
THE LAW FIRM OF
BOVE & LANGA
A PROFESSIONAL CORPORATION

TEN TREMONT STREET, SUITE 600 – BOSTON, MASSACHUSETTS 02108
Telephone: 617.720.6040 – Facsimile: 617.720.1919
www.bovelanga.com

Intra-Family Tax-Deferred Transactions Combined With A Variable Universal Life Policy: More of the Best of All Worlds

By Alexander A. Bove, Jr.

[Published in Estate Planning, Vol. 32 No. 2 (Warren, Gorham & Lamont, February 2005)]

[This article is a sequel to the article, *Combining A Private Annuity With a Variable Universal Life Policy*, by Alexander A. Bove, Jr., which appeared in the December, 2002 issue of Estate Planning magazine.]

The common, if not omnipresent objectives of estate planning are avoidance or reduction of estate and gift taxes while retaining financial security, providing for efficient transfer of wealth within the family, and more recently, asset protection. In an earlier article this author has pointed out how all of these objectives can be met, along with the added benefit of deferral of capital gains taxes through the use of a private annuity (“PAN”) combined with a variable universal life insurance policy (“VUL”).¹ The impressive tax and protective benefits made possible by this arrangement are based on the concept of using an intra-family tax-deferred transaction (“IFTDT”) that allows the transferee to generate tax deferred or tax-free cash with which to purchase a high cash value VUL. This article develops the idea further to show how the IFTDT concept can effectively produce equal or greater benefits with different types of property, including for instance, income-producing real estate and closely held business interests, using self-canceling installment notes.

Which Method to Use?

Deferral of income or capital gains taxes on the sale or exchange of low-basis property is readily obtained under present tax law through the use of properly structured private annuities or installment sales.² Deciding which of these options to choose depends on a number of factors, such as the type of property involved. For example, in the case of publicly traded securities, an installment sale should not be used, as no deferral of gain is allowed.³ There is also the question of who pays the capital gains tax, and when. In the case of the deferred private annuity, for instance, the annuitant may never have to pay the full capital gains tax if she does not receive all of the principal back, and may never have to pay any capital gains or income tax at all if she dies before the deferred payments begin.⁴ In either of those situations, it is the obligor who would have to pay the tax, since on the death of the annuitant, the transaction is closed, and the obligor's gain would, in the case of the annuitant's early death, be fixed.⁵ In the case of the installment sale, it is the seller who will pay the capital gains tax upon receipt of the payments.⁶ If the payments are deferred and the installment note is a self-canceling note (i.e., considered paid in full on the death of the seller), the seller's estate will pay the capital gains tax on the seller's death as income in respect of a decedent.⁷ The buyer will have a basis in the property equal to the fair market value of the note (presumably the face value) and will pay no capital gains tax on the death of the seller even though the buyer may never have paid a penny of principal on the self-canceling note.⁸

Another important income tax consideration in deciding which method to use is whether the property is to be sold by the transferee after the initial transaction. In the case of a private annuity, the obligor could sell the property immediately after the transaction with no adverse tax consequences, except that a later gain to the obligor on the death of the annuitant would be short term instead of long term gain, since the obligor did not hold the property for more than twelve months.⁹ On the other hand, an installment sale to a related party (as would usually be the case with an IFTDT) will not qualify for installment sale treatment if the buyer sells the property within two years of the transaction.¹⁰ And as noted above, publicly traded securities may not be used at all for installment sale treatment. Thus, in addition to the family's personal

circumstances and objectives, the method to be used will depend in large part upon the type of property involved, whether it is to be held indefinitely or sold in the foreseeable future, and, of course, the transferor's (the seller's or annuitant's) cash flow desires. In light of the foregoing comments, the following is a brief analysis of the two most common types of property likely to be used in the subject plan: real estate and closely held business interests.

Income-Producing or Investment Real Estate

Ideally, the subject property would be debt-free or have very low debt to allow for minimum (or no) cash payments to the seller (or the mortgagee) at the time of the transaction. Although either investment real estate (such as developable land) or income-producing real estate may be the subject property of an IFTDT/VUL plan, this discussion illustrates how the idea may be used with income-producing real estate, and perhaps this is best demonstrated by an example.

Hillary, age 63 and who has a substantial estate, owns a parcel of income-producing real estate with a fair market value of \$5,000,000 and which produces an annual net income of \$400,000 before taxes. There is no debt on the property. Hillary has substantial other income from her family business and would be willing to defer the real estate income until her "retirement." Further, she would like to protect this property from any unforeseen creditors. Hillary's advisor recommends and Hillary agrees that she sell the real estate to her daughter, Quincy, for a self-canceling installment note (a "SCIN") due in 20 years.¹¹ The SCIN provides for interest at 8.5 percent, but with payments of interest to be deferred for the first 17 years of the note. The interest rate reflects a premium of 60 percent over the applicable federal rate and the \$5,000,000 sales price reflects an independent appraisal value.¹²

After the sale, Quincy obtains a bank loan of 80 percent of the value of the property at 7 percent amortized over 15 years, but withdraws the \$4,000,000 loan over a 7 year period, applying the proceeds of each withdrawal as a premium on a VUL policy on the joint lives of her husband and her young son.¹³ Over the succeeding 15 years, the income from the real estate is used to pay off the bank loan. In the meanwhile, assuming a 12 percent return on the VUL investments,¹⁴ the cash value in the policy has grown to \$20,000,000 over a 17 year period (when interest payments

are scheduled to begin under the terms of the note). To make the annual interest payments, Quincy withdraws \$425,000 each year from the VUL policy. Since the policy is not considered to be a “modified endowment contract,” the annual withdrawals are tax-free, and even if the VUL is generating a return of only 2.5 percent, it would produce more than enough return to cover the interest payments without using the principal.¹⁵ Furthermore, though the cash withdrawals from the VUL may be tax free, the interest payments to Hillary on the SCIN would be tax deductible to Quincy.¹⁶

If Hillary should die before the principal on the SCIN is paid, the unpaid balance (the entire amount if death occurs before any principal payments are made) will be excluded from Hillary’s estate,¹⁷ although all of the unpaid interest to the date of death will be included,¹⁸ even though payment of interest could be forgiven as well. As noted earlier, Hillary’s gain on the sale will be recognized by the estate as income in respect of a decedent, but that is a bargain considering that the full amount of the real estate at date of death value would otherwise have been included, together with any undisposed income from the property.

If Hillary did not die before the SCIN’s due date and the parties agreed, Quincy could make a part payment on the SCIN, and the balance could be renegotiated or simply extended for a term of something less than Hillary’s life expectancy at that time.¹⁹ Such a lump sum payment could be withdrawn from the VUL tax free.

Whether or not the withdrawal is tax free, we must acknowledge that payment on the principal of the note partially defeats one of the estate planning objectives of the SCIN. Furthermore, the accumulation of interest and the concomitant results produce additional considerations, which are reviewed in the following section.

Estate Tax and Income Tax Comparison of The Private Annuity vs. The Self-Canceling Installment Note

Dealing with the large amount of accumulated interest on any deferred payment note, including a SCIN, could ultimately be a concern and a potential disadvantage when compared with a sale in

return for a private annuity (a “PAN”), particularly in the event of the death of the seller towards the end of the deferral period. While it is true that with both the SCIN and the PAN the death of the seller prior to receipt of full payment for the value of property transferred results in the balance of the property being excluded from the seller’s gross estate, there are important practical differences brought about, based on the time that death occurs. In the above example, for instance, the interest due to the seller (Hillary) accumulates each year so that if the deferred interest payments are to be, say, \$425,000 per year and death occurs at the end of the 15th year, her estate will include \$6,375,000 of deferred accrued interest due to the estate, whether or not collected, producing exposure to a substantial estate tax.²⁰ On the other hand, the same scenario applied to a PAN with deferred payments would effectively result in exclusion of the \$6,375,000 (otherwise accrued interest) in the seller’s estate since nothing was due or accrued at the time of the seller’s death.

Of course, there are corresponding income tax differences to factor in which will have a significant bearing on the results. For instance, the buyer under the SCIN should have an income tax deduction for the interest paid, resulting in income tax savings which could materially offset the estate tax, although the paying parties may not be the same. With a PAN, on the other hand, the obligor gets no deduction for any of the payments made on the annuity. Under a SCIN, while the interest payments may be deductible to the buyer, the gain taxable to the estate as IRD on the seller’s death will produce a tax with no offsetting deduction,²¹ though any income tax on the deferred interest payments should be eligible for a deduction of the estate taxes paid on such interest.²² And while there is no gain recognized to the buyer under a SCIN on the death of the seller, there will be recognition of gain to the obligor of a PAN on the premature death of the annuitant. The obligor will have no offsetting deductions with the possible exception of applicable depreciation deductions on depreciable property. Correspondingly, the deceased annuitant is entitled to a deductible loss on her final income tax return for any unrecovered basis in the property.²³

Clearly, then, a thorough review of all anticipated tax consequences of the various options, as well as having an idea as to whether or not the seller/annuitant has a normal or more or less than normal life expectancy, will have a critical bearing on the method used in the transaction. And

note also, there is always the possibility of using both a PAN and a SCIN as parts of the same transaction, thus “hedging” the life expectancy bet.²⁴

Closely Held Business Interests

An intra-family tax-deferred sale or exchange as contemplated in this discussion (an IFTDT) where a closely held business interest is involved can be similarly effected through a SCIN or a PAN, but there are additional special characteristics to this type of asset, some of which offer even greater advantages than the real estate. (Note that the ideas in this discussion can readily be tailored to all types of business entities, though this discussion assumes a corporation.) For instance, if the family owner plans a sale of the company the plan may differ from one that may be indicated where the owner wishes to retire and arrange for children or other family members to succeed to the business interests. And as observed above, a critical factor (though not necessarily a controlling one) is the reasonably anticipated life expectancy of the seller. It is no secret that, morbid as it may sound, the IFTDT plan is much more strongly indicated where the seller has less than a normal life expectancy. Furthermore, age itself is a major factor (as it always is in estate planning). Clearly the IFTDT will work a lot better with an owner who is age 70 or less than with one who is 80 or more.

Prospective sale of the business. Where the family owner has no plans or circumstances calling for business succession, she may decide that a sale is the only logical solution. Outright sale of a family business always presents a number of serious challenges to the estate planner, perhaps the biggest of which is the double tax if the corporation is a C corporation,²⁵ often forcing the owner to allow purchase money financing (to defer the gain) or to carry on the corporation as a personal holding company with the attendant tax complications.²⁶ Instead, the owner could use an IFTDT. To illustrate, say that Donald is the sole owner of a family entertainment business valued at \$7,000,000. His basis in the stock is only \$500,000. None of his three sons, Huey, Dewey, and Frank, wants to continue the business, so the decision is made to look for a buyer within the next year or two. Donald is advised that he could sell to each of his sons a one-third interest in the business, and that since each would be purchasing a minority unmarketable interest, the price could be discounted to about \$5,000,000.²⁷ The boys then each acquire one-

third of the stock of Donald's company from Donald in return for three SCIN's with deferred payment terms identical to those in the real estate example above. Donald continues to run the company and the boys look for a buyer. Two years later the boys close on a sale of the company for \$7,000,000 cash. If the buyer acquires the corporate assets (usually the case) the C corporation will recognize gain on the sale. A subsequent liquidation and distribution of the cash to the boys as shareholders will also result in recognition of gain (the dreaded double tax), but here the boys' collective basis is \$5,000,000 as opposed to Donald's \$500,000. Assume that after all taxes the boys end up with \$6,000,000. As in the case of Hillary, the boys use the \$6,000,000 to purchase a VUL policy paying in the premiums over 7 years.²⁸ Since we would be working with an amount of cash in excess of the face value of the three underlying SCINs to Donald, the end results (in terms of accumulated cash value) would be far more positive for the boys. (If the sale must take place sooner than two years after the boys acquire the shares, the transaction could be structured as a PAN, which (for capital gains tax to the boys) would suggest a holding period of only twelve months and a day.) Note again that in either event, if the policy is not a modified endowment contract, withdrawals to pay the interest on the SCIN or to make the payments on the annuity are tax free to the maker/obligor (the owner of the policy),²⁹ in this case, the boys.

Retiring owner. It turns out that Donald's sons change their minds and are interested in continuing the business. After discussing the matter, Donald sells each of his three sons a 1 percent interest in the company for \$50,000 and makes a gift to his wife, Daisy, of 48 percent of his remaining 97 percent. Sometime thereafter, the company enters into an agreement to redeem the shares of Donald and Daisy in return for deferred private annuities for each. Future payments would be based on the \$7,000,000 value discounted to \$5,000,000, as Donald and Daisy are each transferring minority, unmarketable interests. In the typical closely held company (as this one) the company would distribute the bulk of its earnings as bonuses or higher salary to its shareholders. Since the company from this point will be distributing around 97 percent less of its profits than before, it will probably now have additional after-tax cash, and with these funds over the next 7 years it could invest the present value of Donald's and Daisy's combined annuity (\$4,850,000) into a VUL policy. At the end of the deferral term, assuming

survival of either or both, the corporation will make tax free withdrawals from the VUL in order to make the (non-deductible) payments to Donald and/or Daisy under the PAN.³⁰

There are two very valuable distinctions and tax advantages to this plan. The first is that, unlike the result where a different obligor is concerned, if Donald and/or Daisy were to deacease prior to receiving the full annuity, the corporation would recognize no gain, even though nothing was paid out on the annuity. This is because generally a corporation recognizes no gain or loss on the sale or exchange of its own stock, and this would include a redemption.³¹

The second valuable distinction allows the selling shareholder to remain on the payroll of the company. In the case of the typical redemption of a parent's shares, the tax code provides that the parent may not be an officer, director, or employee of the company (usually a distasteful situation for the parents) for a period of ten years after the redemption.³² With a redemption using an annuity through the IFTDT, however, the parents can *continue* to work (if desired), take a salary, and/or act as an officer or director of the company until the deferred payments begin. This is because the prohibition under the tax code does not apply until distributions for the redemption of the shares are actually made.³³

Note also that the boys would own 100 percent of the outstanding stock immediately after the redemption (even though no payments may have yet been made), and in the event that either or both Donald and Daisy died before the deferred payments began, the transaction would be gift, income, and estate tax free as to the deceased parent(s) and to the boys as well. The only drawback in such a case is that the boys would each have only a \$50,000 basis in the company stock.

Asset Protection

As discussed in Part I,³⁴ another significant benefit of the IFTDT is its asset protection feature. With most, if not all asset protection plans, the issue of fraudulent transfer is paramount. One of the fundamental questions in considering whether a transfer is fraudulent is whether the transfer was made for less than adequate consideration. In all of the IFTDT's, the transfer is arranged to

be made for full and fair consideration, thus raising a solid defense against a fraudulent transfer attack. In addition, after the transaction, the seller or annuitant has no immediate right to payments, so there is nothing for a creditor to reach, and even when payments begin, a creditor could not force acceleration.³⁵ (In this regard, where a SCIN is involved, if asset protection is an objective, the note should be non-negotiable and provide for liberal default provisions.) And on the premature death of the seller/annuitant, the obligations cease, i.e., there is nothing due the estate, so there would be no further assets for a creditor to reach. Of course, if there is accrued interest due and payable on a SCIN, this could possibly be reached by a creditor of the seller or the seller's estate.

Conclusion

While the intra-family tax deferred transaction itself is certainly not new, the significant tax, wealth transfer, and asset protection benefits available by using it in tandem with a tax deferred investment vehicle like the variable universal life insurance policy have either gone unrecognized or seriously under-utilized. The two basic risks involved – the seller living “too long,” and a poor investment performance in the VUL – can either be dealt with or assumed. In the first instance, for example, the maker of a SCIN can offer a small principal payment on the note and extend it; or with a PAN, the contract can be for the shorter of the annuitant's life or a specified term of years, limiting the obligor's exposure.³⁶ In the second instance, even with a long term return as low as 6 percent in the VUL, examples as those discussed in the first article show that the VUL cash value will fund payments through the seller's age into the late 80's and early 90's, depending of course on the seller's age at the time of the transaction and the length of the deferral. With no deferral or a very short term deferral, the plan will, as a general rule, be uneconomical and the buyer/obligor's risks will increase dramatically. Thus, like any other creative, beneficial estate planning idea, it can only be creative and beneficial if it fits into the family's circumstances and plan.

Copyright © 2005 by Alexander A. Bove, Jr. All rights reserved.

¹ Alexander A. Bove, Jr., *Combining A Private Annuity With a Variable Universal Life Policy*, Estate Planning December, 2002.

² See generally, Internal Revenue Code (IRC) §§ 72, 453.

³ IRC § 453(k)(2)(A).

⁴ Rev. Rul. 69-74, 1969-1 C.B. 43.

⁵ Rev. Rul. 55-119, 1955-1 C.B. 352.

⁶ IRC § 453(a).

⁷ *Estate of Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993).

⁸ Gen. Couns. Mem. 39,503.

⁹ IRC § 1222(3).

¹⁰ IRC § 453(e)(2).

¹¹ It is critical that the term of the note does not exceed the seller's life expectancy; if it does, the note would be treated as a private annuity and a very different set of rules would apply, possibly causing inclusion of the full value of the property in the seller's estate. *Supra* note 8.

¹² The applicable federal rate (AFR) would be the minimum chargeable rate under IRC §§ 7872(c)(1)(E) and 1274(d) for seller financed sales under "standard" terms. The example is based on the long term AFR rate for July 2004, of 5.34 percent. Because of the self-canceling feature of the note, the Internal Revenue Service takes the position (which is generally followed by practitioners) that a premium must be added either to the interest rate or the principal amount. *Supra*, note 8. There are virtually no standards or authority for the amount of the premium in either case.

¹³ A factor that will affect the net investment return produced in the VUL policy is the internal administrative and mortality costs of the insurance company. Because of the somewhat younger age of the proposed insureds and substantial amount of the premiums, it is likely that the face value of the VUL policy would be huge, say \$60 million to \$100 million. Further, it is unlikely that a policy with a face amount of this size would be available from one insurance company, so a portion would have to be re-insured, possibly increasing costs. It may also be worthwhile to consider even younger insureds, say grandchildren, and to purchase a survivorship policy on two or more individuals. This would substantially reduce the mortality costs and provide a larger net return.

Further, this article does not necessarily suggest that the VUL must be domestic. A foreign VUL could also be considered, as could a private placement policy, foreign or domestic. In the case of private placement or foreign policies, the insured/owner would typically have more investment flexibility, administrative costs are often lower, and may be able to produce an even greater return.

¹⁴ The average rate of return for common stocks over the past 45 years has been over 12%; more than 300 mutual funds have produced a rate of return in excess of 12% over the past 15 years; thus an assumed return of 12% is not unreasonable. However, if the VUL funds should earn substantially less than the projected amount or, however unlikely, should actually result in a loss, daughter would nevertheless have the obligation to make the annuity or SCIN payments. If daughter defaulted, Hillary could sue for the payments, and it would not be impossible that a negotiated settlement could be reached, but not without tax consequences. This scenario, however, is quite remote.

¹⁵ IRC §§ 7702A, 72(e)5(A) and 72(e)(10).

¹⁶ IRC § 163(a).

¹⁷ *Estate of Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993).

¹⁸ IRC § 2033.

¹⁹ If Hillary's health is failing the tables may not be used. *Infra*, note 24.

²⁰ Of course, if by that time the payments are for some reason uncollectible or actually worth less than the face amount then a lower amount would be includible. Another important planning point to consider is the tax allocation clause, directing the source of payment of the tax.

²¹ Treas. Reg. § 20.2053-6(f). This position is also reflected in the Frane case, *supra* note 17. Some commentators argue and this author agrees that in this respect Frane is wrong, and the income tax on the phantom gain on the self-canceling note should clearly be treated as a claim against the estate and thus a deduction for estate tax purposes.

²² IRC § 691(c).

²³ IRC § 72(b)(3).

²⁴ Most estate planners are aware that the life expectancy tables may not be used if death is expected to occur within a twelve month period of the transaction. Treas. Reg. § 20.7520-3(b)(3).

²⁵ IRC § 331.

²⁶ IRC §§ 541-547.

²⁷ See Rev. Rul. 93-12, 1993-1, C.B. 202. Further, \$5,000,000 is used as the sales price for convenience of this discussion and based on IRC §§453A(a)(1) and 453A(b)(2), imposing interest on the tax applicable to the given amounts in excess of \$5,000,000. If a private annuity is used or even combined with the sale, the purchase price is virtually unlimited. Furthermore, the \$5,000,000 limit under IRC §453A(b)(2) applies per taxpayer per year, so that the limit could easily be exceeded with a little planning.

²⁸ Space does not permit a discussion of how the policy would be owned by the boys, such as in a trust or perhaps a limited liability company, but it is contemplated there would be separate shares, if not separate VUL policies.

²⁹ It is this feature which makes the private annuity work in this case, refuting the position of some commentators that private annuities are never economically sound.

³⁰ *Supra*, note 5. As illustrated in the previous article, the growth of the cash value in the VUL over the term of the deferral should produce more than enough cash to make the annual payments to the seller without jeopardizing the policy.

³¹ IRC § 311(a), but only if cash or equivalent is distributed. If the corporation uses property to redeem shares, there could be recognizable gain. IRC § 311.

³² IRC § 302(c)(2)(A)(ii).

³³ IRC §§ 302(b)(3) and 302(c)(2)(A).

³⁴ *Supra*, note 1.

³⁵ *In re Grossman*, 259 B.R. 708 (N.D. 2001).

³⁶ This concept, a private annuity for a term of years, is discussed in "Part I," *supra*, note 1.