Irrevocable Life Insurance Trusts: An Effective Estate Tax Reduction Technique (Part 1)

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This two-part article addresses irrevocable life insurance trusts as a method for reducing the estate tax. Part 1 covers estate and income tax issues. Part 2, to be published in a subsequent issue, will cover gift and generation skipping transfer tax issues.

The Liquidity Problem

Many individuals, when contemplating their estate planning, want to avoid liquidity problems in paying for their funeral expenses, estate or trust administrative expenses, federal and state estate taxes, inheritance tax (where applicable), and debts. Perhaps most if not all of the assets are illiquid (for example, a closely-held business), or they would be subject to tax if reduced to cash (for example, IRAs or other retirement plans). The client may want surviving family members to continue the business or may want to maximize post-death income tax deferral. Or he may own real estate that is "underwater," and thus the estate cannot liquidate the real estate in order to pay any estate expenses.

Most people purchase term or cash value policies insuring their lives, separately or together with their spouses, to provide a nest egg for their loved ones and so that their estates can promptly obtain funds to pay any expenses and taxes. If the insured owns the policy or transfers ownership to the spouse outright, these purposes are compromised. An increase in the gross estate (insured's estate or spouse's estate), ultimately increases liquidity needs for federal and state estate tax purposes.

To determine if a decedent's estate is subject to estate tax, one must first determine the value of the gross estate. I.R.C. § 2031. What many people often do not realize is that the gross estate includes amounts receivable by the estate's executor/personal representative as insurance under policies on the life of the decedent. I.R.C. § 2042(1). The gross estate also includes amounts receivable by other beneficiaries of those insurance policies if the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person. I.R.C. § 2042(2).

Some individuals may not elect or may neglect to purchase life insurance or may allow policies to expire. They may believe that the surviving family members can liquidate the successful business to pay any estate expenses or that the business will have enough cash or liquid assets to satisfy any debt. This creates additional problems. The sale of substantial business assets may severely affect the ability to continue the business. In addition, potential income tax issues arise on the sale of business assets. They may have underestimated the estate expenses, thus overestimating the cash available to pay such expenses.

An Effective Solution: An Irrevocable Life Insurance Trust (ILIT)

What Is an ILIT?

An ILIT is a trust primarily designed to hold life insurance. Because it is irrevocable, the grantor cannot change or terminate it. The ILIT's trustee is the policy's owner and beneficiary. The ILIT's terms determine who ultimately receives the policy proceeds. At the insured's death, the policy proceeds are paid to the trust. An ILIT removes the life insurance proceeds from the gross estate, thus reducing the taxable estate.

An insured creates an inter vivos trust with a trustee other than himself. The insured may transfer an existing insurance policy or policies to the trust or a sufficient amount of cash for the trustee to purchase a new insurance policy.

Transfers to irrevocable trusts usually do not qualify for the $14,000 annual gift tax exclusion and therefore are subject to gift tax. However, this exclusion is available if the ultimate beneficiaries are given a limited right of immediate withdrawal from the trust, as discussed below. If the beneficiary is a minor, a parent or legal guardian (other than the grantor) can exercise that beneficiary's rights. If the named beneficiaries do not exercise their withdrawal rights within the specified time period, the withdrawal rights lapse and the trustee has more funds available to pay the life insurance premiums.

At the insured's death, the trustee collects the policy proceeds from the life insurance company. If the estate of the grantor-insured needs cash to pay estate taxes or debts of the estate, the ILIT trustee has various options. The trustee could buy assets from the estate for cash. This provides liquidity for the estate and allows the purchased assets to pass to the trust beneficiaries. The trustee could also lend cash to the personal representative of the estate (and to a trustee of any revocable living trust). The estate would repay the loan upon the sale of estate assets or would distribute the assets subject to the loan.

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Why Is an ILIT Useful?

An ILIT is a useful estate planning tool because it avoids federal estate tax on assets passing that do not qualify for a charitable or marital deduction. If the insured transfers an existing policy into an ILIT, he must survive a minimum of three years from the date of transfer to avoid any inclusion of the policy in his gross estate. I.R.C. § 2035(a). If he does, an ILIT can increase the amount of assets passing to beneficiaries without increasing the estate tax. In effect, the insured can establish an ILIT without using any estate tax exemption equivalent of either spouse.

ILITs can immediately provide liquidity for the decedent's estate and estate beneficiaries. They can be used to fulfill family plans to provide education, support and maintenance for beneficiaries after the death of the insured. Testamentary trusts can provide similar benefits. However, a testamentary trust does not provide the same protection from estate taxes as an ILIT.

An ILIT is generally not subject to creditors' claims against the insured's estate. Neither an ILIT beneficiary nor a creditor of a beneficiary has a right to demand a distribution from the trust or the right to attach a beneficiary's interest in the trust. The trustee could also use trust assets to pay a beneficiary's expenses directly, for example, making car payments, rather than distributing cash that would be subject to claims of the beneficiary's creditors. The ILIT could also purchase a car for use by a beneficiary. Because the ILIT owns the car, the asset is protected from the beneficiary's creditors.

An ILIT can provide beneficiaries with special powers to appoint property to family members or charities during their lifetime or at death. ILITs can also provide beneficiaries with the power to withdraw funds up to 5% of the trust principal without incurring any possible transfer tax. Beneficiaries or an independent trustee can change trustees. An independent adviser (sometimes called a trust protector) can also change grantor trust status, change trust situs, terminate the trust, or keep the trust in compliance with any state law pertaining to trusts or any federal or state tax laws. The ILIT may also contain flexible investment and distribution provisions, including the choice of other professional advisers.

Typical ILIT Terms and Provisions

An ILIT typically provides a temporary "spray" of income and principal to the insured's spouse and descendants as discretionary distributees. (Some forms provide for no distributions during the insured's life, because the intent is for the policy to accumulate to maximize the death benefit, but that ignores the possibility that the policy might be cashed in or sold.) Unless the trustee is independent, the trustee's discretionary power to use income or principal should be limited to an ascertainable standard. Section 2041(b)(1) provides that, for purposes of section 2041(a), the term general power of appointment means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. It does not include a power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent. *See also* Treas. Reg. § 20.2041-1.

The ascertainable standard generally pertains to distributions for the health, education, support or maintenance of a trust beneficiary. Treas. Reg. § 20.2041-1(c)(2). The terms "support" and "maintenance" are synonymous, and their meaning is not limited to bare necessities. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary must exhaust his other income before the power can be exercised. The regulations also provide that clauses such as "support in reasonable comfort" and "support in his accustomed manner of living" are limited by the requisite standard. Courts generally have permitted the ascertainable standard to include the accustomed manner of living when they can make a concrete determination about the beneficiary's prior living situation. Treas. Reg. § 20.2041-1(c)(2). *See also Estate of Chancellor v. Commissioner*, T.C. Memo. 2011-172.

An ILIT should expressly state that it is irrevocable. Typical trustee provisions include a statement that the trustee shall be the absolute owner of all insurance policies held by the trust, a statement relieving the trustee from the duty to file a lawsuit to enforce payment of premiums without indemnification, a statement that the insured is not obligated to enter into any covenant to keep any insurance policies in force, and a statement empowering the trustee to loan or purchase estate assets. This provides liquidity for a decedent's estate.

Potential Estate Tax Pitfalls

The settlor must not list the estate's personal representative as the beneficiary of the ILIT. Otherwise, any life insurance proceeds are included in the gross estate of the decedent-insured and subjected to claims of the decedent's creditors. I.R.C. § 2042(1). Policy proceeds cannot be paid to any beneficiary subject to a legally binding obligation to pay expenses of a decedent's estate. Treas. Reg. § 20.2042-1(b). Such expenses include an obligation to pay any taxes or debts. An ILIT can still authorize a trustee to loan any proceeds to the insured's estate or to purchase assets from the estate without triggering estate tax. *Old Colony Trust Co. v. Commissioner*, 39 B.T.A. 871, 879 (1939). The power to loan or purchase should only be a discretionary tool and not a required duty of a trustee. Treas. Reg. § 20.2042-1(b)(1).

If a decedent possessed any incidents of ownership, the policy proceeds are

included in the gross estate. Treas. Reg. § 20.2042-1(b)(1). The regulations define incidents of ownership as an insured having sole or co-power to obtain a loan, pledge the policy for a loan, surrender or cancel the policy, change the policy beneficiary, assign the policy, or revoke or veto an assignment made by the owner of the policy. Treas. Reg. § 20.2042-1(c)(2). *See also* TAM 9128008 (holding that the right to repurchase a policy from an assignee was the equivalent of a right to revoke the assignment and was thus an incident of ownership). Incidents of ownership include power over choice of settlement options, power to change beneficial ownership, or power to surrender the policy. Treas. Reg. § 20.2042-1(c)(4). A 5% or greater reversionary interest is an incident of ownership. I.R.C. § 2042(a); Treas. Reg. § 20.2042-1(c)(3).

Income Tax Issues

Life insurance contract proceeds received upon the death of an insured are generally excluded from gross income. I.R.C. § 1.101(a)(1); Treas. Reg. § 1.101-1(a)(1). Income tax issues could nevertheless arise over transfer for value questions, potential gain to the policy owner, failure of a beneficiary to exercise the right of withdrawal, and power of substitution of assets of equal value.

Transfer for Value

Under the transfer for value rules, a transfer or sale of a life insurance contract for valuable consideration could make the death benefit's exclusion from income tax unavailable. I.R.C. § 101(a)(2); Treas. Reg. § 1.101-1(b). Amounts excluded from income include the actual value of consideration, premiums, and other amounts such as interest. I.R.C. § 101(c). *See also* Treas. Reg. § 1.101-1.

The Service considered the transfer for value limitation of section 101(a)(2) in the context of one ILIT selling a policy to another ILIT. Rev. Rul. 2007-13, 2007-11 I.R.B. 684. The Service has ruled that a grantor who is treated for federal income tax purposes as the owner of both ILITs is treated as the owner of the contract for purposes of applying any transfer for value limitations under section 101(a)(2), because there is no "transfer" of the contract within the meaning of such code section. *Id.*

Potential Gain to Policy Owner—Use of a Grantor Trust

If the ILIT is a grantor trust under sections 671 through 677, the grantor-insured is taxed on trust income and loss. ILITs will qualify as grantor trusts if income may be distributed to or accumulated for the grantor's spouse, or may be used to pay life insurance premiums. I.R.C. § 677(a). The Service has approved using a swap power to create grantor trust status when insurance is involved, without causing section 2036 or section 2042 to apply. I.R.C. § 675(4)(C). *See also* Rev. Rul. 2011-28, 2011-49 I.R.B. 830.

For an unfunded ILIT that produces no income, it is irrelevant whether the ILIT is a separate tax entity or a grantor trust. Funded ILITs (front-end loaded to pay premiums or owning other assets used to purchase a policy) have potential income tax ramifications, however. A grantor's payment of income tax on trust income attributable to a grantor under the grantor trust rules does not constitute a gift from the grantor to the ILIT. Rev. Rul. 2004-64, 2004-27 I.R.B. 7. However, trust provisions requiring the ILIT to reimburse a grantor for the payment of income tax cause the full value of the ILIT's assets to be includible in a grantor's gross estate. Treas. Reg. § 20.2036-1(b)(2).

There may also be issues for beneficiaries from lapsed *Crummey* powers. Any grantor of a grantor trust is subject to income tax, notwithstanding the existence of any *Crummey* power, however. I.R.C. § 678(b). *See also* PLR 200949012.

Failure of Beneficiary to Exercise Right of Withdrawal

The annual lapse of the ILIT beneficiary's right of withdrawal (or general power of appointment) may create income tax problems for the beneficiary in the context of the grantor trust rules. A beneficiary may be deemed to be the permanent owner of any portion of the ILIT if the beneficiary has released a power solely exercisable by the beneficiary to receive principal or income of the ILIT. I.R.C. § 678(a)(2).

If the beneficiary is eligible to receive trust income without any consent of an adverse party, the beneficiary may be subject to income tax pro rata on the lapsed portion of trust property. I.R.C. §§ 677(a) & 678(a)(2). *See also* PLR 200022035. It does not matter if the beneficiary actually receives the income. *Id.* Also, the "5 and 5" exception for lapsed powers for estate and gift tax does not apply to the grantor trust rules. PLR 200022035. Finally, there may be income tax exposure if the ILIT earns income after the death of the grantor-insured.

Power of Substitution of Assets of Equal Value

An ILIT may also include a power to substitute assets of equivalent value if one has non-fiduciary powers exercisable without the consent of a fiduciary. Regarding estate tax liability, the grantor-insured may substitute life insurance policies of equal value for those owned by the ILIT without causing inclusion in the gross estate. Rev. Rul. 2011-28, *supra*. A trustee may elect to trade a high basis or high cost asset (thus taking that asset out of the ILIT) for a low basis or low cost asset without any step-up in basis (thus the ILIT owns the low basis asset) to reduce a grantor-insured's income tax.

Revenue Ruling 2011-28 clarifies issues regarding the trustee power of substitution of a life insurance policy. A grantor's power to acquire an insurance policy held in a trust by substituting

other assets of equal value will not cause inclusion of the policy in the grantor's gross estate under section 2042, as long as certain guidelines are met. This is significant because section 2042 includes as a taxable asset in one's gross estate any share of life insurance proceeds to which the decedent possessed at the decedent's date of death any incidents of ownership in the policy, exercisable either alone or in conjunction with any other person.

Conclusion

ILITs are an excellent estate planning tool for decedents whose estate assets consist primarily of an ownership interest in a business, including real estate development. This tool is available in the event the estate lacks liquidity for paying estate taxes and other estate administrative expenses. This option allows a decedent's family or successors to continue the business.

ILITs also serve as an effective estate planning option where one's sole liquid assets consist of retirement accounts. If the estate withdraws funds from a retirement account to pay estate taxes or other estate expenses, the estate is also subject to income tax caused by the withdrawal. An ILIT alleviates the effects of this potentially catastrophic tax consequence (income and estate tax in the same year) by loaning money to an estate to pay estate tax. ■

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September 26-27, 2013	**Health and Welfare Benefit Plans 2013** The Ritz-Carlton Pentagon City – Arlington, VA	ABA JCEB www.americanbar.org/jceb 202.662.8670
October 16-18, 2013	**ERISA Basics National Institute** Westin Chicago River North – Chicago, IL	ABA JCEB www.americanbar.org/jceb 202.662.8670
October 17-18, 2013	**ALI CLE Course of Study: How to Handle a Tax Controversy at the IRS and in Court** Washington Marriott – Washington, DC	ALI CLE www.ali-cle.org 800.CLE.NEWS
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