

## **Premium Financing as Tool for Life Insurance Funding**

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Life insurance is an important part of any high net worth client's financial picture. Since adequate life insurance usually requires significant premium payments, the premium financing strategy can be an effective solution for clients who do not want to liquidate assets to fund their life insurance premiums.

## 1. Standard Model

In the "standard" model, the irrevocable trust will borrow money from a third-party lender unrelated to the life insurance carrier issuing the trust owned policy. Financing the premiums will generally make sense when the interest rate charged on the loan is lower than the rate the client would expect to earn on the assets that he or she did not need to liquidate in order to pay the life insurance premiums.

### A. Deductibility of Interest for Income-Tax Purposes

1. While each individual situation can affect the outcome, interest incurred by an individual for the payment of life insurance premiums is generally deemed to be personal interest and is not deductible for income tax purposes pursuant to IRC Sections 163 and 264. Furthermore, interest deduction will also likely be disallowed under IRC § 264(a)(3) if the loan to purchase a insurance policy is part of a systematic plan to directly or indirectly borrow the cash value of the contract. Where the ownership of the life insurance policy lies with the business, interest may be deductible in certain situations prescribed in IRC § 264(e).

2. Personal Interest. If the interest is deemed to be personal interest it is not deductible (IRC § 163(h)(2)). Generally, the determination of deductibility is made by tracing the use to which the proceeds are put. See Temp. Treas. Reg. §1.163-8T. In order for interest to be deductible, and not be deemed personal, interest must be classified (per IRC § 163) as one of the following:

- Investment interest
- Trade or business interest
- Qualified residence interest
- Interest taken into account in computing income or loss from passive activity
- Interest on extended payments of estate tax
- Interest on education loan

It is unlikely that interest on a loan to purchase a life insurance policy would fall under one of the above categories, resulting in such interest being personal, and therefore not deductible. One possibility for deduction is if the interest qualifies as investment interest. Unfortunately, there is little guidance as to whether life insurance (either personally owned or owned by a business) is an investment so as to qualify for this exception.

3. Plan-of-purchase rule. Under IRC § 243(a)(3), there is no deduction in the case of "any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise)."

Although, IRC § 243(d) provides four exceptions to this disallowance rule, the interest deduction may still be denied if the interest is deemed to be personal interest (as discussed previously). In

addition, interest paid or accrued on a policy covering a “key person” is deductible for income tax purpose but is subject to limitations.

In order to be exempted from the plan-of-purchase rule, one of the following four exceptions must be met:

- a) The four-out-of-seven rule. Interest paid can be deducted if no part of 4 of the first 7 annual premiums, beginning on the date the first premium is paid, is paid by means of a loan.
- b) \$100 exception. Interest paid or accrued for the year on such borrowings is \$100 or less. For this purpose all interest paid on such borrowings is added together, regardless of the number of plans. Deduction is allowed only if the total interest is \$100 or less. Treas. Reg. § 1.264-4(d)(2).
- c) The unforeseen events exception. If the debt is incurred because of an unforeseen substantial loss of income or an unforeseen increase in financial obligations, the taxpayer is not barred from deducting the interest.
- d) The trade or business exception. If debt was incurred in connection with the taxpayer’s trade or business, the plan-of-purchase rule will not apply. To qualify under this exception, the indebtedness must be incurred to finance business obligations rather than to finance cash value life insurance, and is determined by examining the facts and circumstances of each case. Treas. Reg. § 1.264-4(d)(4). If the premium financing loan is obtained to purchase business life insurance such as key person, split-dollar, and stock purchase plan, such a loan is not considered to be incurred in connection with the taxpayer’s trade or business, and will not fall under this exception. Treas. Reg. § 1.264-4(d)(4); *American Body & Equipment CO. v. U.S.*, 511 F.2d 647 (5<sup>th</sup> Cir. 1975)

#### 4. Policy on a Key Person

As set forth above, generally interest paid or accrued on indebtedness related to an insurance policy is not deductible. Nevertheless an exception is allowed for interest paid or accrued on any indebtedness with respect to policies or contracts covering “key persons” to the extent that the aggregate amount of the indebtedness with respect to policies and contracts covering that person does not exceed \$50,000. IRC §§ 264(e)(2) and 264(e)(1).

For purposes of IRC § 264, a key person is defined as an officer or 20% owner. The numbers of people that can be consider key person can not exceed 5 individuals or the lesser of 5% of the total officers and employees or 20 individuals. IRC § 264(e)(3).

#### B. Estate Tax Issues

In most premium financing cases, the policy is owned by an irrevocable trust. This format is intended to prevent the life insurance proceeds from being included in the estate of the insured grantor. In most cases, the grantor will be required to make a personal guarantee of the loan. Is this personal guarantee an incident of ownership in the policy that would cause the policy proceeds to be includible in the gross estate of the insured under IRC Sections 2033 through 2045?

In PLR 9809032, the IRS ruled that even though an irrevocable trust had borrowed funds from the insured to pay life insurance premiums and the loan remained outstanding at death, the life insurance proceeds payable to the trust as beneficiary were not includible in the insured/grantor’s estate. Of course, private letter rulings are only applicable to the specific

taxpayer that requested the ruling and to the specific facts presented in the taxpayer's request. However, it may indicate how the IRS might rule in a similar fact situation.

## 2. Separate Transactions

The life insurance policy issuance and loan qualification will be evaluated as independent and separate transactions. The insured may qualify for insurance coverage while the trust can be denied the loan. Some premium financing programs are offered in which the lender and the insurance company are owned by the same holding company. Even so, it is prohibited under state law to require a loan transaction in order to qualify for the life insurance.

## 3. Variety of Sources for Premium Funding

Premium financing for life insurance had until recently been generally limited to either a single national lender working exclusively with 10 life insurance carriers or lending programs developed by the life insurance carrier itself. In addition, some banks were loaning premiums to preferred clients on a small scale.

Within the last two years, a number of sources for premium financing have appeared including several national banks and brokerage firms that often limited financing to their clients. The market seems to be in flux with lenders entering and leaving on a constant basis. Many lenders are having problems reaching critical mass in their programs while others continue to struggle to profitably price their loans in the market. Most of these lenders specialize in limited term loans so they can better match their asset/liability lending requirements.

Most recently the market has seen the introduction of lender brokers that act like a mortgage broker in attempting to match the right borrower to the right lender. These brokers claim they can tailor a unique financing solution based on the individual client's situation. Generally, such brokers are paid by the lender through loan origination fees charged to the client.

## 4. Factors to Consider in Premium Financing

Almost all premium financing lenders have general requirements based on minimum loan size and minimum net worth. Minimum loan size and minimum net worth requirements differ by lender and can be significant. Minimum loan size generally refers to the amount of funds borrowed to pay premiums. So either the premium for the first year of the policy needs to meet a minimum amount or the total loan commitment needs to meet a minimum. For example, some lenders' minimum loan size is an initial \$75,000 to \$100,000 in initial premium, while other lenders require a minimum loan commitment of \$1 million, usually based on a multiple-year premium commitment. Some lenders will allow a borrower to aggregate the loans of multiple policies owned by the borrower to meet these minimum requirements. Minimum net worth requirements also must be met. Generally, a client's total net worth must exceed \$5 million. Some lenders require a minimum policy death benefit.

These requirements are important to keep in mind because a client may not meet the minimum requirement for one lender, but will for another.

## 5. Interest Component

One of the most important issues in the loan arrangement is the interest component. Generally, loan interest is made up of two components: an index such as LIBOR (London Interbank Offering Rate) and a spread that can range from 175 to 300 basis points. Similar to a residential mortgage, the lowest offered

interest rate does not always equate to the best loan offer. Other factors need to be considered.

For example, are there additional fees, such as loan origination fees (commonly 0.5 to 1.25% of the expected total loan balance), associated with the loan that can offset any savings related to a low interest rate? Often times these fees must be paid up front while some lenders allow them to be financed with the policy premiums.

In addition, is the interest variable or fixed, and if variable, how often does it reset? Typically, in most arrangements the interest is a variable rate, with a portion of the interest determined by an index resetting each year, but the spread on top of the index may be fixed for the life of the loan. The 12-month LIBOR is a common index as well as the prime rate. If there is a fixed interest rate, it is important to determine how long it will be fixed. In many instances the fixed rate is only for a certain time period such as five or 10 years.

A cap will set on how high the loan interest rate can go during the loan term. So while the loan interest might be variable, there is a cap that will limit how high the interest rate can grow, such as 8%. When the loan interest has both a cap and a floor it is said to have a “collar.” The lender limits how high the loan rate can go, and the borrower agrees that the rate may never go below a certain amount even if the index with the spread is below that rate. A cap by itself is more expensive than a collar, and the expense is usually expressed in a loan origination fee or in the amount of spread placed in the offer.

Caps and collars are generally offered only in fairly sizable loan arrangements, generally in excess of \$1 million.

## 6. Payment of Interest

Generally, interest must be paid annually on the loan, so it’s important that the borrower, usually an irrevocable trust, has the money to pay it.

One possible strategy to ensure that there are funds available to pay interest is for the client to purchase a Single Premium Immediate Annuity (SPIA) whose annual income stream can then be used to pay the loan interest. Although not always the case, in general, a higher interest rate environment benefits this strategy as does the ability to get a rated SPIA. A rated SPIA is one in which the life insurance carrier underwrites the applicant medically and attempts to determine if he or she has health conditions that lessen life expectancy. If so, these health conditions would allow for a higher payout than would normally be justified using the general mortality assumptions for that applicant’s age and gender.

Most lenders generally require interest to be paid annually (a non-capitalized loan), but some lenders will allow the client to accrue interest (capitalized interest). Most lenders will impose time restrictions as to how long interest can be accrued (e.g., five years), and additional financial requirements may have to be met by the borrower (e.g., higher net-worth requirements or additional collateral).

Although accruing interest may seem like a great way of avoiding interest payments, it should be done with caution. Because the loan principal now reflects funds borrowed for premiums and interest, the amount of the loan could balloon rapidly, resulting in a huge loan principal. This loan principal will need to be paid back from either a lifetime repayment strategy or from the life insurance policy death benefit. If the policy death benefit does not grow to the same degree as the loan balance, the borrower may have an insufficient death benefit to meet other liquidity needs after repaying the loan balance.

## 7. Terms of the Loan

An often overlooked factor in examining financing arrangements is whether the loan is a term loan. A term loan is a loan that is effective for only a certain number of years. For example, if the loan is a 5-year term loan, after five years the entire principal will need to be paid on the loan unless a new loan is offered for additional years.

In this situation, the borrower is dependent on the lender granting an additional, new loan after the term of the original loan. Because this is technically a new loan, the lender does not necessarily have to offer the new loan on the same terms as the original loan. If no new loan is offered, the borrower must either use current assets to pay off the loan or find another financing source. If a new loan is desired, the client will need to go through financial underwriting and may have to pay a new origination fee.

Other questions in regard to the terms of the loan that should be asked include: Is the loan a recourse loan? A recourse loan means the lender can go after other assets than just the policy cash value if the borrower defaults on the loan. A non-recourse loan generally means the lender is limited to only the policy cash values or death benefit to satisfy the outstanding loan balance. A non-recourse loan typically will be offered at a higher rate or with additional fees than a recourse loan.

Does the lender have the right to call the loan? An unlimited right to call the loan at any time provides very little security to the borrower. Generally, lenders can call the loan only in an event of default as specified by the lender, but some lenders do retain the right to call the loan at any time if they feel the financial condition of the borrower or the collateral backing the loan has deteriorated.

Since the borrower may be an irrevocable trust with no assets or credit history, lenders will often require that the grantor of the trust personally guarantee the loan. If the trust defaults, the lender can go after the personal assets of the grantor to satisfy the loan. Some lenders tout that they do not require a personal guarantee even if the borrower is an irrevocable trust.

## 8. Gift Tax Issues

Does a grantor's personal guarantee constitute a gift from the grantor to the trust? If a payment is made under the guarantee, the grantor will likely be deemed to have made a gift for gift tax purposes at that time. At the outset, however, there is only the provision of a guarantee and no payment is yet required. Therefore, it is uncertain as to whether a personal guarantee constitutes a completed gift.

A. In *Bradford v. Commissioner*, 24 TC 1059 (1960), the Tax Court ruled that a wife's substitution of her promissory note for the notes of her husband held by a bank did not constitute a taxable gift to her husband. In making this determination the Court reasoned that in order for there to be a gift there must be a transfer of property owned by the donor with a clear and unequivocal intent to divest himself/herself presently of the property transferred. The substitution of notes was not a transfer of a property interest but only a promise to pay in the future if called upon to do so. Therefore, the mere promise to make a gift is not taxable, even though the promise may be enforceable, because a mere promise to make a transfer in the future is not itself a transfer. See also, *Archbold v. Commissioner*, 42 BTA 453 (1940); *Grossinger Est. Of v. Commissioner*, 723 F.2d 1057 (2<sup>nd</sup> Cir. 1983).

B. In Private Letter Ruling (PLR) 9113009, the IRS found a guarantee to be a completed gift as soon as it became legally enforceable. However, the IRS withdrew PLR 913009 in PLR 9409018. It is important to note that PLR 9409018 only modified IRS' conclusions it had reached earlier in respect to the estate tax consequences of the guarantee, but otherwise expressed no opinion about the gift tax consequence. The IRS has indicated that it is still considering its position on the issue.

C. The IRS' position in regard to the impact on a shareholder's S corporation basis when that shareholder personally guarantees debt of the S corporation may provide some support that a guarantee should not be deemed a taxable gift. In *Harris v. U.S.*, 778 F.2d 769 (5<sup>th</sup> Cir. 1990), the Fifth Circuit affirmed the IRS' position in denying a shareholder of an S corporation from increasing the basis of his S corporation stock by the amount of loan that the shareholder personally guaranteed on behalf of the S corporation. The Court in *Harris* held that the guarantee was not an economic outlay and therefore had no impact on shareholder's basis. There is also no economic outlay where a shareholder pledges or mortgages his own property to secure loan of the S corporation, and therefore shareholder was not allowed to increase his basis in the S corporation stock as a result of providing the security. See *Estate of Alton Bean v. Commissioner*, 268 F.3d 553 (8<sup>th</sup> Cir. 2001). The Sixth Circuit in *Brown v. Commissioner*, 706 F.3d 755 (6<sup>th</sup> Cir. 1983) further held that a shareholder who guarantees a loan for the S corporation must make actual disbursements on the debt in order to increase his basis. Thus, even though the lender relied on these guarantees due to the poor financial condition of the corporation, the shareholder had no basis in the debt when they guaranteed a note from the S corporation to a commercial lender.

## 9. Loan Renewal

Generally, the borrower will have to re-qualify or renew the loan each year. With a non-term loan, renewal is generally done for two reasons. First, the lender wants to verify that the borrower's financial position has not deteriorated. If financial condition has not changed significantly, renewal should not be an issue. Nevertheless, it is important to obtain from the lender clear guidelines as to the factors used in granting renewals.

Secondly, depending on the collateral used for the loan, the lender may reduce or require additional collateral for the loan at time of renewal.

If the original loan is a term loan, as discussed before, the client will have to go through full financial underwriting at the end of the term of the loan and will be subject to new loan conditions and possibly a new origination fee.

## 10. Collateral Requirements

The trust will need to qualify for the loan, typically pledging existing collateral. Collateral requirements are a crucial issue in premium financing cases. Policy cash values serve as a source of collateral for the loan. However, in early policy years, there is typically a short fall between the loan balance equal to the premiums paid into the policy and the policy cash surrender value. Many insurance carriers participating in premium financing programs offer a modified version of their cash surrender value in early years to mitigate or eliminate the need for additional collateral. For instance, the lender may be able to use a universal life policy's accumulation value instead of the cash surrender value if the policy owner selects this provision. Some policies may even offer cash values equal to premiums paid. These provisions typically result in reduced compensation to the producer selling the policy or a possible charge back in commissions if the policy is actually surrendered in its early years.

If a shortfall exists, it must be filled with collateral pledged by either the policy owner or another party. In many cases, the policy owner will be an irrevocable trust and will have no other asset to pledge as collateral. In this common scenario, the grantor of the trust will need to pledge collateral for the loan.

## 11. Lender May Limit Forms of Collateral

Lenders often limit the type of assets they will allow to serve as collateral. Collateral can be in the form

of cash, certificates of deposit, government-issued bonds and other non-financed life insurance policy cash values. Of course, the lender prefers the most liquid form of collateral favoring cash, certificates of deposit, or government bonds. One lender still discounts government bonds to 95% of their value for collateral purposes. In some situations, the irrevocable trust or the insured have other cash value life insurance policies and they are an excellent source of collateral.

If a letter of credit is being used, most lenders will only accept a letter of credit from an “approved” bank. It is important to check with the lender to make sure it will accept a letter of credit from the bank chosen by the borrower. The cost of obtaining such a letter of credit is typically between 0.5 to 1% of the total credit amount.

Additional issues arise when securities are used as collateral. Due to SEC regulations, securities are subject to at least a 50% discount when used as collateral. This 50% discount also applies to the cash value of variable policies used as collateral. The lender also may not accept a large holding of a single security due to diversification issues, so a diversified portfolio will likely be needed.

Some lenders will require that they manage the assets held for collateral. Others will require the assets pledged to exceed the loan balance by 25-50% so a loan for \$1,000,000 will require collateral assets, even if cash or cash equivalents are used, to equal \$1,500,000.

In most cases, collateral requirements are reduced as policy cash values grow and ultimately the policy cash value may serve as the only collateral for the loan.

## 12. Repayment of Loan Principal

Unless the loan has a fixed term, individual situations determine if the loan is paid before the death of the insured. Otherwise, the lender is repaid from the life insurance proceeds. The lender’s collateral assignment on the policy secures its right to repayment of the outstanding loan balance before the remaining policy proceeds are paid to the policy beneficiary. Since a collateral assignment has been placed on the policy, the policy owner will not be able to surrender the policy or access the cash value without the approval of the collateral assignee, the lender.

Another possible repayment option is to use the policy cash values during the life of the insured. The problem with this approach is that most lenders require approval before any withdrawals can be made from the policy, and secondly, the policy may not perform as projected, resulting in insufficient cash value to pay off the loan. Another concern may be the policy performance after the cash values have been accessed for loan repayment.

Certainly other strategies could be employed depending upon the client’s overall estate situation and planning needs. One could be the use of a grantor remainder annuity trust or the sale of an asset to an intentionally defective grantor trust. In addition, the use of a settlement, the selling of the actual policy to a third-party financial institution, might be employed if the client’s need for the life insurance has disappeared.

## 13. Identifying Proper Use of Premium Financing

Premium financing may not be suited for every client. Generally, premium financing should be considered by clients with large estates who need to purchase substantial amounts of insurance due to estate tax liquidity issues but do not have the available cash to pay the premiums on such a policy. Traditional funding typically involves an Irrevocable Life Insurance Trust (ILIT) which obtains the

financing to purchase a policy owned and payable to the ILIT.

In addition, premium financing should be used only by those clients who understand the concept of financial leverage and are comfortable with the financing concept.

Generally, an individual or family prospect will have one or more of the following characteristics:

- Estate is typically greater than \$5 million.
- Traditional funding of a policy inside an irrevocable trust will create gift taxes.
- The individual or family wealth is illiquid, but assets are available for collateral, or a letter of credit can be obtained.
- The trust grantor and trustee understand financial leverage and are comfortable with the financing concept.

It is always important to remember that premium financing is not a means for obtaining free insurance. The cost of buying insurance is the same since both interest and loan principal need to be paid to the lender.

Not all financing programs are the same. Depending on the lender and carrier involved, the actual terms of each case will differ. Therefore, when evaluating these programs, comparison should be made as to the differing terms for each program to find the right fit for the client.

## **Annuity/Insurance Arbitrage: Overstatement or Reality?**

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## **Annuity/Insurance Arbitrage: Overstatement or Reality?**

### 1. The Goal: To Achieve A Risk Free Return On One's Money.

The definition of "arbitrage:" the practice of taking advantage of a state of imbalance between two (or possibly more) markets for the same or related assets.<sup>2</sup> Pure arbitrage is the purchase of one security and simultaneous sale of another to give a risk free profit.<sup>3</sup>

**Example 1:** In a connotative sense, we typically regard an investment in two different assets as creating the possibility of an arbitrage.<sup>4</sup> For example, Shell and Royal Dutch are subsidiaries of a holding company and entitled to cash flows from the holding company in required percentages. After adjusting for differences in price attributable to differences in the cash flows and currency adjustments, the price of Royal Dutch versus Shell in January, 1996 was: Royal Dutch: \$141/share; Shell: \$126/share. Shell was essentially trading at \$15/share less than Royal Dutch, or approximately 11.71 % lower. Theoretically, an investor (assuming no transaction costs, which is not actually true in the marketplace) could short one share of Royal Dutch, receive say \$141 in cash, purchase one share of Shell at \$126, and still be ahead \$15/share. Any increase in the price of stock in Shell or Royal Dutch should have been parallel since they were receiving the same results from the holding company (one company could not be favored over another in terms of cash flow, other than pursuant to an adjustment taken into account in the above example). But with this investment, the investor, at no cost, was \$14 ahead.<sup>5</sup>

### 2. Components of the Insurance/Annuity Arbitrage

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

### 3. Premises Underlying the Strategy

The strategy attempts to use the different pricing of annuities and insurance products, on the same individual, in an arbitrage fashion. For example, as evidenced by the IRS' shift in mortality tables,<sup>6</sup> actuaries can use different assumptions in determining one's expected mortality. In an efficient market, the mortality assumptions built into annuity and insurance products should be the same; that is, each product should use the same actuarial assumptions for a given consumer regardless of which product – an annuity or insurance policy—the consumer is purchasing.

A shift in mortality to a longer expectancy means that a life insurance product, whose costs is based in part on how long the insured will live, will have lower premiums. Further, insurance products are typically priced taking into account that not all insurance policies are held to maturity (a variable that

also lowers costs). Conversely, a shift in mortality to a lower life expectancy means that an annuity, whose payout is based in part on how long the insured will live, will have higher payouts.

**Example 2:** Assume a 79-year-old in standard health status has an 8 year life expectancy, and the cost of a \$1,000,000 face universal life policy based on this 8-year life expectancy is \$57,000 annually. Assume the life expectancy assumption is increased 20% to 9.6 years; although the calculation of premium cost to life expectancy is not linear, an extrapolation of cost based on a geometric progression would be to decrease the policy cost to \$45,600 annually. Contrast this with a 79-year-old in standard health status who has a life expectancy of 8 years, and pays \$1,000,000 to purchase a single premium immediate annuity (SPIA). The immediate annuity is \$164,515 annually. Now assume that the life expectancy assumptions decrease by 20% and assume the same linearity in pricing. The single premium annuity payment now will increase to \$197,479 annually.<sup>7</sup>

One variable used by the consumer in choosing life insurance policies is the annual premium, the lower being better, all else being equal. One variable used by the consumers in choosing annuity products is to get the greatest annual payout, all else being equal. The incentive of insurance companies in structuring products is, therefore, to lower the expected annual premiums in life insurance products, and to increase the annual payouts in annuity products, versus those offered by their competitors. Since pricing of those two products is based on mortality assumptions, a tweak in mortality assumptions can allow the products to be more competitively priced. Hence, Company A may use a longer mortality assumption when determining the price of a life insurance policy of an individual than Company B will use when determining the price of an annuity contract for that same individual.<sup>8</sup>

#### 4. The Strategy in Its Simplest Iteration

The nutshell version: Buy an insurance policy with a face amount of \$X, and use \$X to buy a single premium immediate pay annuity (for these purposes, a "SPIA"). The after tax cash flow from the annuity would be used to pay for the premium on the insurance policy, and the differential in the annuity cash flow would be garnered as profit.

**Example 3:** One possibility would then be for an insured, aged 79, to purchase a life insurance policy, say with a face amount of \$1,000,000, which requires premiums of \$57,025, annually. The same insured would then invest \$1,000,000 in a SPIA that pays \$164,515 annually, for the insured's lifetime.<sup>9</sup> The death benefit of \$1,000,000 would replace the principal lost of \$1,000,000 with the purchase of the SPIA. Each year the insured would receive a net cash flow of \$81,684, after taxes, through life expectancy, and \$41,684, thereafter. See attachment 2.

The above example has leakage, in various spots. First, it is not a true arbitrage because it is costing the insured the use of money on \$1,000,000 between the time the insured purchases the annuity and the insured's death. The value to the insured is really the differential between the rate of return on the transaction and the risk adjusted rate of return that the insured could have received on alternative transactions (the opportunity cost). In the above example, as noted on attachment 2, the after tax rates of return are 8.168 % (through life expectancy) and 4.168 % (after life expectancy).

Second, the insurance companies are not the equivalent of the U.S. government, and each company, the one paying the annuity, and the one that will pay the death benefit, could default. A default over and above the state-covered insured amount will eliminate the sure gain inherent in the transaction. Therefore, concluding that this is the arbitrage gain would be wrong. Instead, a higher cost of capital than the risk free rate of return must be assumed as an investor's desired rate in this type of alternative investment. If the transaction does not exceed that alternative higher risk adjusted rate (whatever it is), then there will not be true arbitrage gain. The 8.168 % may represent a reasonable return based on the risk; the 4.168 % does not. For the transaction in Example 3 to work, a greater rate of return is required. If a third party finances the transaction (at 4 %), discussed below, a pure arbitrage rate of return of 4.17 % exists prior to life expectancy. See attachment 3.

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

The unknown costs are more difficult. One is the cost of the insurance in the long run. For example, typically this type of arbitrage will be done with a universal life product, versus a whole life product, because the premium costs earlier on will be less. As Barry Commoner emphasized, "There is no such thing as a free lunch."<sup>10</sup> The lowest cost universal policies reserve the right to change the mortality costs inherent in annual premiums to account for future, bad mortality experience. Accordingly, a universal policy can afford to require less premiums up front because if societal health gets worse going forward, it can always increase the mortality costs associated with policies; in contrast, whole life policies guarantee these costs, and hence amortize the risk by increasing premiums required throughout the life of the policy. Therefore, if engaging in the strategy using a non-guaranteed insurance policy, an insured cannot be guaranteed that his or her or its annual premium costs for the life insurance policy will be at a fixed cost.<sup>11</sup>

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

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

Fifth, the strategy has obvious illiquidity concerns because it is implemented with a term relating to the insured's life. (See Example 4, below).<sup>12</sup>

Sixth, the arbitrage works best when the annuity and insurance mortality and other costs assumptions diverge the greatest. To uncover this, "shopping" the annuity and life insurance markets, understanding the built in assumptions, navigating health and medical issues, and engaging in successful negotiations, will all be crucial. Meaning: it is tough to find the right companies without substantial resources.

## 5. Using a Third Party Financing Arrangement for the Pure Arbitrage

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

**Example 4:** Assume the following (from a proposed case). An insured aged 85 is considering the purchase of a one million dollar SPIA that pays \$13,480 per month. The same individual is buying a universal life policy that costs \$5,759 per month. Note that these are being paid/received monthly because of the age. The annual rate differential, after tax, is 8.6% up through life expectancy, and thereafter 2.8%. Assume that a Bank is willing to provide the insured with a loan of \$1,000,000, renewable annually, at 2% over LIBOR (currently this would be about 4.36%). If the interest is not deductible (see discussion below), the arbitrage rate of return, after financing, is 4.23%. If not for the required guarantee and collateral issues, this would be a true arbitrage return, as no principal of the insured is at risk. Bad news occurs after life expectancy. After life expectancy, because of the increased income taxes, there is a negative 1.57% return. If there was a point that the loan (interest or principal) could not be paid, there could be a default. But without recourse to the insured, the loan would simply not be repaid. See attachment 4.

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

The arbitrage could be increased if the interest expense incurred in the loan could be argued not to be tied to the purchase of the annuity, and somehow deductible as investment interest. In that event, there is arbitrage gain between .18% and 4.91% (which does not look great until the percentage is applied against say, a one hundred million dollar loan, the net result being potentially \$4,910,000 received with no outlay of capital). See attachment 5. Unfortunately, the interest expense typically falls under section 264 as a non deductible expense.<sup>13</sup>

## 6. Facing the Grim Income Tax Reaper

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

The taxation of the SPIA is governed by section 72 of Internal Revenue Code. Under the simplified version of section 72, a portion of the annuity each year is deemed a return of principal (the exclusion ratio) for a period of time, and the remainder is taxable income. The exclusion ratio, which is determined by reference to IRS tables, is a fraction equal to the investment in the contract divided by the expected return.<sup>14</sup> The expected return is determined by multiplying the annual annuity payments by the

factor shown in Table V of Treas. Reg. § 1.72-9 corresponding to the annuitant's age (as of the annuity starting date).

A heuristic is that the annual payout is multiplied by the IRS prescribed life expectancy to get the expected return. This forms the denominator of the exclusion ratio. The numerator is the amount of consideration paid for the SPIA. Each year, then, for an older individual, the amount of the annuity excluded from tax is significant, until the annuitant reaches life expectancy. After life expectancy, the entire consideration paid for the annuity should have been returned to the owner of the annuity, and the full annuity then becomes taxable to the owner.

#### 7. The Insurance Must Remain Insurance

The annuity and insurance will be purchased from different companies. This is intuitive: a company's actuaries are not likely to engage in wide enough pricing disparities on these two products. Moreover, if purchased from one company, there would be substantial income tax concerns. Specifically, there is the issue of whether this will render the life insurance fully subject to taxation at death, as the IRS ruled in 1965.<sup>15</sup> In that ruling, the Service concluded that an insurance and annuity combination purchased from one company removed the insurance element, thereby resulting in the loss of the income tax exclusion. Query further whether the proximity in time and amount of the insurance and annuity, even when purchased from different companies, can invoke the haunting vestiges of the 1965 ruling, thereby rendering the insurance taxable.

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

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

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

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

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

The arbitrage is an estate tax arbitrage, more than anything else, at essentially no cost.<sup>16</sup> As attachment 6 illustrates, the elimination of the taxable income to the insurance trust increases the overall return to the insurance trust. Using the \$1,000,000 borrowing rate for the purchase of a SPIA, attachment 6 illustrates that the net amount (after income tax) in the irrevocable insurance trust is \$44,252 after the first year, \$239,683 after the fifth year, and \$596,798 after ten years. If the arrangement is financed at \$10,000,000 versus \$1,000,000, the numbers gain more significance (\$5,967,980). And, in the worst case scenario, in which the annuity cannot service both the loan and the insurance premium amount, the insurance trust defaults. But there were no transfer tax costs to set it up.

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

Second, there is the risk that the IRS could apply a step transaction principle to collapse all steps; or asserts a 2036 argument. Among the collapsible steps is the loan, initially. Would a third party loan money, unsecured, to the trust? Would the third party charge a higher interest rate if it knew that its buyer's income tax would be shifted to it, the lender? And if there is a pure arbitrage created, isn't this known up front (and **priced** into the bargain) by all parties?<sup>17</sup>

#### A. Step Transaction Doctrine

Courts will sometimes view all the steps of a transaction as a whole. In essence, if taxpayer takes steps A → B → C to lead eventually to result D, and if the step transaction doctrine is deemed to apply, the court then recharacterizes the taxpayers' actions as going from step A directly to result D and disregarding the intermediate steps.<sup>18</sup>

In the income tax area, there are three different tests that have been applied to determine if the steps of a transaction should be ignored. Although the courts may discuss these tests as alternatives in determining if a step transaction is to be found,<sup>19</sup> often a court will focus on just one of these tests in its determination.<sup>20</sup>

One test, the "binding commitment" test, collapses the steps if, "at the time the first step is entered into, there was a binding commitment to undertake the later step."<sup>21</sup> Note that this test would not unwind the Transaction.

A more liberal standard, the "interdependence test," asks whether the steps are so interdependent that "the legal relations created by one transaction would have been fruitless without a completion of the series."<sup>22</sup> The interdependence test focuses upon each step in a series of events, and asks whether those steps were interdependent of the other steps or whether they have independent significance. Note that this test would not unwind the Transaction.

The most liberal standard is the "end result" test. This test ignores intermediate steps if it appears that a series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result.<sup>23</sup> The end result test skips to the end of the entire series of steps, and evaluates whether this is what the parties were trying to achieve, without regard to the steps interposed between the beginning and end. Subjective intent is relevant because it allows the court to determine whether the taxpayer directed a series of transactions for an intended purpose. Under the end result test, a series of transactions are stepped together if they are prearranged parts of a single transaction intended from the outset to reach a specific end result.<sup>24</sup> This test could re-characterize the Transaction as the grantor purchasing the annuities and the insurance, thereby ignoring the loan and deeming the entire insurance trust includible in the grantor's gross estate.\*\*

There is the important question of whether the end result test can even be applied by a court in the transfer tax area.<sup>25</sup> Application of the step transaction doctrine to complicated and substantial income tax cases has resulted in uneven results. It is difficult to tell when and how the courts will apply a specific prong or alternative of the step transaction test. As this doctrine moves over to the estate and gift tax area, it is likely that a more conservative application of it will result.

The step transaction doctrine is an outgrowth of the substance over form doctrine, in which congressional intent is observed by interpreting a statute consistent with the actions of the parties. This means, reasonably, that the parties cannot say they are doing one action -- consistent with the Code -- and then actually act differently -- inconsistent with the Code. From a legislative intent perspective, the "binding commitment" test is the truest application of the step transaction doctrine. Because that test asks whether the parties allowed the intermediate steps to really have any meaning, to create legally

enforceable rights at those intermediate steps; versus the form of the transaction being to achieve the end result and no independent, enforceable, acknowledgeable rights were being created by the intermediary steps.

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

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

“[T]he facts of this case invite us to use the end-result version of the step-transaction doctrine to treat the underlying partnership assets – the property originally held by the descendant – as the property to be valued for estate tax purposes.”<sup>26</sup>

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

The cases cannot be reconciled. Analogizing to *Maxwell*, a court could be tempted to apply an end result analysis to invoke the step transaction doctrine to this strategy.<sup>27</sup> Whether a particular court will go this far depends in part on their willingness to legislate. Because in that instance, the imposition of the step transaction doctrine will be tantamount to legislation, essentially fixing a tax strategy that is permitted under the clear terms of the statutes. Not all courts would go this far. In this regard, compare the *Strangi II* holding and dicta against the taxpayer with the Third Circuit’s emphasis in *D’Ambrosio*, 101 F.3d 309 (1996):

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

#### B. Section 2036 Analysis

Alternatively, the court could apply a 2036 analysis, referencing the *Strangi II* and *Thompson* concepts. Here, the retained interest would be the implied right to receive annual interest payments, which clearly comes out of the transferred property (through the purchase of the annuity). There are older cases dealing with the life insurance/annuity combination that could be extended in principle to implicate section 2036.<sup>28</sup> And the *bona fide* sale test as outlined in *Strangi II* and *Thompson* could be a concern.

The Tax Court in *Strangi II* used a harsh application of the term “*bona fide*” in the full and adequate consideration exception. The Tax Court looked for actual negotiations between family members to demonstrate and satisfy this requirement; and absent such negotiations, refused to implement the full and adequate consideration exception to Section 2036.<sup>29</sup>

In contrast, the Fifth Circuit in *Kimbell* focused on its prior decision in *Wheeler*, in which it had held that the *bona fide* full and adequate consideration exception applied if the transaction was not a sham or illusory and if objective facts demonstrated that the transfer was made for full and adequate

consideration. In reaching its holding, the *Kimbell* court emphasized: “However, we made it clear that just because a transaction takes place between family members does not impose an additional requirement not set forth in the statute to establish that it is *bona fide* . . . . A transaction that is a *bona fide* sale between strangers must also be *bona fide* between members of the same family. In addition, the absence of negotiations between family members over price or terms is not a compelling factor in the determination as to whether a sale is *bona fide*, particularly when the exchange value is set by objective factors. . . . In summary, the *Wheeler* case directs us to examine whether 'the sale . . . was, in fact a *bona fide* sale or was instead a disguised gift or a sham transaction.' ”<sup>30</sup>

The *Kimbell* court emphasized that, “[i]n order for the sale to be for adequate and full consideration . . . the transaction [must be] entered into for substantial business and other non-tax reasons.”<sup>31</sup> The court seemed to go a bit further than it went in *Wheeler* in expressing that there must be substantial non-tax and business reasons for a transaction. But, in application, and when the facts in the case are examined for what they were, this added requirement is not a far extension of the *Wheeler* application of the exception.

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

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

## 9. Novel Gift Tax Issues

In *Dickman*, the United States Supreme Court noted: “We assume that the focus of the Internal Revenue Service is not on such traditional familial matters. When the government levies a gift tax on routine neighborly or familial gifts, there will be time to deal with such a case.”<sup>32</sup> This has been correctly interpreted to mean: “Hey, IRS, don’t be bugging us with these theoretical and technically correct gift issues; they are not significant enough for us to bother with.” Since 1984, the IRS has not bothered the taxpayer with these, to any great degree.

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

## 10. Selling the Arbitrage

The third party financing arrangement presents a pure arbitrage arrangement, but for two elements: the income tax cost as the annuitant matures, and the loan guarantee required of the annuitant. These are probably sufficient impediments for most insureds not to consider the arrangement, or at least to proceed cautiously. But investment bankers may not be as shy. If the arbitrage potential is there, and still exists after financing, and if interest can be rendered deductible, this opens up a market for an insured to leverage his or her insurability, i.e., the arbitrage opportunity, to a third party, for consideration. This arrangement will be discussed in more detail in the oral presentation.

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<sup>1</sup> J.D. from Duke University School of Law, B.A. in math from Colgate University, M.B.A. in finance from University of Chicago.

<sup>2</sup> From *Wikipedia*, on-line encyclopedia.

<sup>3</sup> Brealey & Meyers, Principles of Corporate Finance.

<sup>4</sup> "Risk" arbitrage is essentially the act of benefiting from differences in price of the same or empirically related commodities, currencies, securities, or other assets traded in two or more markets. The arbitrageur makes money by taking advantage of the price disparity by selling in one market while simultaneously buying in another market. Free markets tend to attract arbitrageurs, and thus converge the disparities toward equilibrium.

<sup>5</sup> See Harvard Business School, "Global Equity Markets: The Case of Royal Dutch and Shell" (case study). The pricing differential could have been a result of illiquidity concerns related to the stocks in the two companies, or that one of the companies at the time was in the S & P 500, and the other was not. The prices did, over time, converge to an adjustment that was much closer, meaning that the arbitrage opportunity noted in the text disappeared. Further, shorting stock is not always available and is often accompanied with its own transaction costs, as is the normal sale and purchase of stock.

<sup>6</sup> See I.R.C. § 7520's shift from mortality tables in 80 CSM to 90 CSM.

<sup>7</sup> The author emphasizes this is merely an example to illustrate the theoretical point. Pricing is **not** this linear.

<sup>8</sup> Although other variables go into the pricing of these products, such as commissions, profit margins, and interest crediting rate assumptions, it is the divergence in mortality assumptions that creates the arbitrage opportunity. This kind of pricing discrepancy works better for older insureds because the percentage pricing differential can be significant.

<sup>9</sup> In this example, the insured was treated as an 82-year-old for actuarial purposes and for pricing the annuity.

<sup>10</sup> *The Closing Circle: Nature, Man, and Technology*, 1971, in reference to environmental externalities, not insurance products.

<sup>11</sup> If the policy is a variable policy that increases cash value in the policy based on both premiums paid (in excess of the annual insurance and insurance company's costs allocated to the policy) and market performance, the insured is then subject to the market performance variable. Because this arrangement is intended to be an arbitrage arrangement, from a pragmatic perspective, no one would subject it to this kind of market risk. Meaning: a variable policy will not be used in this arrangement. Or, the universal policy could have a guaranteed mortality charge, with the strategy of a lower premium being tied solely to not reserving cash value. However, the guaranteed mortality charge will increase the premium, thereby decreasing the arbitrage opportunity.

<sup>12</sup> As is amply demonstrated, or attempted to be demonstrated in the family limited partnership marketability cases, illiquidity of an asset results in a justifiable discount off of face value (one aspect of the so called marketability discount). How much is this illiquidity worth?

<sup>13</sup> One iteration may be to use an irrevocable insurance trust as purchaser, with a loan from the grantor to the insurance trust. Thereafter, say a year after the transaction is in place, the grantor obtains financing from a third party. Assuming there is no tax exempt bond income in the grantor's portfolio (thereby avoiding section 265 issues),

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the taxpayer is trying to position itself to have deductible investment income. However, the step transaction principles discussed below could be more applicable to this arrangement than they would the estate tax arrangements, and do pose a concern.

<sup>14</sup> “To determine the proportionate part of the total amount received each year as an annuity which is excludable from the gross income of a recipient in the taxable year of receipt ... an exclusion ratio is to be determined for each contract. In general, this ratio is determined by dividing the investment in the contract as found under § 1.72-6 by the expected return under such contract as found under § 1.72-5.” Treas. Reg. § 1.71-1.

<sup>15</sup> Rev. Rul. 65-57.

<sup>16</sup> The loan is not secured by the insurance policy, to avoid split dollar and § 2036 and § 2042 issues.

<sup>17</sup> Arguably not because of the idiosyncratic risks associated with the insurance companies defaulting on the insurance or annuity payments, or not meeting the projections built into the strategy, as discussed earlier in the text.

<sup>18</sup> In applying the step transaction doctrine, the Supreme Court has stated that a given result at the end of a straight path is not made a different result because reached by following a devious path. *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938)

<sup>19</sup> *True v. U.S.*, 84 AFTR2d Par. 99-524 (1999)

<sup>20</sup> *Penrod v. Commissioner*, 88 T.C. 1415 (1987)

<sup>21</sup> *Commissioner v. Gordon*, 391 U.S. 83, 96 (1968).

<sup>22</sup> *Redding v. Commissioner*, 630 F. 2d 1169, 1177 (7th Cir. 1980), *cert denied* 450 U.S. 913 (1981).

<sup>23</sup> *King Enterprises v. United States*, 418 f2d at 516 (1969).

<sup>24</sup> *True v. U.S.*, 84 AFTR2d Par. 99-524 (1999). It is certainly arguable that the end result test subsumes the requirements of the other tests, and therefore it would be more appropriate for a court to consider which alternative prong of the step transaction doctrine to apply, versus applying all three.

<sup>25</sup> Courts have been willing to apply lesser versions of the step transaction doctrine, such as the integrated transaction approach. *See, e.g., Brown v. U.S.* 329 F.3d 664, C.A. 9 (Cal.), 2003; argued and submitted 2003; *See also Sather v. C.I.R.*, 251 F.3d 1168, C.A. 8, 2001, submitted: January 12, 2001

<sup>26</sup> *Strangi*, 115 T.C. 478 (2000). Judge Beghe advised that he was not using the step transaction to conclude anything about the fair market value of the transferred limited partnership interests. Instead, he said, the step transaction doctrine identifies the property subject to tax. Accordingly, by treating the formation of the partnership, its corporate general partner and the transfer of the limited partnership interest to the children as one transaction solely to achieve a discount, Judge Beghe would then ignore all of the steps and include all the partnership assets in the decedent’s estate. The reliance seems to be, primarily, on *Penrod v. Commissioner*. However, in *Penrod*, the Tax Court found that an exchange of stock did qualify as a reorganization and prevented the Service from immediately taxing the gain.

<sup>27</sup> *Maxwell v. Commissioner*, 3 F.3d 591 (C.A.2, 1993) (holding that promissory notes issued with an intent that the holder/seller would forgive \$20,000 of principal each year did not constitute consideration). *But cf. Haygood v. Commissioner*, 42 T.C. 936, 1964 WL 1247 (1964), not acquiesced, 1977-2 C.B. 1, 1977 WL 185635 IRS ACQ Dec 31, 1977, and not followed by Rev. Rul. 77-299, 1977-2 C.B. 343 (1977), *Kelley v. Commissioner*, 63 T.C. 321, 1974 WL 2687 (1974), not followed by Rev. Rul. 77-299, 1977-2 C.B. 343 (1977), and *Wilson v. Commissioner*, 64 T.C.M. (CCH) 583, 1992 WL 201812 (1992).

<sup>28</sup> *See, e.g., Helvering v. LeGierse*, 312 U.S. 531 (1941). *But see Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), in which a clear annuity-insurance combination was not grouped together.

<sup>29</sup> *See also Stone*, T.C. Memo 2003-309 (2003).

<sup>30</sup> *Kimbell*, 371 F.3d 257, 93 A.F.T.R. 2d 2004--2400 (5<sup>th</sup> Cir. 2004), at 262.

<sup>31</sup> *Kimbell*, *infra* at 265.

<sup>32</sup> *Dickman V. Comm'r*, 104 S. Ct. 1086 (1984), at 1090.

Attachment 1  
Life Insurance Annuity Arbitrage Illustrated: \$5m arb for 79 year old

Assumptions	
Exclusion Ratio	0.607847309
Client Age	79
Annuity Cost: SPIA	\$5,000,000
Insurance	\$5,000,000

Age	Annual SPIA Payout	Tax on Non Excluded Portion at 40 %	Net Spia Cash Flow	Insurance Premium (at 5%; guaranteed 4 %)	Differential Return in Dollars	Percentage Differential	Loan at 4 % and arbitrage rate of return assuming interest only and no deductibility
79	\$822,575	\$129,030	\$693,545	\$285,125	\$408,420	8.168%	4.17%
80	\$822,575	\$129,030	\$693,545	\$285,125	\$408,420	8.168%	4.17%
81	\$822,575	\$129,030	\$693,545	\$285,125	\$408,420	8.168%	4.17%
82	\$822,575	\$129,030	\$693,545	\$285,125	\$408,420	8.168%	4.17%
83	\$822,575	\$129,030	\$693,545	\$285,125	\$408,420	8.168%	4.17%
84	\$822,575	\$129,030	\$693,545	\$285,125	\$408,420	8.168%	4.17%
85	\$822,575	\$129,030	\$693,545	\$285,125	\$408,420	8.168%	4.17%
86	\$822,575	\$129,030	\$693,545	\$285,125	\$408,420	8.168%	4.17%
87	\$822,575	\$129,030	\$693,545	\$285,125	\$408,420	8.168%	4.17%
88	\$822,575	\$129,030	\$693,545	\$285,125	\$408,420	8.168%	4.17%
89	\$822,575	\$329,030	\$493,545	\$285,125	\$208,420	4.168%	0.17%
90	\$822,575	\$329,030	\$493,545	\$285,125	\$208,420	4.168%	0.17%
91	\$822,575	\$329,030	\$493,545	\$285,125	\$208,420	4.168%	0.17%
92	\$822,575	\$329,030	\$493,545	\$285,125	\$208,420	4.168%	0.17%
93	\$822,575	\$329,030	\$493,545	\$285,125	\$208,420	4.168%	0.17%
94	\$822,575	\$329,030	\$493,545	\$285,125	\$208,420	4.168%	0.17%
95	\$822,575	\$329,030	\$493,545	\$285,125	\$208,420	4.168%	0.17%
96	\$822,575	\$329,030	\$493,545	\$285,125	\$208,420	4.168%	0.17%
97	\$822,575	\$329,030	\$493,545	\$285,125	\$208,420	4.168%	0.17%
98	\$822,575	\$329,030	\$493,545	\$285,125	\$208,420	4.168%	0.17%
99	\$822,575	\$329,030	\$493,545	\$285,125	\$208,420	4.168%	0.17%

## Attachment 2

### Life Insurance/Annuity: After Tax Return

<u>Assumptions</u>	
<u>Exclusion Ratio</u>	0.607847309
<u>Client Age</u>	79
<u>Annuity Cost: SPIA</u>	\$1,000,000
<u>Face Amount of Insurance</u>	\$1,000,000

Age	Annual SPIA Payout	Tax on Non Excluded Portion at 40 %	Net Spia Cash Flow	Insurance Premium (at 5%; guaranteed 4 %)	Differential Return in Dollars	Percentage Differential
79	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%
80	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%
81	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%
82	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%
83	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%
84	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%
85	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%
86	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%
87	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%
88	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%
89	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%
90	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%
91	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%
92	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%
93	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%
94	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%
95	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%
96	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%
97	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%
98	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%
99	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%

Attachment 3  
Life Insurance/ Annuity: Financing the Arb: Age 79

<u>Assumptions</u>	
<u>Exclusion Ratio</u>	0.607847309
<u>Client Age</u>	79
<u>Annuity Cost: SPIA</u>	\$1,000,000
<u>Face Amount of Insurance</u>	\$1,000,000

Age	Annual SPIA Payout	Tax on Non Excluded Portion at 40 %	Net Spia Cash Flow	Insurance Premium (at 5%; guaranteed 4 %)	Differential Return in Dollars	Percent Differential	Loan at 4 % and arbitrage rate of return assuming interest only and no deductibility	Arbitrage Rate of Return after Loan
79	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%	-\$40,000	4.17%
80	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%	-\$40,000	4.17%
81	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%	-\$40,000	4.17%
82	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%	-\$40,000	4.17%
83	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%	-\$40,000	4.17%
84	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%	-\$40,000	4.17%
85	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%	-\$40,000	4.17%
86	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%	-\$40,000	4.17%
87	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%	-\$40,000	4.17%
88	\$164,515	\$25,806	\$138,709	\$57,025	\$81,684	8.168%	-\$40,000	4.17%
89	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%	-\$40,000	0.17%
90	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%	-\$40,000	0.17%
91	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%	-\$40,000	0.17%
92	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%	-\$40,000	0.17%
93	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%	-\$40,000	0.17%
94	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%	-\$40,000	0.17%
95	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%	-\$40,000	0.17%
96	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%	-\$40,000	0.17%
97	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%	-\$40,000	0.17%
98	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%	-\$40,000	0.17%
99	\$164,515	\$65,806	\$98,709	\$57,025	\$41,684	4.168%	-\$40,000	0.17%

**Attachment 4**  
**Life Insurance/ Annuity; Age 85 with financing**

<u>Assumptions</u>	
<u>Exclusion Ratio</u>	0.895941742
<u>Client Age</u>	85
<u>Annuity Cost:</u> SPIA	\$1,000,000
<u>Face Amount of Insurance</u>	\$1,000,000

Age	Annual SPIA Payout	Tax on Non Excluded Portion at 40 %	Net Spia Cash Flow	Insurance Premium (at 5%; guaranteed 4 %)	Differential Return in Dollars	Percentage Differential	Loan at 4.36% and arbitrage rate of return assuming interest only and no deductibility	Arbitrage Rate of Return after Loan
85	\$161,760	\$6,733	\$155,027	\$69,108	\$85,919	8.592%	-\$43,600	4.23%
86	\$161,760	\$6,733	\$155,027	\$69,108	\$85,919	8.592%	-\$43,600	4.23%
87	\$161,760	\$6,733	\$155,027	\$69,108	\$85,919	8.592%	-\$43,600	4.23%
88	\$161,760	\$6,733	\$155,027	\$69,108	\$85,919	8.592%	-\$43,600	4.23%
89	\$161,760	\$6,733	\$155,027	\$69,108	\$85,919	8.592%	-\$43,600	4.23%
90	\$161,760	\$6,733	\$155,027	\$69,108	\$85,919	8.592%	-\$43,600	4.23%
91	\$161,760	\$6,733	\$155,027	\$69,108	\$85,919	8.592%	-\$43,600	4.23%
92	\$161,760	\$64,704	\$97,056	\$69,108	\$27,948	2.795%	-\$43,600	-1.57%
93	\$161,760	\$64,704	\$97,056	\$69,108	\$27,948	2.795%	-\$43,600	-1.57%
94	\$161,760	\$64,704	\$97,056	\$69,108	\$27,948	2.795%	-\$43,600	-1.57%
95	\$161,760	\$64,704	\$97,056	\$69,108	\$27,948	2.795%	-\$43,600	-1.57%
96	\$161,760	\$64,704	\$97,056	\$69,108	\$27,948	2.795%	-\$43,600	-1.57%
97	\$161,760	\$64,704	\$97,056	\$69,108	\$27,948	2.795%	-\$43,600	-1.57%
98	\$161,760	\$64,704	\$97,056	\$69,108	\$27,948	2.795%	-\$43,600	-1.57%
99	\$161,760	\$64,704	\$97,056	\$69,108	\$27,948	2.795%	-\$43,600	-1.57%

## Attachment 5

### Life Insurance/ Annuity: Interest Deductible

<u>Assumptions</u>	
<u>Exclusion Ratio</u>	0.895941742
<u>Client Age</u>	85
<u>Annuity Cost:</u> SPIA	\$1,000,000
<u>Face Amount of Insurance</u>	\$1,000,000

Age	Annual SPIA Payout	Tax on Non Excluded Portion at 40 % after considering offset against interest expense	Net Spia Cash Flow	Insurance Premium (at 5%; guaranteed 4 %)	Differential Return in Dollars	Percentage Differential	Loan at 4.36 % and arbitrage rate of return assuming interest only and no deductibility	Arbitrage Rate of Return after Loan
85	\$161,760	\$0	\$161,760	\$69,108	\$92,652	9.265%	-\$43,600	4.91%
86	\$161,760	\$0	\$161,760	\$69,108	\$92,652	9.265%	-\$43,600	4.91%
87	\$161,760	\$0	\$161,760	\$69,108	\$92,652	9.265%	-\$43,600	4.91%
88	\$161,760	\$0	\$161,760	\$69,108	\$92,652	9.265%	-\$43,600	4.91%
89	\$161,760	\$0	\$161,760	\$69,108	\$92,652	9.265%	-\$43,600	4.91%
90	\$161,760	\$0	\$161,760	\$69,108	\$92,652	9.265%	-\$43,600	4.91%
91	\$161,760	\$0	\$161,760	\$69,108	\$92,652	9.265%	-\$43,600	4.91%
92	\$161,760	\$47,264	\$114,496	\$69,108	\$45,388	4.539%	-\$43,600	0.18%
93	\$161,760	\$47,264	\$114,496	\$69,108	\$45,388	4.539%	-\$43,600	0.18%
94	\$161,760	\$47,264	\$114,496	\$69,108	\$45,388	4.539%	-\$43,600	0.18%
95	\$161,760	\$47,264	\$114,496	\$69,108	\$45,388	4.539%	-\$43,600	0.18%
96	\$161,760	\$47,264	\$114,496	\$69,108	\$45,388	4.539%	-\$43,600	0.18%
97	\$161,760	\$47,264	\$114,496	\$69,108	\$45,388	4.539%	-\$43,600	0.18%
98	\$161,760	\$47,264	\$114,496	\$69,108	\$45,388	4.539%	-\$43,600	0.18%
99	\$161,760	\$47,264	\$114,496	\$69,108	\$45,388	4.539%	-\$43,600	0.18%

**Attachment 6**  
**Life Insurance/ Annuity: Irrevocable Trust Return**

<u>Assumptions</u>	
<u>Exclusion Ratio</u>	0.895941742
<u>Client Age</u>	85
<u>Annuity Cost: SPIA</u>	\$1,000,000
<u>Face Amount of Insurance</u>	\$1,000,000

Age	Annual SPIA Payout	Income Cost Borne by the Insurance Trust	Net Spia Cash Flow	Insurance Premium (at 5%; guaranteed 4 %)	Differential Return in Dollars	Cost of Loan at 4.86 %	Excess return	After tax accumulation that is free of estate tax(inc. at 4 %)
85	\$161,760	\$0	\$161,760	\$69,108	\$92,652	-\$48,400	\$44,252	\$44,252
86	\$161,760	\$0	\$161,760	\$69,108	\$92,652	-\$48,400	\$44,252	\$90,274
87	\$161,760	\$0	\$161,760	\$69,108	\$92,652	-\$48,400	\$44,252	\$138,137
88	\$161,760	\$0	\$161,760	\$69,108	\$92,652	-\$48,400	\$44,252	\$187,915
89	\$161,760	\$0	\$161,760	\$69,108	\$92,652	-\$48,400	\$44,252	\$239,683
90	\$161,760	\$0	\$161,760	\$69,108	\$92,652	-\$48,400	\$44,252	\$293,522
91	\$161,760	\$0	\$161,760	\$69,108	\$92,652	-\$48,400	\$44,252	\$349,515
92	\$161,760	\$0	\$161,760	\$69,108	\$92,652	-\$48,400	\$44,252	\$407,748
93	\$161,760	\$0	\$161,760	\$69,108	\$92,652	-\$48,400	\$44,252	\$468,310
94	\$161,760	\$0	\$161,760	\$69,108	\$92,652	-\$48,400	\$44,252	\$531,294
95	\$161,760	\$0	\$161,760	\$69,108	\$92,652	-\$48,400	\$44,252	\$596,798
96	\$161,760	\$0	\$161,760	\$69,108	\$92,652	-\$48,400	\$44,252	\$664,922
97	\$161,760	\$0	\$161,760	\$69,108	\$92,652	-\$48,400	\$44,252	\$735,771
98	\$161,760	\$0	\$161,760	\$69,108	\$92,652	-\$48,400	\$44,252	\$809,454
99	\$161,760	\$0	\$161,760	\$69,108	\$92,652	-\$48,400	\$44,252	\$886,084