of one (+1) with either a risk-free bank savings account, or the portfolio of assets that make up the general account, or the separate, mutual fund-life, sub-accounts, therefore disqualifying life insurance as a separate, uncorrelated asset class.

However, when the unique tax aspects and distinctive tax advantages of the cash values of life insurance, and the common effect to growth of policy cash values caused by expenses and cost of insurance, are taken into consideration along with the investment return, characteristics and attributes of the policy cash values, it can be stated strongly that the cash values in life insurance policies all have “similar characteristics and properties” and are a “common financial form” unique to any other asset or asset class, therefore qualifying the cash values in life insurance policies to be treated as a separate asset class. The question of whether the cash
values of life insurance policies “will perform in a significantly similar fashion” and “will tend to react in a specific way to economic factors” is more nebulous. As stated above, from an investment return, characteristics and attributes standpoint alone, the guaranteed portion of the cash values in whole life and universal life, the non-guaranteed portion of the cash values in whole life and universal life, and the cash values in variable universal life, perform and react to economic factors as would a risk-free bank savings account, the portfolio of assets that make up the general account, or the separate, mutual fund-life, sub-accounts, respectively. Thus, from the investment return, characteristics and attributes perspective the guaranteed portion of the cash values of whole life and universal life policies, the non-guaranteed portion of the cash values of whole life and universal life policies, and the cash values of variable universal life policies all perform in a different way and react to economic factors in a different way.\textsuperscript{216} The specific direct expenses for administrating the various policy types are all different with whole life being the least expensive and variable universal life the most expensive. However, overall expenses and costs to the insurance companies as a whole and, at least in the long run, the cost of insurance, or mortality, relative to each policy type, should “perform in a significantly similar

\textsuperscript{216} Separate sub-account fixed-income type funds, such as bond funds, will perform similarly to the nonguaranteed portion of whole life and universal life policies, since the primary nature of the investments in the general account supporting the cash value in these policies is fixed-income securities. However, variable universal life cash values invested in the bond sub-account are subject to market value adjustments, whereas, the nonguaranteed portion of the cash values in whole life and universal life policies are not subject to market value adjustments. Cash values of variable universal life policies invested in more equity-like sub-accounts will, of course, perform differently and react to economic factors differently than the nonguaranteed portion of the cash values in whole life and universal life policies. In other words, the amount of differences in how the cash values in variable universal life and the nonguaranteed portion of the cash values in whole life and universal life policies perform differently and react to economic factors differently is dependent on how the premiums and cash values in variable universal life policies are allocated among different types of sub-accounts.
way” and “tend to react in a specific way to economic factors.” What is clear, however, is that the tax aspects and tax advantages of life insurance do “perform in a significantly similar fashion;” and “will tend to react in a specific way to economic factors,” if only the tax factors are considered such as an overall increase or decrease in income tax rates. It is hard to believe that the tax aspects of the cash values of life insurance could change the correlation coefficient with respect to the underlying assets supporting the cash values in life insurance policies. Likewise, it is doubtful whether the effect of cost of insurance (mortality) or expenses of the life insurance policies on the growth of the cash values within life insurance policies would significantly change the correlation coefficient, if it would even affect the correlation coefficient, with respect to the underlying assets supporting the cash values in life insurance policies.

So far, the authors have examined and analyzed the Weber and Hause death benefit characteristics of life insurance arguments presented in sub-paragraphs (1) and (4), and the living benefits or cash value characteristics of life insurance arguments presented in sub-paragraph (2) for treating life insurance as a separate, uncorrelated asset class with the context of MPT. The arguments in sub-paragraph (3) concerned the tax aspects of life insurance and the creditor protection aspects of the policy proceeds. The tax aspects of the death benefit and the creditor protection aspects of the policy proceeds arguments of sub-paragraph (3) were considered in conjunction with the examination and analysis of sub-paragraphs (1) and (4).

217 Weber and Hause discuss the issue of similar mortality and expense experience in the long run by “peer” insurance companies in endnote 45 on page 105. Weber & Hause, supra note 2 and 132, at 105.
Similarly, the tax aspects of the cash values argument of sub-paragraph (3) were considered in conjunction with the examination and analysis of sub-paragraph (2). Therefore, the examination and analysis of sub-paragraph (3) has been completed.

The Weber and Hause argument presented in sub-paragraph (5) is not per se an argument as to why life insurance should be treated as an asset class but rather an observation that: “[i]ndividuals with sufficient assets to retain portfolio managers are most often buyers of significant amounts of life insurance that are funded with capital rather than budgeted income.”

If there is a reason in this sub-paragraph to treat life insurance as an asset class than it is the “bandwagon” approach that life insurance is included in portfolios with other assets that fund the premiums for the life insurance policy, as would be the case with a funded irrevocable life insurance trust (ILIT), a funded intentionally defective grantor trust (IDGT) or a CVBDIT. Indeed, Malcolm Forbes, the founder and publisher of Forbs magazine, was reported to have owned at least $46 million of “The Capitalist Tool” life insurance.218

In addition, the second statement in sub-paragraph (5) states that: “[d]etermining from which ‘pockets’ of portfolio investments the premiums should be paid is inherently an activity of asset allocation and re-allocation [rebalancing].”

The sentence above is more or less a description of the activities and functions associated with asset allocation and rebalancing rather than an argument for treating life insurance as an asset class. When permanent cash value life insurance is included in a portfolio along with cash and other securities that could fund the premiums of the life insurance, it is a necessary function of appropriate planning to determine which investments will provide the cash flow to pay the premiums on the policy(ies). However, this activity, while common to asset allocation within a portfolio, does not rise to the standard as presented by the definitions and characteristics in the section on “Asset Allocation and Asset Classes” to treat life insurance as an asset class.

Similarly, the Weber and Hause argument presented in sub-paragraph (6) is not *per se* a direct argument as to why life insurance should be treated as an asset class, but an observation that life insurance behaves like an asset of a separate asset class. Weber and Hause observed in sub-paragraph (6) that:

> Permanent life insurance intended for a lifetime can produce at least as favorable a long-term return with less risk within a portfolio of equity and fixed components than a portfolio without life insurance (a favorable efficient frontier result).

Sub-paragraph (6) is a description of precisely how an asset of an asset class should react in a portfolio with assets of a different asset class, and a justification, through examination, for treating life insurance as an asset class. The authors will examine and analyze the phenomenon described in sub-paragraph (6) in the next section of this article.
In summary, the death benefit aspects, and, taken as a whole, the cash value aspects of life insurance both clearly and strongly conform to the definitions of an asset class as assets having “similar characteristics and properties,” and a “common financial form.” Without a doubt, the death benefit aspects of life insurance “perform in a significantly similar fashion” and “react in a specific way to economic factors,” which is not to react, and have a correlation coefficient with all other assets and asset classes of zero (0). However, the cash value aspects of life insurance tend not to “perform in a significantly similar fashion” and “react in a specific way to economic factors.” Rather, the cash values of life insurance tend to “perform in a significantly similar fashion” and “react in a specific way to economic factors” to the underlying assets that support the cash values in the various different types of life insurance policies. In addition, the performance of the cash values of the different types of life insurance tend to have an extremely high correlation [if not a correlation coefficient of one (+1)] with the underlying assets that support the cash values in the various different types of life insurance policies.

However, permanent cash value life insurance is an integrated financial product consisting of both a cash value and a death benefit. It comes as a “packaged” deal where to get the death benefit part you must get the cash value part and vice versa. Thus, when considering in total the various components of cash value life insurance, it perfectly meets all of the criteria set forth above of a separate, uncorrelated asset class. It also should be noted that from a functional standpoint, life insurance is a very unique asset and no other asset can do what life insurance can do.
In conclusion, the authors agree with Weber and Hause that permanent cash value life insurance is a unique, separate asset class by itself within MPT. As such, permanent cash value life insurance has the ability to diversify, enhance and complement other assets in an investor’s portfolio, thereby, adding to a comprehensive wealth accumulation strategy.

1.18 **Building an Efficient Investment Portfolio by Including Life Insurance**

As mentioned previously in an earlier section of this article, a portfolio is optimal when for any given level of return there is no lower risk for the same return, or, conversely, for any given level of risk there is no higher return for the same risk. The curve on a graph of risk and return that describes the set of optimal portfolios is referred to as the “efficient frontier.” The crux of MPT is taking into account how investments or securities, or asset classes, relate to one another or to a particular market or market indices such as the [Standard & Poor’s 500® Index (S&P 500®)]. As long as there is not a direct one-to-one correlation, planners can reduce the overall risk of a portfolio by combining investments and securities whose market price or return movement varies differently from one another.

Thus, planners can build diversity into a portfolio by including assets from different asset classes, thereby lowering the overall risk of the portfolio and/or increasing the rate of return for the same portfolio risk. The true “test” of an asset class, therefore, is whether the addition of an asset from the asset class to the portfolio either lowers the overall risk of the portfolio and/or increases the overall expected return from the portfolio with the same amount of risk or
a lower risk. If the asset class “passes the test” the addition of an asset from the asset class helps build a more “efficient” investment portfolio.

Both Weber and Hause\textsuperscript{219} and Robert G. Alexander and Michael W. Halloran\textsuperscript{220} have “tested” and analyzed the effects of including life insurance in an investment portfolio and both have concluded that “[permanent] life insurance has unique characteristics that qualify it as an asset class in the consideration of combining with other portfolio assets to achieve an optimal and efficient return within the investor/insured’s risk tolerance.”\textsuperscript{221}

While both sets of authors used a participating whole life policy to compare the results of a hypothetical fixed-return portfolio with and without life insurance, what is particularly relevant and noteworthy about the Weber and Hause analysis is that they used a “benchmark” “policy standard” rather than a specific life insurance policy. Weber and Hause have created and developed proprietary illustration software for the main life insurance policy types that essentially is a “truly a generic policy design” that represents an “average” life insurance policy that is “available to the general public by commissioned agents.”\textsuperscript{222} As explained by Weber and Hause, “[policy] standards are used to demonstrate how modern life insurance policies work without the distraction of one insurance company’s non-guaranteed values projections versus

\textsuperscript{219} Weber & Hause, supra note 2 and 132, at 65-72.
\textsuperscript{220} Alexander and Halloran, supra note 1 and 156 at 27-31, Exhibits 1-5 and 7-10.
\textsuperscript{221} Weber & Hause, supra note 2 and 132, at 94.
\textsuperscript{222} Id. at 103-104.
another.\textsuperscript{223} Weber and Hause describe and elucidate on the derivation and some of the details of the policy standard as follows:

A policy standard is derived by looking at industry resources such as actuarial tables, general levels of investment returns, and the average of other expenses incurred by insurance companies in the management and maintenance of blocks of life insurance policies. The result is the projection of an industry average to produce an actuarially certified, hypothetical “policy” that cannot be purchased, but that nonetheless reasonably represents what would have been available in the examined time frame. Because scales of COI [cost of insurance] (term insurance rates projected into the future for increasing age) and other expense assumptions may be somewhat different between universal life, variable universal life and whole life, three separate Policy Standards policies have been created for this study. In the case of universal and variable universal life – not generally available as early as 1975 – reasonable simulations of likely pricing have been modeled\textsuperscript{224}

Thus, the use of this actuarially certified policy standard lends extra creditability to the Weber and Hause study regarding the effects of life insurance in an investment portfolio. A detailed explanation and analysis of the Weber and Hause study regarding the use of participating

\textsuperscript{223} Id. at 103.

\textsuperscript{224} Id. at 43.
whole life with a hypothetical fixed-return investment portfolio is contained in the Weber and Hause monograph as well as the article by Robert G. Alexander and Michael W. Halloran and, therefore, will not be repeated here. Nor will the authors repeat the independent analysis by Robert G. Alexander and Michael W. Halloran which confirms the Weber and Hause findings. The authors will, however, summarize the risk and return results of the Weber and Hause research, and comment on their risk analysis and the reasons that the risk measurement was lower.

It should be noted that Weber and Hause did a similar type of analysis using universal life, no-lapse secondary guarantee universal life and variable universal life “with similar risk characteristics for the non-guaranteed portion of the policy.” While they did not produce or comment on the results, they observed that participating whole life “produced the best projected results of the various policy styles.”

Weber and Hause project the value of a portfolio of an investor (who is age 45) over the investor’s life expectancy plus five (5) years, which comes out to age 89. The portfolio contains

225 The explanation and analysis of the Weber and Hause study by Weber and Hause has already been noted in footnote 219. The explanation and analysis of the Weber and Hause study by Robert G. Alexander and Michael W. Halloran is contained in Alexander & Halloran, supra note 1 and 156, at 24-27. Weber and Hause also do an analysis of buy term and invest the difference and buy whole life and invest the difference that is relevant to the effectiveness and efficiency of including life insurance within a portfolio. See Weber & Hause, supra note 2, at 52-62. Robert G. Alexander and Michael W. Halloran review and report extensively on this aspect of the Weber and Hause research, Alexander & Halloran, supra note 1, at 20-24.

226 The independent analysis by Robert G. Alexander and Michael W. Halloran which confirms the Weber and Hause findings has already been noted in footnote 220.

227 Weber & Hause, supra note 2 and 132, at 107.

228 Id.
$500,000 of fixed-return, tax-free municipal bonds that will be held to maturity and earn a constant 4% rate of return. In the bond only portfolio the income from the bond starting at $20,000 ($500,000 X 4%) will be reinvested in the original portfolio with a constant return of 4%. In the portfolio of bonds that include the participating whole life policy, the $20,000 income from the bonds is used to pay the premiums on the life insurance policy. The values of the portfolio with and without the life insurance are compared and reveal that the all-bond portfolio produces slightly more asset value than the bonds plus cash value of the life insurance portfolio for the first 19 years. However, after that time the asset value of the bonds plus the life insurance cash values portfolio exceeds the all-bonds portfolio. Of course, the accumulated wealth value of the bonds plus the life insurance death benefit at all times exceeds the accumulated wealth value of the all-bonds portfolio.\footnote{229}

Weber and Hause go on to report that the rate of return of the bond portfolio without life insurance is 4% with a “risk index” of 2.48, and, the rate of return of the bond portfolio with life insurance is 4.77% with a “risk index” of 2.09, “based on legacy value at life expectancy plus 5 Years.”\footnote{230} They go on to conclude:

[There] is synergy in funding a life insurance policy from the income stream of a component of the fixed [return] portfolio. It produces a more favorable result

\footnote{229} Id. at 66-67.\footnote{230} Id. at 68. The authors of this article use the term “accumulated wealth value” in place of the term “legacy value”.

210
than if the policy weren’t part of the portfolio: [The] return is higher and the risk is lower for the existence of needed life insurance.231 (Emphasis added)

Weber and Hause do a variation of the above analysis by comparing the retirement distribution value (and subsequent accumulated wealth value) of a bond portfolio with and without life insurance. In this analysis, they compare the after-tax (40% tax bracket) retirement income, beginning at age 65 and continuing to age 89, consisting of the income that can be generated by the accumulated all-bond portfolio at age 65 to the income that can be generated by a combination of the accumulated bond portfolio at age 65 and the participating whole life policy. The accumulated value at age 65 of the all-bond portfolio will be preserved as a legacy value (“accumulated wealth value”) to pass on to the investor’s heirs. The results of this research are that the bond plus life insurance portfolio as compared to the all-bond portfolio produces a 17% greater retirement income and a 24% greater legacy value (“accumulated wealth value”) to pass on to the investor’s heirs.232 While the risk and return at life expectancy plus five years for the all-bond portfolio did not change in this variation of the Weber and Hause research from the previously reported research, the “imputed net after-tax return” for the bond with life insurance portfolio was 4.52% with a “risk index – accumulation phase” of 2.10 and a “risk index – distribution phase” of 2.43.233

Weber and Hause summarized the findings of their study as follows:

231 Id.
232 Id. at 69. The percentage increases were derived from the values reported on page 69.
233 Id.
A participating whole life policy funded by the income from a municipal bond component within a larger investment portfolio was found to produce a significantly larger legacy value [“accumulated wealth value”] and a growing advantage in liquidity value over the life of the investor having lifetime uses for life insurance. When viewed from the perspective of maximizing retirement income, the bond plus life insurance strategy produced a higher retirement income than did the bond asset by itself. In fact, it met the ideal criteria of an efficient asset allocation: [Higher] return with lower volatility/risk.234

As noted previously in an earlier section, risk is defined as the variability, or degree of uncertainty, of a return, which is commonly measured by the standard deviation of the expected or anticipated return.235 Weber and Hause use a “risk index” to measure volatility and risk for life insurance policies, municipal bonds, equity funds and portfolios. According to a conversation that Gary L. Flotron had with Richard M. Weber, the risk index used by Weber and Hause is “a proprietary system that was developed by Weber and Hause.”236 It is the authors’ understanding that part of this system is based on actual or “reasonable estimates” of standard deviations of various securities, including the general account and separate sub-account assets that support the cash values in permanent life insurance policies. Some of the risk indexes are based on weighted averages, such as the risk index for participating whole life policies.

234 Id. at 94.
235 See footnote 139.
In comments following their study on life insurance in a bond portfolio Weber and Hause expound on their assignments of the risk index as such:

> With an average Risk Index of “3.0” assigned to 10-year U.S. Bonds for the historic fluctuations in market value (which is most closely correlated to the type of investments backing a participating whole life policy’s dividend scale), we assign a Risk Index of “1.8” to the combined guaranteed plus non-guaranteed components of a participating whole life policy. Similarly, an average Risk Index of “2.48” is assigned to a single municipal bond that will be held to maturity; a municipal bond fund has a Risk Index of “6.0.”

In an endnote to a previous section of their white paper, Weber and Hause elaborate on their calculation of the 1.8 risk index for participating whole life policies:

> The annual standard deviation in investment grade fixed instruments has been approximately 3% over the past 40 years. To assign a risk factor to a participating whole life [policy], we separate the policy into its guaranteed and non-guaranteed face amounts at life expectancy. From Table 12, the guaranteed portion of the death benefit is $50,000,000, or approximately 40% of the total $124,428,350. The non-guaranteed portion is the other 60%. 60% of the 3%

---

237 Weber & Hause, supra note 2 and 132, at 70.
standard deviation produces an overall standard deviation of 1.8%. We use the value of 1.8 to reflect this standard deviation.\textsuperscript{238}

Thus, the risk index for participating whole life policies is a weighted average of the guaranteed and non-guaranteed death benefit at life expectancy. The 40% guaranteed portion of the death benefit at life expectancy is treated as a “risk-free” amount with a standard deviation of zero (0). The 60% non-guaranteed portion of the death benefit at life expectancy is treated as having a standard deviation of 3%. Weighting the two proportions creates a standard deviation of 1.8%. The guaranteed and non-guaranteed cash values that form part of the death benefit\textsuperscript{239} at life expectancy, or for any policy year, will be in the same proportion as the guaranteed and non-guaranteed death benefit. Thus, the total cash value at life expectancy would be made up of 40% guaranteed cash value and 60% non-guaranteed cash value, and the standard deviation, or risk index, would be the same as the death benefit derived standard deviation, or risk index, and vice versa.

However, the guaranteed death benefit in the participating whole life policy remains constant and the non-guaranteed death benefit increases each year the policy is in force from zero at the inception of the policy. This implies that the risk index for the participating whole life policy during the first year would be zero, since no dividends will be paid until the end of the first policy year and the policy is entirely made up of guaranteed cash value and death benefit. It

\textsuperscript{238} Id. at 105.

\textsuperscript{239} The other part of the death benefit is referred to as the net amount at risk. Total death benefit is, therefore, equal to the cash value plus the net amount at risk for any given age.

214
also implies that since the non-guaranteed portion of the policy increases as the insured ages, the risk index for years less than life expectancy would be less than 1.8, and the risk index after life expectancy would be greater than 1.8. In other words, the standard deviation or risk index of the participating whole life policy increases over time.

The expected return of a portfolio is the weighted average of the expected return of the individual securities comprising the portfolio.\(^{240}\) If the correlation coefficients of the individual securities, or asset classes, comprising the portfolio is one (+1), than the risk of the portfolio, as measured by standard deviation, is a weighted average of the standard deviations of the individual securities comprising the portfolio. However, if the correlation coefficients of the individual securities, or asset classes, is anything but one (+1), then the standard deviation of the portfolio is less than the weighted average of the standard deviations of the individual securities or asset classes.\(^{241}\) It is these uncorrelated securities and asset classes that provide for diversification and lower risks for portfolios and make up the synergistic effect of MPT.\(^{242}\)

\(^{240}\) See footnote 139.

\(^{241}\) The mathematical formula for calculating the standard deviation of a two security portfolio is:

\[
\sigma_p = \sqrt{w_1^2 \sigma_1^2 + w_2^2 \sigma_2^2 + 2w_1w_2\sigma_1\sigma_2R_{12}}
\]

Where:

\(\sigma_p\) = Standard deviation of the portfolio.
\(w_1\) = Percentage weight of Security 1.
\(\sigma_1\) = Standard deviation of Security 1.
\(w_2\) = Percentage weight of Security 2.
The participating whole life policy that was analyzed with the municipal bond portfolio in the Weber and Hause study was an asset comprised of two parts or portions: Risk-free guaranteed part, or portion, and a non-guaranteed part, or portion. The risk-free portion had a standard deviation, or risk index, of zero (0), whereas the non-guaranteed portion had a standard deviation, or risk index, of 3.0. The standard deviation, or risk index, is properly a weighted average and was equal to 1.8.\textsuperscript{243} Even when combined with the municipal bond fund, whose risk index was given as 2.48, a weighted average of the two assets' risk index would lower the risk of the all-bond portfolio because the participating whole life insurance policy risk index is less than 2.48. However, the reduction of portfolio risk over and above the weighted risk index would be due to the fact that the correlation coefficient between the 10-year U.S. Bonds and municipal bonds would be less than one (+1).

\[
\sigma_2 = \text{Standard deviation of Security 2.} \\
R_{12} = \text{Correlation coefficient between Security 1 and Security 2.} \\
\text{If } R_{12} = 1, \text{ then } \sigma_p = \sqrt{w_1^2 \sigma_1^2 + w_2^2 \sigma_2^2 + 2w_1w_2 \sigma_1 \sigma_2} \\
= \sqrt{(w_1 \sigma_1 + w_2 \sigma_2)^2} \quad \text{Distributive law of mathematics } [a^2 + b^2 + 2ab = (a + b)^2]. \\
= w_1 \sigma_1 + w_2 \sigma_2 \quad \text{Square root of a squared number.}
\]

Thus if \( R_{12} = 1, \) than the standard deviation of the portfolio is a weighted average of the standard deviations of the two securities.


\textsuperscript{243} The concept of combining a risk-free asset with another security or portfolio is the basis for the Capital Asset Pricing Model (CAPM) originally developed by Professor William F. Sharpe. Because the risk-free asset has a standard deviation of zero (0), the standard deviation of the portfolio of a risk-free asset and another security or portfolio becomes a linear, weighted average. See William F. Sharpe, \textit{Capital Asset Prices - A Theory of Market Equilibrium Under Conditions of Risk}, The Journal of Finance, Vol. XIX, No. 3, September 1964, pp. 425-442.
Indeed, the risk of the participating whole life policy may be overstated in the Weber and Hause study. From the American Council of Life Insurers *ACLI Fact Book 2009*, the authors have examined the net rates of return on the general account assets of life insurers for the 29 year period from 1980 to 2008 and have calculated an average net rate of return of 7.93% and a standard deviation of 1.33%. Applying the Weber and Hause concept of 60% of policy values representing non-guaranteed values, this would suggest a standard deviation on the participating whole life policy of 0.80%. The reason for the lower variability of the general account assets as compared to a 10-year U.S. Bonds, which Weber and Hause use as a proxy for the general account assets and assigned a “risk index” of 3, is due to the diversified nature of the general account assets with 72% of the assets in corporate or government bonds, 11% primarily in mortgages and real estate, including company occupied real estate, 4% in policy loans, 4% in stocks and 10% in miscellaneous assets. This is an example of a perfect application of MPT in that the overall risk of the general account portfolio is lower than any one asset class due to diversification and correlation coefficients between the asset classes of less than one (+1).

While the authors have no doubt as to the relative accuracy, creditability and integrity of the Weber and Hause study, they believe further research needs to be conducted on the effects of including the different types of life insurance in investment portfolios. The authors suggest that

---

244 American Council of Life Insurers, supra note 174, Chapter 4, page 45.

245 Id. Chapter 2, page 14.
accurate data on the standard deviations of the general accounts of life insurance companies investments should be incorporated in future analyses. In addition, the correlation coefficients between the general accounts of life insurance companies investments and general investment asset classes, such as various types of bonds and equities, and market indices, needs to be factored in future studies. Lastly, it is suggested that all risk factors be expressed in the common measurement of standard deviation. The authors will continue to conduct research on this topic and will report their findings in future articles.

Finally, the question raised in the “BDIT Investment Portfolios – Family Businesses and Life Insurance” section was whether it is possible that the permanent cash value life insurance policy could provide diversification to the family business, real estate, and/or farm or ranch portfolio of assets contained within the BDIT and, through a correlation coefficient of less than one (+1) with these family enterprises, lower the risk of the portfolio of family businesses within the BDIT according to Harry Markowitz’s MPT.

If one uses the cross-correlations of historic annual returns from 1926-2008, compiled in the 2009 Ibbotson SBBI Classic Yearbook, between small company stocks as a proxy for family businesses, and intermediate-term government bonds as a proxy for the general account for life insurance companies, there is a cross-correlation of -0.10. A similar low cross-correlation is found between small company stocks, and long-term corporate bonds and long term

government bonds of 0.07 and -0.06, respectfully. Even the cross correlation between small company stocks and large company stocks was only 0.79.

While the data compared above were “proxies” for the actual correlation coefficients between family business, real estate and/or farm or ranch portfolios in a BDIT, and the general account or separate sub-account investments that support the cash values in a life insurance policy, it is not too difficult to extrapolate from this data that, indeed, the correlation is considerably less than one (+1). Therefore, permanent cash value life insurance can provide diversification to the family business, real estate, and/or farm or ranch portfolio of assets contained within the BDIT, consequently enhancing and lowering the risk of the portfolio of family businesses within the BDIT according to Harry Markowitz’s MPT.

1.19 Building a Life Insurance Policies Portfolio of Different Policy Types

In previous sections the authors discussed the concept of permanent cash value life insurance as a separate, uncorrelated asset class and how permanent cash value life insurance can be used to diversify, enhance and built an efficient investment portfolio. Recall from the section on “Asset Allocation and Asset Classes” that in building a portfolio, primary asset classes such as permanent cash value life insurance are further subdivided into sub-categories. For example,

\footnote{247}{Id. at 99.}
\footnote{248}{Id.}
common stock equities can be segregated into large-cap, mid-cap, small-cap and international. Thus, each primary asset class can be diversified and assets allocated to different sub-asset classes. Through this division of allocated investment resources, total risk of a portfolio can be minimized and returns maximized for any given level of risk tolerance.

Just as one can create a sub-portfolio of common stock equities within a larger portfolio consisting of large-cap, mid-cap, small-cap and international stocks, one can build a permanent cash value life insurance policies portfolio consisting of participating whole life, universal life, no-lapse secondary guarantee universal life and variable universal life. The selection of the mix of these policies is based on the risk tolerance and other preferences of the trustee/Beneficiary/Inheritor. The economics of life insurance (such as premium rate “banding” by face amount size of the policy and policy fees) make the process of creating a portfolio of life insurance policies relevant, from a practical standpoint, when acquiring total life insurance, or a combination of acquiring and transferring existing life insurance policies into a portfolio or trust, with a bare minimum of $1 million, and, preferably, in excess of $3 to $5 million.  

The seminal monograph *Life Insurance as an Asset Class: A Value-Added Component of an Asset Allocation* by Weber and Hause, presents a plethora of innovative concepts and techniques that have been created and developed by Richard M. Weber and his partner Christopher Hause, including the proprietary illustration software developed around the concept of the policy

249 Weber & Hause, *supra* note 2 and 132, at 73 concur with this assessment.
standard, the concept of life insurance as an asset class and the use of permanent cash value life insurance to build a more efficient investment portfolio. However, perhaps the most ingenious and useful concept in the monograph is their technique for creating a portfolio of life insurance policies. The authors are unaware of any other writings on this subject. This is such a natural application of MPT that it is surprising this technique (and the process of creating a portfolio of life insurance policies) never has been discussed before and is rarely applied and practiced.

As a starting point it needs to be noted that there are four dominant attributes for life insurance policies:

(1) the “price”, better known as premium outlay;

(2) the “cost”, which is the net of the premium outlays and resulting cash value measured in terms of net present value (NPV) discounted at 5%;

(3) the potential for death benefit over and above that guaranteed in the policy as generated by either dividends (participating whole life) or the cash value “pushes” from the IRC §7702 “corridor” (universal life and variable universal life); and

---

250 The Weber and Hause proprietary illustration software has the capability of applying Monte Carlo simulations to come up with probability analysis of the adequacy of funding premiums for universal and variable universal life insurance policies. This is the only such system that the authors are aware of that has this capability.

251 There are other concepts and techniques presented in their white paper that the authors have not discussed and are beyond the scope of this article.

252 Weber & Hause, supra note 2 and 132, at 73-85.

253 See footnote 173.
the risk to the policy owner associated with the variability of the investments used to support the policy cash value.254

Weber and Hause note that “[the] specific mixture of these attributes results in a “style” of policy.”255 Each of the four main types of permanent life insurance previously discussed presents different combinations of the above attributes. No single type or style of policy can be classified as the “best” for every attribute or the “best” for all circumstances and situations. The insurance buyer must prioritize these attributes and pick the life insurance policy type or style based on which policy is the best with respect to the attributes that the policy owner prioritizes.

Exhibit F contains a matrix comparing the four main types (or styles) of permanent cash value life insurance to the four attributes stated above.256 Note that the four life insurance policy styles are ranked by each of the four attributes.

Review this exhibit in the context of the following example. Suppose an insurance buyer’s main focus is on the lowest premium outlay; therefore the buyer might acquire a no-lapse secondary guarantee universal life insurance policy. However for best cost, he might consider purchasing a whole life or variable universal life insurance policy. If the buyer does not have much of a risk

254 This discussion is derived from the material presented in Chapter 10 of Weber & Hause, supra note 2 and 132, at 73-85.
255 Id. at 73.
256 The authors greatly wish to acknowledge the permission of Weber and Hause to reproduce this matrix. Id. at 74.
## Exhibit F
Matrix Comparing Four Main Styles of Life Insurance to Four Policy Attributes

<table>
<thead>
<tr>
<th></th>
<th>Price (Premium Outlay)</th>
<th>Cost (NPV (Premium/CV))</th>
<th>Potential for Increasing DB@LE</th>
<th>Investment Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>No Lapse Guarantee Universal Life</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Life Expect.</td>
<td>Lowest</td>
<td>Highest</td>
<td>None</td>
<td>Lowest</td>
</tr>
<tr>
<td>Age 100</td>
<td>Lowest</td>
<td>2nd Highest</td>
<td>None</td>
<td>Lowest</td>
</tr>
<tr>
<td><strong>Universal Life (minimally funded)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Life Expect.</td>
<td>2nd Lowest</td>
<td>2nd Highest</td>
<td>Some</td>
<td>Low</td>
</tr>
<tr>
<td>Age 100</td>
<td>2nd Lowest</td>
<td>Highest</td>
<td>Some</td>
<td>Low</td>
</tr>
<tr>
<td><strong>Variable Universal Life</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Life Expect.</td>
<td>2nd Highest</td>
<td>2nd Best</td>
<td>Good</td>
<td>High</td>
</tr>
<tr>
<td>Age 100</td>
<td>2nd Highest</td>
<td>Best</td>
<td>Good</td>
<td>High</td>
</tr>
<tr>
<td><strong>Par Whole Life</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Life Expect.</td>
<td>Highest</td>
<td>Best</td>
<td>Excellent</td>
<td>Very Low</td>
</tr>
<tr>
<td>Age 100</td>
<td>Highest</td>
<td>2nd Best</td>
<td>Excellent</td>
<td>Very Low</td>
</tr>
</tbody>
</table>

tolerance, consideration of the lowest risk might suggest purchasing a no-lapse secondary guarantee universal life insurance policy; however, this policy has the highest cost.

When constructing a portfolio of life insurance policies, or when selecting only one life insurance policy style, Weber and Hause note that the starting point is to determine the appropriate amount of policy investment “risk” the policy owner is willing to take.\(^\text{257}\) This is parallel to determining risk tolerance, as discussed previously, before constructing any portfolio of investments or deciding on portfolio asset allocation mixes. While a “total” portfolio approach should be taken (that is, considering and coordinating the total portfolio as a whole rather than considering the investment portfolio, the life insurance portfolio and the retirement portfolio separately and individually) many investors have a more conservative risk tolerance with respect to their life insurance portfolio than with respect to their investment portfolio.

Before describing a table of matrix of risk indices that is analogous to asset allocation mixes based on risk tolerances used for investment portfolios, Weber and Hause describe how they assigned “risk indexes” to the individual life insurance policy styles as follows:\(^\text{258}\)

\[
\begin{array}{|c|c|c|}
\hline
 & \text{No-lapse Secondary Guarantee} & \text{Universal Life} \\
\hline
\text{Risk Index} & \text{Low} & \text{Medium} \\
\hline
\end{array}
\]

As suggested in the above table, [Exhibit F] NLG [no-lapse secondary guarantee universal life] has no investment risk (that is to say, the investment risk is the insurance company’s and not the policy owner’s – unless of course the adverse

\(^{257}\) Id.

\(^{258}\) Since it is assumed that the life insurance policy carrier selection will depend heavily on financial stability, the focus is solely on the investment risk tolerance and other preferences underlying the selection of policy mix or the selection of a policy style.
investment experience is so severe that the carrier becomes insolvent). Assuming the selection of a financially superior insurance company, we assign NLG [no-lapse secondary guarantee universal life] a “Risk Index” of 0.

At the other end of the spectrum, a VUL [variable universal life] entirely utilizing an S&P 500® Index sub account typically has a standard deviation (a measurement of risk) of 15%; we would assign such a VUL [variable universal life] allocation a “Risk Index” of 15.

Participating whole life is comprised of two components: [The] underlying guaranteed policy which, as with NLG [no-lapse secondary guarantee universal life] has no explicit investment risk, and a non-guaranteed dividend whose risk of meeting dividend projections is most closely associated with an investment in investment grade bonds. As indicated in the last section, we assign a “Risk Index” of “1.8” to participating whole life (blending the underlying guarantees of a base whole life policy with the bond-like portfolio returns of the non-guaranteed dividend scale).

Because the UL [universal life] policy doesn’t offer sufficient unique or advantageous attributes compared to the other policy styles, it will not be considered in this context.259

259 Weber & Hause, supra note 2 and 132, at 75.
Given the “Risk Indexes” assigned to participating whole life (Par WL in the table), no-lapse secondary guarantee universal life (NLSGUL in the table) and variable universal life (VUL in the table), Weber and Hause list the derived weighted average “Risk Index,” in ascending order, for different percentage mixes (in increments of 10%) of participating whole life, no-lapse secondary guarantee universal life and variable universal life. This table has been reproduced, with permission as Exhibit G.260 Weber and Hause further divide the table into sections based on four types of investor risk styles, which are the same investor risk styles that the authors of this article previously have described in the “Asset Allocation Mixes for Six Types of Investor Risk Style.”261 The Conservative investor is given a “Risk Index” range of 0 to 3.9, the Balanced investor is given a range of between 4.0 [4.5 is actually shown in the table] and 7.9, the Growth investor is given a range from 8.0 to 11.9 and the Aggressive Growth investor is given a range from 12 to 15.262

Weber and Hause stipulate that “[a] process for determining a reasonable, responsive, and effective blend of policies for maximization of desired qualities would be as follows.263

(1) What is the risk tolerance and time horizon of the insurance buyer, using the labels described above? For the first example, we’ll assume that the response is “4” – in other words, within the higher range of “Conservative” (and comparable to a [80/20] mix of fixed and equity assets classes in a general portfolio).

260 Again, the authors greatly wish to acknowledge the permission of Weber and Hause to reproduce this matrix. Id. at 84-85.
261 Only four types of investor risk style are considered in the Weber and Hause table. The Short Term and Most Aggressive styles are omitted.
262 Weber & Hause, supra note 2 and 132, at 75.
263 Id.
### Exhibit G

Policies Portfolio Risk Index Matrix

<table>
<thead>
<tr>
<th>Par WL</th>
<th>NLSGUL</th>
<th>VUL</th>
<th>Weighted</th>
<th>Risk Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>% Weight</td>
<td>% Weight</td>
<td>% Weight</td>
<td>Index</td>
<td>Classification</td>
</tr>
<tr>
<td>0</td>
<td>100</td>
<td>0</td>
<td>0.00</td>
<td>Conservative</td>
</tr>
<tr>
<td>10</td>
<td>90</td>
<td>0</td>
<td>0.18</td>
<td>Conservative</td>
</tr>
<tr>
<td>20</td>
<td>80</td>
<td>0</td>
<td>0.36</td>
<td>Conservative</td>
</tr>
<tr>
<td>30</td>
<td>70</td>
<td>0</td>
<td>0.54</td>
<td>Conservative</td>
</tr>
<tr>
<td>40</td>
<td>60</td>
<td>0</td>
<td>0.72</td>
<td>Conservative</td>
</tr>
<tr>
<td>50</td>
<td>50</td>
<td>0</td>
<td>0.90</td>
<td>Conservative</td>
</tr>
<tr>
<td>60</td>
<td>40</td>
<td>0</td>
<td>1.08</td>
<td>Conservative</td>
</tr>
<tr>
<td>70</td>
<td>30</td>
<td>0</td>
<td>1.26</td>
<td>Conservative</td>
</tr>
<tr>
<td>80</td>
<td>20</td>
<td>0</td>
<td>1.44</td>
<td>Conservative</td>
</tr>
<tr>
<td>90</td>
<td>10</td>
<td>0</td>
<td>1.62</td>
<td>Conservative</td>
</tr>
<tr>
<td>10</td>
<td>80</td>
<td>0</td>
<td>1.68</td>
<td>Conservative</td>
</tr>
<tr>
<td>100</td>
<td>0</td>
<td>0</td>
<td>1.80</td>
<td>Conservative</td>
</tr>
<tr>
<td>20</td>
<td>70</td>
<td>10</td>
<td>1.86</td>
<td>Conservative</td>
</tr>
<tr>
<td>30</td>
<td>60</td>
<td>10</td>
<td>2.04</td>
<td>Conservative</td>
</tr>
<tr>
<td>40</td>
<td>50</td>
<td>10</td>
<td>2.22</td>
<td>Conservative</td>
</tr>
<tr>
<td>50</td>
<td>40</td>
<td>10</td>
<td>2.40</td>
<td>Conservative</td>
</tr>
<tr>
<td>60</td>
<td>30</td>
<td>10</td>
<td>2.58</td>
<td>Conservative</td>
</tr>
<tr>
<td>70</td>
<td>20</td>
<td>10</td>
<td>2.76</td>
<td>Conservative</td>
</tr>
<tr>
<td>80</td>
<td>10</td>
<td>10</td>
<td>2.94</td>
<td>Conservative</td>
</tr>
<tr>
<td>90</td>
<td>0</td>
<td>10</td>
<td>3.12</td>
<td>Conservative</td>
</tr>
<tr>
<td>10</td>
<td>70</td>
<td>20</td>
<td>3.18</td>
<td>Conservative</td>
</tr>
<tr>
<td>20</td>
<td>60</td>
<td>20</td>
<td>3.36</td>
<td>Conservative</td>
</tr>
<tr>
<td>30</td>
<td>50</td>
<td>20</td>
<td>3.54</td>
<td>Conservative</td>
</tr>
<tr>
<td>40</td>
<td>40</td>
<td>20</td>
<td>3.72</td>
<td>Conservative</td>
</tr>
<tr>
<td>50</td>
<td>30</td>
<td>20</td>
<td>3.90</td>
<td>Conservative</td>
</tr>
<tr>
<td>60</td>
<td>20</td>
<td>20</td>
<td>4.08</td>
<td>Conservative</td>
</tr>
<tr>
<td>70</td>
<td>10</td>
<td>20</td>
<td>4.26</td>
<td>Conservative</td>
</tr>
<tr>
<td>80</td>
<td>0</td>
<td>20</td>
<td>4.44</td>
<td>Conservative</td>
</tr>
<tr>
<td>10</td>
<td>60</td>
<td>30</td>
<td>4.68</td>
<td>Balanced</td>
</tr>
<tr>
<td>20</td>
<td>50</td>
<td>30</td>
<td>4.86</td>
<td>Balanced</td>
</tr>
</tbody>
</table>

## Exhibit G (Continued)
### Policies Portfolio Risk Index Matrix

<table>
<thead>
<tr>
<th>Weber &amp; House Risk Index (RI) Matrix Table</th>
</tr>
</thead>
<tbody>
<tr>
<td>Par WL</td>
</tr>
<tr>
<td>--------</td>
</tr>
<tr>
<td>30</td>
</tr>
<tr>
<td>40</td>
</tr>
<tr>
<td>50</td>
</tr>
<tr>
<td>60</td>
</tr>
<tr>
<td>70</td>
</tr>
<tr>
<td>80</td>
</tr>
<tr>
<td>90</td>
</tr>
<tr>
<td>100</td>
</tr>
<tr>
<td>110</td>
</tr>
<tr>
<td>120</td>
</tr>
<tr>
<td>130</td>
</tr>
<tr>
<td>140</td>
</tr>
<tr>
<td>150</td>
</tr>
<tr>
<td>160</td>
</tr>
<tr>
<td>170</td>
</tr>
<tr>
<td>180</td>
</tr>
<tr>
<td>190</td>
</tr>
<tr>
<td>200</td>
</tr>
<tr>
<td>210</td>
</tr>
<tr>
<td>220</td>
</tr>
<tr>
<td>230</td>
</tr>
</tbody>
</table>

“Determine which of the following is the greater priority: Lowest premium outlay, development and access to cash value, or the ability to generate excess death benefit. Since the existence and access to cash value is closely linked to the ability to generate increases in death benefit (Section 7702 of the IRC [Internal Revenue Code] we will combine the cash value and death benefit criteria for the following choices:
(a) Lowest premium outlay; or
(b) Development and access to cash value and subsequent ability to generate excess death benefit.264

“From the Risk Index Table, select the portfolio policy mixes ranging from] 3 steps below to 3 steps above the Risk Index closest to “4.”265

After selecting the range in (3) above, portfolios then are optimized based on the criteria described above in (2) (a) and (b). In other words, “the portfolio of policies has been optimized within a given range of Risk Indices for a desired premium outlay budget and considerations of access to cash value and the desire for an increasing death benefit.”266

In their white paper Weber and Hause go through three examples of choosing life insurance portfolios for a Conservative investor with a Risk Factor of 4, a Balanced investor with a Risk Factor of 7 and an Aggressive Growth investor with a Risk Factor of 12, based on either a preference of lowest premium or access to cash value and increasing death benefit, for a portfolio with a $50 million initial death benefit. Exhibit H reproduces the Matrix Results by Risk Index table, which shows the results for the portfolios of policies for total premium, life

264 See footnote 173.
265 Weber & Hause, supra note 2 and 132, at 75-76.
266 Id. at 82.
expectancy death benefit, Risk Index and net present value to life expectancy. What is particularly noteworthy in this table is the comparison shown at the bottom of the table between selecting only one of the three types of policies, as opposed to selecting one of the portfolios of policies. Once again, this shows the synergistic effects of diversification and MPT.

In cases involving large death benefits, after the “policies portfolio mix” has been determined based on (i) risk tolerance and (ii) preference for lowest premium outlay or increasing cash value and death benefit, further diversification is achieved by using multiple insurance carriers for each policy type or style. Insurance carriers will be selected based on financial strength ratings. Obviously, the higher the ratings the better; and, this is particularly true for no-lapse secondary guarantee universal life where only the highest rated carriers should be selected.

There is an old adage in the life insurance profession that says you buy life insurance with your health and you pay for it with money. Consequently, the proposed insured’s health and other considerations and risk factors used in underwriting insurance, such as avocations like private flying and parachuting, can have a bearing on the selection of carriers. While the underwriting criteria used by the highest rated carriers may be very similar, some carriers can have different approaches with regard to underwriting and can evaluate various health risks and other risks

267 One again, the authors greatly wish to acknowledge the permission of Weber and Hause to reproduce this material. Id. at 81 and descriptions of policies portfolios at 76-80.

268 The values in these tables were derived by Weber and Hause through the use of their proprietary illustration software using policy standards and Monte Carlo simulation to produce a confidence level of 90% for the adequate funding of policies and the results shown.
### Exhibit H

**Matrix Results by Risk Index—$50 million Initial Death Benefit**

<table>
<thead>
<tr>
<th>Risk Factor 4</th>
<th>Lowest Premium</th>
<th>Access to Cash Value / Increasing Death Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Conservative</strong></td>
<td>WL 0% / NLSGUL 70% / VUL 30%</td>
<td>WL 80% / NLSGUL 0% / VUL 20%</td>
</tr>
<tr>
<td>Total Prem</td>
<td>$923,000</td>
<td>$1,546,400</td>
</tr>
<tr>
<td>LE DB</td>
<td>$78,754,100</td>
<td>$128,712,080</td>
</tr>
<tr>
<td>Risk Index</td>
<td>4.50%</td>
<td>4.44%</td>
</tr>
<tr>
<td>NPV to LE*</td>
<td>$3,165,440</td>
<td>$4,590,968</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Risk Factor 7</th>
<th>Lowest Premium</th>
<th>Access to Cash Value / Increasing Death Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balanced</strong></td>
<td>WL 0% / NLSGUL 50% / VUL 50%</td>
<td>WL 60% / NLSGUL 0% / VUL 40%</td>
</tr>
<tr>
<td>Total Prem</td>
<td>$1,145,000</td>
<td>$1,584,800</td>
</tr>
<tr>
<td>LE DB</td>
<td>$97,923,500</td>
<td>$132,995,810</td>
</tr>
<tr>
<td>Risk Index</td>
<td>7.50%</td>
<td>7.08%</td>
</tr>
<tr>
<td>NPV to LE*</td>
<td>$3,976,915</td>
<td>$4,944,626</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Risk Factor 12</th>
<th>Lowest Premium</th>
<th>Access to Cash Value / Increasing Death Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Aggressive Growth</strong></td>
<td>WL 10% / NLSGUL 20% / VUL 70%</td>
<td>WL 30% / NLSGUL 0% / VUL 70%</td>
</tr>
<tr>
<td>Total Prem</td>
<td>$1,458,800</td>
<td>$1,642,400</td>
</tr>
<tr>
<td>LE DB</td>
<td>$124,535,735</td>
<td>$139,421,405</td>
</tr>
<tr>
<td>Risk Index</td>
<td>10.68%</td>
<td>11.04%</td>
</tr>
<tr>
<td>NPV to LE*</td>
<td>$5,017,298</td>
<td>$5,475,114</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>All WL</th>
<th>All NLSGUL</th>
<th>All VUL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Prem</td>
<td>$1,508,000</td>
<td>$590,000</td>
</tr>
<tr>
<td>LE DB</td>
<td>$1,24,428,350</td>
<td>$50,000,000</td>
</tr>
<tr>
<td>Risk Index</td>
<td>1.8%</td>
<td>0.0%</td>
</tr>
<tr>
<td>NPV to LE*</td>
<td>$4,237,310</td>
<td>$1,948,228</td>
</tr>
</tbody>
</table>

*Net Present Value (at 5%) of premiums paid to life expectancy AND receipt of the death benefit at LE. The higher the number, the more favorable the total economic outcome.

The above results are in contrast to the selection of just ONE policy for any Risk Index:

differently. However, in large cases almost all insurance carriers will reinsure part of the insurance risk (death benefit) with various insurance carriers that specialize in reinsurance. This reinsurance process among the primary insurance carriers can have a “smoothing effect” by causing more uniformity in the evaluation of insurance risks. The evaluation of the insurance risk affects the pricing of the insurance. A less favorable insurance risk adds extra cost to the cost of insurance (mortality) and the policy is said to be “rated.” Therefore, how the various carriers underwrite and treat the insurance risk can take preference over financial strength ratings in the selection of insurance carriers.

Weber and Hause make the following observation about the alternative of only using variable universal life as oppose to their portfolio approach:

> It might appear that it takes some effort to mix policy styles to derive the most efficient blend based on risk tolerance. It would be fair to ask: “Why not just buy a VUL [variable universal life] and adjust the sub-account selection to match investment risk?”

Many buyers of life insurance have a subjective concern about the “risk” of supporting a foundation asset with an aggressive investment approach. Further, it may not simply be the investment risk concerning the investor, but the consideration – rational or not – of depending on a policy that has no guaranteed premium, not to mention a policy style that’s been labeled “risky.” Technically, of course, it is possible to accomplish the underlying objective of matching risk tolerance and “return” optimization by purchasing, appropriately
allocating, and carefully managing a VUL policy. But some buyers of life insurance may want guaranteed components, which a VUL policy can only simulate but not replicate.

A VUL policy may – based on its allocation and market volatility acting at the policy’s sub-accounts – be at the extreme of policy risk. A key issue is that the entire death benefit is subject to investment risk in the event the policy is not able to sustain itself based on premiums paid, assessed expenses and insurance charges, and portfolio gains or losses. At the other end of the risk spectrum, WL [whole life] and NLG [no-lapse secondary guarantee universal life] policies do not put the death benefit at risk as long as the required premium is paid.\textsuperscript{269}

As previously noted above, the Weber and Hause Risk Index Matrix for the various mixes of the three styles of policies were derived using a weighted average. In combining a risk-free asset, such as no-lapse secondary guarantee universal life, with one other asset that contains “risk” this is the proper procedure. However, the participating whole life policy and the variable universal life are not risk-free assets. What lowers the risk in a diversified portfolio is combining assets that are not perfectly correlated with one another and that have a correlation coefficient other than one (+1). While the authors do not have the data on the correlation coefficient of the general account that supports the participating whole life and the equity sub-account that supports the variable universal life, the authors can say that it is less than one. In

\textsuperscript{269} Weber & Hause, supra note 2 and 132, at 82-83.
fact, the cross-correlation from 1926-2008 of long-term government bonds and long-term
corporate bonds to large company stocks is 0.05 and 0.18, respectively.\footnote{270} Thus, when
participating whole life and variable universal life both are included in the portfolio mix of
policies, a weighted average overstates the risk factor.\footnote{271}

\footnote{270}Ibbotson SBBI 2009 Classic Yearbook, supra note 246 at 99.
\footnote{271}The Policies Portfolio Risk Index Matrix tables produced in Exhibits G and I contain life insurance policies portfolios of various percentage mixes of three different types or styles of policies that we have described in this article. Footnote 241 contains and explains the mathematical formula to compute the standard deviation, or risk factor, of a two security portfolio. However, the Risk Index Matrix tables contain portfolios of up to three different styles of policies.

The mathematical formula for the standard deviation for a three security portfolio is as follows:

$$\sigma_p = \sqrt{w_1^2 \sigma_1^2 + w_2^2 \sigma_2^2 + w_3^2 \sigma_3^2 + 2w_1 w_2 \sigma_1 \sigma_2 R_{12} + 2w_1 w_3 \sigma_1 \sigma_3 R_{13} + 2w_2 w_3 \sigma_2 \sigma_3 R_{23}}$$

Where:

- $\sigma_p =$ Standard deviation of the portfolio.
- $w_1 =$ Percentage weight of Security 1.
- $\sigma_1 =$ Standard deviation of Security 1.
- $w_2 =$ Percentage weight of Security 2.
- $\sigma_2 =$ Standard deviation of Security 2.
- $w_3 =$ Percentage weight of Security 3.
- $\sigma_3 =$ Standard deviation of Security 3.
- $R_{12}$ = Correlation coefficient between Security 1 and Security 2.
- $R_{13}$ = Correlation coefficient between Security 1 and Security 3.
- $R_{23}$ = Correlation coefficient between Security 2 and Security 3.

However, if one of the securities, or life insurance policies in the case of the Policies Portfolio Risk Index Matrix tables, is a risk-free security, or a risk-free policy such as no-lapse secondary guarantee universal life, than the standard deviation for that security, or policy, is zero (0). Suppose in the above formula Security 3 is a risk-free asset than the standard deviation of the portfolio becomes:
In Exhibit I, the authors have calculated Revised Risk Indexes using the formula for the standard deviation of a three asset portfolio, with a revised “Risk Index” for participating whole life, and, different assumed correlation coefficients between the participating whole life and variable universal life policies of 1.00, 0.05 and 0.18. The revised “Risk Index” for participating whole life is 0.80, instead of the 1.8 “Risk Index” used by Weber and Hause, which is 60% of the standard deviation of 1.33% for the general account assets of life insurers, as calculated by the authors and described in the previous section. The correlation coefficient of 1.00 (R = 1.00) represents

\[ \sigma_p = \sqrt{w_1^2 \sigma_1^2 + w_2^2 \sigma_2^2 + w_3^2 (0)^2 + 2w_1w_2 \sigma_1 \sigma_2 R_{12} + 2w_1w_3 \sigma_1 (0) R_{13} + 2w_2w_3 \sigma_2 (0) R_{23}} \]

Since zero (0) multiplied by any number or term is equal to zero (0) than the equation becomes:

\[ \sigma_p = \sqrt{w_1^2 \sigma_1^2 + w_2^2 \sigma_2^2 + 0 + 2w_1w_2 \sigma_1 \sigma_2 R_{12} + 0 + 0} \]

Or

\[ \sigma_p = \sqrt{w_1^2 \sigma_1^2 + w_2^2 \sigma_2^2 + 2w_1w_2 \sigma_1 \sigma_2 R_{12}} \]

This means that when Security 3 is a risk-free security than the standard deviation of the three security portfolio becomes the standard deviation of the two securities with risk using the percentage weights of the two securities with risk for the three asset portfolio.

Similarly, if Security 3 is a risk free security (and a given standard deviation for a risk free security is 0) and either the percentage weight of Security 2 is 0 or Security 2 is also a risk free security than:

\[ \sigma_p = \sqrt{w_1^2 \sigma_1^2} = \sqrt{w_1^2} \sqrt{\sigma_1^2} = w_1 \sigma_1 \]

Thus, the standard deviation becomes a linear function of the percentage rate of the security with risk. The concept of combining a risk-free security, or asset, with another security or portfolio is the bases for the Capital Asset Pricing Model (CAPM) which is described and cited in note 243.

The above mathematical concepts and formulas were used to calculate the Revised Risk Index with the different correlation coefficients in Exhibit I.
a 100% correlation between participating whole life and variable universal life policies, and results in a weighted average “Risk Index.” The correlation coefficient of 0.05 (R = 0.05) is the correlation coefficient between long-term government bonds and large company stocks as proxies for the general account assets backing up the reserves of participating whole life and the equity sub-account backing up the variable universal life. The correlation coefficient of 0.18 (R = 0.18) is the correlation coefficient between long-term corporate bonds and large company stocks as alternative proxies for the general account assets backing up the reserves of participating whole life and the equity sub-account backing up the variable universal life.

For policies portfolios that do not contain (or have a percentage of 0%) participating whole life the Revised Risk Indexes did not change from the Weber and Hause weighted “Risk Index,” which is to be expected because the two policies in the portfolio are the risk-free no-lapse secondary guarantee universal life and the variable universal life whose “Risk Index” was not revised. The correlation coefficients between the participating whole life and the variable universal life have no effect on these calculations because the policies portfolios do not contain both types of policies.

272 See note 241.
274 Id. at 99.
275 See note 271.
### Exhibit I

**Policies Portfolio Risk Index Matrix - Revised With Risk Index (RI) for Par WL of 0.8 & Including the Effect of Different Correlation Coefficients**

<table>
<thead>
<tr>
<th>Weber &amp; Hause Risk Index (RI) Matrix Table</th>
<th>Revised Risk Indices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Par WL</td>
<td>NLSGUL</td>
</tr>
<tr>
<td>% Weight</td>
<td>% Weight</td>
</tr>
<tr>
<td>----------</td>
<td>---------</td>
</tr>
<tr>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>10</td>
<td>90</td>
</tr>
<tr>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td>30</td>
<td>70</td>
</tr>
<tr>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>60</td>
<td>40</td>
</tr>
<tr>
<td>70</td>
<td>30</td>
</tr>
<tr>
<td>80</td>
<td>20</td>
</tr>
<tr>
<td>90</td>
<td>10</td>
</tr>
<tr>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>10</td>
<td>80</td>
</tr>
<tr>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>20</td>
<td>70</td>
</tr>
<tr>
<td>30</td>
<td>60</td>
</tr>
<tr>
<td>40</td>
<td>50</td>
</tr>
<tr>
<td>50</td>
<td>40</td>
</tr>
<tr>
<td>60</td>
<td>30</td>
</tr>
<tr>
<td>70</td>
<td>20</td>
</tr>
<tr>
<td>80</td>
<td>10</td>
</tr>
<tr>
<td>0</td>
<td>80</td>
</tr>
<tr>
<td>90</td>
<td>0</td>
</tr>
<tr>
<td>10</td>
<td>70</td>
</tr>
<tr>
<td>20</td>
<td>60</td>
</tr>
<tr>
<td>30</td>
<td>50</td>
</tr>
<tr>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>50</td>
<td>30</td>
</tr>
<tr>
<td>60</td>
<td>20</td>
</tr>
<tr>
<td>70</td>
<td>10</td>
</tr>
<tr>
<td>80</td>
<td>0</td>
</tr>
<tr>
<td>0</td>
<td>70</td>
</tr>
<tr>
<td>10</td>
<td>60</td>
</tr>
<tr>
<td>20</td>
<td>50</td>
</tr>
</tbody>
</table>

R = Correlation Coefficient Between Par WL and VUL

The first five columns of this table are derived from Table 20, Risk Index Matrix, of Richard M. Weber and Christopher Hause, *Life Insurance as an Asset Class: A Valued-Added Component of an Asset Allocation*, Ethical Edge Insurance Solutions, LLC, 2009, pages 84-85.

Used by Permission. The last three columns of this table were calculated by the authors based on the percentage weights from the first three columns; the Policy Risk Index (RI) for Par WL = 0.8, NLSGUL = 0, and VUL = 15; and the correlation coefficients (R) between Par WL and VUL as stated; using the formula for the standard deviation of a three asset portfolio.
### Exhibit I (Continued)

**Policies Portfolio Risk Index Matrix - Revised With Risk Index (RI) for Par WL of 0.8 & Including the Effect of Different Correlation Coefficients**

<table>
<thead>
<tr>
<th>Weber &amp; Hause Risk Index (RI) Matrix Table</th>
<th>Revised Risk Indexes</th>
<th>With the Risk Index (RI) for Par WL Changed to 0.8</th>
</tr>
</thead>
<tbody>
<tr>
<td>Par WL</td>
<td>NLSGUL</td>
<td>VUL</td>
</tr>
<tr>
<td>RI = 1.8</td>
<td>RI = 0</td>
<td>RI = 15</td>
</tr>
<tr>
<td>30</td>
<td>40</td>
<td>30</td>
</tr>
<tr>
<td>40</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>50</td>
<td>20</td>
<td>30</td>
</tr>
<tr>
<td>60</td>
<td>10</td>
<td>30</td>
</tr>
<tr>
<td>70</td>
<td>0</td>
<td>30</td>
</tr>
<tr>
<td>0</td>
<td>60</td>
<td>40</td>
</tr>
<tr>
<td>10</td>
<td>50</td>
<td>40</td>
</tr>
<tr>
<td>20</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>30</td>
<td>30</td>
<td>40</td>
</tr>
<tr>
<td>40</td>
<td>20</td>
<td>40</td>
</tr>
<tr>
<td>50</td>
<td>10</td>
<td>40</td>
</tr>
<tr>
<td>60</td>
<td>0</td>
<td>40</td>
</tr>
<tr>
<td>0</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>10</td>
<td>40</td>
<td>50</td>
</tr>
<tr>
<td>20</td>
<td>30</td>
<td>50</td>
</tr>
<tr>
<td>30</td>
<td>20</td>
<td>50</td>
</tr>
<tr>
<td>40</td>
<td>10</td>
<td>50</td>
</tr>
<tr>
<td>50</td>
<td>0</td>
<td>50</td>
</tr>
<tr>
<td>0</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>10</td>
<td>30</td>
<td>60</td>
</tr>
<tr>
<td>20</td>
<td>20</td>
<td>60</td>
</tr>
<tr>
<td>30</td>
<td>10</td>
<td>60</td>
</tr>
<tr>
<td>40</td>
<td>0</td>
<td>60</td>
</tr>
<tr>
<td>0</td>
<td>30</td>
<td>70</td>
</tr>
<tr>
<td>10</td>
<td>20</td>
<td>70</td>
</tr>
<tr>
<td>20</td>
<td>10</td>
<td>70</td>
</tr>
<tr>
<td>30</td>
<td>0</td>
<td>70</td>
</tr>
<tr>
<td>0</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td>10</td>
<td>10</td>
<td>80</td>
</tr>
<tr>
<td>20</td>
<td>0</td>
<td>80</td>
</tr>
<tr>
<td>0</td>
<td>10</td>
<td>90</td>
</tr>
<tr>
<td>10</td>
<td>0</td>
<td>90</td>
</tr>
<tr>
<td>0</td>
<td>0</td>
<td>100</td>
</tr>
</tbody>
</table>

R = Correlation Coefficient Between Par WL and VUL.

The first five columns of this table are derived from Table 20, Risk Index Matrix, of Richard M. Weber and Christopher Hause, *Life Insurance as an Asset Class: A Valued-Added Component of an Asset Allocation*, Ethical Edge Insurance Solutions, LLC, 2009, pages 84-85. Used by Permission. The last three columns of this table were calculated by the authors based on the percentage weights from the first three columns; the Policy Risk Index (RI) for Par WL = 0.8, NLSGUL = 0, and VUL = 15; and the correlation coefficients (R) between Par WL and VUL as stated; using the formula for the standard deviation of a three asset portfolio.
For policies portfolios that contain only participating whole life and no-lapse secondary guarantee universal life, in other words do not contain (or 0%) variable universal life, the Revised Risk Indexes are lower than the Weber and Hause “Risk Index” due to the revised lower “Risk Index” for participating whole life. The Revised Risk Indexes for these policies portfolios are weighted “Risk Indexes” because the two policies in the portfolios are the participating whole life and the risk-free no-lapse secondary guarantee universal life. Again, the correlation coefficients between the participating whole life and the variable universal life have no effect on these calculations because the policies portfolios do not contain both types of policies.

For policies portfolios that do contain both participating whole life and variable universal life, and may or may not contain no-lapse secondary guarantee universal life, (which are over two-thirds of the policies portfolios contained in the Policies Portfolio Risk Index Matrix), the combined effect of the revised “Risk Index” for participating whole life and the different correlation coefficients between the participating whole life and the variable universal life can be seen in Exhibit I. With the correlation coefficient between the participating whole life and the variable universal life equal to one (R = 1.00) the Revised Risk Index becomes a weighted average of the “Risk Indexes” of the policies contained in the portfolio, and the Revised Risk Indexes are lower than the Weber and Hause weighted “Risk Indexes” only because of the revised “Risk Index” for the participating whole life of 0.80 as opposed to 1.8 used by Weber.

---

276 See note 271. The correlation coefficients between participating whole life and no-lapse secondary guarantee universal life, and between no-lapse secondary guarantee universal life and variable universal life are irrelevant because when the correlation coefficients are used in the standard deviation formula for a three asset portfolio the correlation coefficients are multiplied by the standard deviation, or “Risk Index,” for no-lapse secondary guarantee universal life which is zero (0). Remember zero multiplied by any number is zero (0).
and Hause. However, the true synergistic effect of MPT becomes apparent when the correlation coefficients between the participating whole life and the variable universal life are equal to either 0.05 or 0.18 \((R = 0.05 \text{ or } R = 0.18)\). The greater the percentage of participating whole life combined with variable universal life in the policies portfolio the greater the effect on the Revised Risk Indexes. For example, with the correlation coefficient between the participating whole life and the variable universal life equal to 0.05 \((R = 0.05)\) there is a 46% reduction with the Revised Risk Index compared to the Weber and Hause weighted “Risk Index” with a 90% participating whole life and 10% variable universal life policies portfolio. Half of this reduction, or 23%, is due to the revised “Risk Index” for participating whole life and the other half of the reduction, or 23%, is due to the effect of the correlation coefficient between the participating whole life and the variable universal life equal to 0.05 \((R = 0.05)\). The actual true synergistic effect of MPT on the reduction of the Revised Risk Indexes from when the correlation coefficient between the participating whole life and the variable universal life is equal to one \((R = 1.00)\), (which produces the weighted average Revised Risk Indexes), to when the correlation coefficient is equal to 0.05 \((R = 0.05)\) varies from a reduction in the Revised Risk Indexes of 0.6% with a 10% participating whole life and 90% variable universal life policies portfolio to 23% with a 90% participating whole life and 10% variable universal life policies portfolio. In some cases, the Revised Risk Indexes have changed the Risk Type Classification of various policies portfolios to lower Risk Type Classifications.

—

\(^{277}\) See note 241 and 271.
This suggests that when both participating whole life and variable universal life insurance policies are included in the “policies portfolio mix”, the percentage of variable universal life included in the mix can be increased, and the percentage of the participating whole life and no-lapse secondary guarantee universal life insurance policies can be decreased, due to the overstated risk index derived by using simple weighted averages. Furthermore, as noted in the previous section, the risk index for participating whole life insurance is not constant and increases as the insured ages. The Weber and Hause Risk Index for participating whole life policies used in Exhibits G and I, and the revised “Risk Index” for participating whole life used by the authors in Exhibit I, is comprised of a weighted average of the guaranteed death benefit and non-guaranteed death benefit at life expectancy. However, in the participating whole life policy the guaranteed death benefit remains constant and the non-guaranteed death benefit increases each year that the policy is in force (increasing from zero at the inception of the policy). This implies that the risk index will be zero for the participating whole life policy during the first year, since no dividends will be paid until the end of the first policy year and the policy is made up entirely of guaranteed cash value and death benefit. It also implies that since the non-guaranteed portion of the policy increases as the insured ages, the risk index for years less than life expectancy will be less than 1.8, or 0.8 as used by the authors, and the risk index after life expectancy will be greater than 1.8, or 0.8 as used by the authors. In other words, the standard deviation/risk index of the participating whole life policy increases over time.

Consequently, since the risk index at earlier ages for participating whole life policies will be lower than the risk index at life expectancy, perhaps a higher percentage of variable universal life insurance with an all equity sub-account allocation could be included in the “policies
portfolio mix” than is stated in the Risk Index Matrix table. Recall that one of the features of variable universal life insurance is the ability of the policy owner to direct, allocate, reallocate and rebalance the investments and premiums of the variable universal life policy. This allows the policy owner the ability to change to more conservative allocations within the variable universal life policy in order to compensate for the increasing risk of the participating whole life policy as the insured ages.

The authors believe that Weber and Hause have made a watershed contribution by applying the principles of MPT to creating a portfolio of life insurance policies. However, just as the authors of this article have suggested that further research needs to be conducted with respect to the effects of including the different types of life insurance policies in investment portfolios, the authors believe that further research needs to be conducted with respect to creating portfolios of life insurance policies, and, accordingly, refinements made to the Risk Index Matrix table. This will entail compiling accurate data on both the standard deviations of the general accounts and the separate sub-accounts of life insurance companies’ investments, as well as compiling accurate data to derive the correlation coefficients between the general account investments and the separate sub-account investments (such as the various bond and equities sub-account funds). The authors suggest that the common measurement for risk, standard deviation, should be incorporated in all future analyses. The authors will continue to conduct research on this topic and will report their findings in future articles.

Finally, it should be noted that there is one aspect of a life insurance policy portfolio that is in sharp contrast to a general investment portfolio – rebalancing. While sub-accounts with the
variable universal life policy in the portfolio can be rebalanced, life insurance cannot be sold or traded like general investment securities.\textsuperscript{278} In addition, purchasing or replacing policies is always subject to evidence of insurability.\textsuperscript{279}

1.20 Conclusions Regarding the Cash Value BDIT, Modern Portfolio Theory and Life Insurance

While modern portfolio theory (MPT) is not so “modern” anymore, it is indeed relevant and applicable to the management of wealth within the Beneficiary Defective Inheritor’s Trust (BDIT). While some BDITs may contain well diversified portfolios, most BDITs are comprised of family businesses, real estate and/or farms and ranches, and are in need of some investment vehicle that can provide diversification.

The authors have thoroughly examined and analyzed the concept of life insurance as an asset class and concluded that permanent cash value life insurance is a unique, separate asset class by itself within MPT. As such, permanent cash value life insurance has the ability to diversify, enhance and complement other assets in an investor’s portfolio, thereby adding to a comprehensive wealth accumulation strategy.

\textsuperscript{278} Sales of life insurance are “transfers for value” and, unless they fall within a few exceptions, cause the death benefit under the policy to be taxable. In certain cases, such as when the insured is expected to die within no more than five years, a policy can be sold to a life settlement company for greater than its cash value.

\textsuperscript{279} There also is a maximum age in which a policy can be issued. For most single life policies that age is 80 and for survivorship policies that age is generally 85.
The authors reviewed existing studies of the effects on the risk and return of bond portfolios with and without life insurance and concluded that life insurance can enhance a portfolio by raising the return and lowering the risk – the very essence of an “efficient frontier.” In addition, life insurance can significantly increase the after-tax retirement income when combined with other assets in a portfolio.

Importantly, the authors asked the question whether it is possible that permanent cash value life insurance policies could provide diversification to the family business, real estate, and/or farm or ranch portfolio of assets most often contained within the BDIT and, through a correlation coefficient of less than one (+1) with these family enterprises, lower the risk of the portfolio of family businesses within the BDIT according to Harry Markowitz’s MPT. By examining proxies for the correlation coefficients of family businesses and types of life insurance policies the authors have concluded that permanent cash value life insurance can provide diversification to the family business, real estate, and/or farm or ranch portfolio of assets most often contained within the BDIT, consequently, enhancing and lowering the risk of the portfolio of family businesses within the BDIT according to Harry Markowitz’s MPT.

Lastly, the authors reviewed the concept of applying the techniques of MPT to build a portfolio of life insurance policies of different policy types or styles. Similar to an investment portfolio, assets were allocated to different policy types or styles based on the risk tolerance and other preferences of the policy owner. A comparison was shown of the differences between selecting only one of three types of policies, as opposed to selecting choices of portfolios
consisting of a combination of policies. Once again the comparison demonstrated the synergistic effects of diversification and MPT.