PRACTICAL TAX STRATEGIES

LIFE INSURANCE TRUSTS

RULING OFFERS FLEXIBILITY FOR IRREVOCABLE LIFE INSURANCE TRUST SETUP

The IRS has eliminated tax concerns about shifting a life insurance policy between irrevocable trusts in order to alter who gets the policy proceeds without making the proceeds taxable.

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For years, tax advisors and their clients have been faced with a problem. How can an individual unravel an irrevocable life insurance trust without running afoul of Section 101(a)(2)? In Rev. Rul. 2007-13, [1] the IRS provides tax advisors and their clients with an effective tool to cut through the "transfer for value" rules of Section 101(a)(2)-the grantor trust. Rev. Rul. 2007-13 holds that a transfer of a life insurance policy from one grantor trust to another grantor trust, where both trusts are wholly owned by the same grantor, is not a transfer for valuable consideration within the meaning of Section 101(a)(2).

Income and estate taxation of life insurance

Generally, the proceeds of a life insurance policy received by a beneficiary on the death of an insured are excluded from gross income under Section 101(a)(1). While the interest that accrues on the proceeds may be subject to income tax, for various reasons Congress has determined that the proceeds of the life insurance policy should not be subject to tax. Because, as a general rule, the value that accrues inside a life insurance policy is also excluded from gross income, [2] a life insurance policy may offer these income tax savings oppor-

tunities:

(1) The cash value and earnings build-ups within the policy are not taxable, and can often be accessed through a loan without triggering gain. (This advantage, however, may not apply to certain life insurance policies known as modified endowment contracts.)

(2) If the taxpayer holds the policy until the insured's death, he or she completely escapes income tax on the accrued value inside the policy.

Congress has created several exceptions to the tax-favorable treatment of life insurance. The most important exception, the transfer for value rule, is found in Section 101(a)(2). It provides that:

> [i]n the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income ... shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee.

Thus, under the transfer for value rule, if a life insurance policy is transferred to another

person for consideration after the policy is issued, the transferee (with certain exceptions) must include in gross income the excess of the proceeds received on the insured's death over the transferee's basis in the policy. [3]

Example. Lucy buys a life insurance policy on John's life with a face amount of $1 million. If Lucy holds the policy until John's death, the proceeds from the policy generally will not be subject to income tax. If instead Lucy sells the policy to Matthew for $50,000, and Matthew pays an additional $150,000 in premiums before John dies, Matthew would have $800,000 of gross income on receipt of the proceeds ($1,000,000 - $200,000).

Besides potentially subjecting life insurance proceeds to income tax under the transfer for value rule, the receipt of life insurance proceeds can also have an effect on the insured's estate taxes. Under Section 2042, proceeds from a life insurance policy are included in the insured's gross estate if they are payable directly or indirectly to the insured's estate or if the insured retained any "incidents of ownership" over the policy at his or her death. More specifically, Section 2042 provides that:

> [t]he value of the gross estate shall include the value of all property [t]o the extent of the amount receivable by the executor as insurance under policies on the life of the decendent[, and] [t]o the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of owner ship, exercisable either alone or in conjunction with any other person.

The regulations do not limit incidents of ownership to ownership of the policy in a technical legal sense. Instead, incidents of ownership include:

- The right to change the beneficiary.
- The right to surrender or cancel the policy.
- The right to assign the policy.
- The right to revoke an assignment of the policy.
- The right to pledge the policy for a loan.
- The right to obtain a loan from the insurer against the surrender value of the policy. [4]

In addition, proceeds from a life insurance policy are included in the insured's gross estate if the insured had any incident of ownership in the policy, and the insured transferred the policy within three years of his or her

death. [5] On the other hand, as long as certain conditions are met, namely, the insured does not possess any of the incidents of ownership when he or she dies, the proceeds of the life insurance policy are not paid to the insured's estate, and the insured does not transfer any incidents of ownership in the policy within three years of his or her death, the proceeds will not be included in the insured's gross estate for estate tax purposes. [6]

Irrevocable life insurance trusts

Taxpayers have used the favorable tax treatment accorded life insurance to their advantage by creating irrevocable life insurance trusts. Conceptually, an irrevocable life insurance trust is relatively straight-forward. In a typical case, the creator of the trust, called the grantor, assigns the incidents of ownership in an insurance policy on the grantor's life to a trust and names the trust as beneficiary. By assigning the incidents of ownership in the policy to the trust, the grantor ensures that the proceeds of the policy will not be included in his or her gross estate when he or she dies. Because one of the incidents of ownership is the ability to revoke the assignment of the policy to the trust or change the beneficiary, the assignment will usually be irrevocable (i.e., the transfer will be to an irrevocable life insurance trust).

The assignment of all the incidents of ownership to the trust may enable the grantor to avoid estate taxes when he or she dies, but it still leaves him or her exposed to gift taxes on the transfer itself. If the value of the life insurance policy transferred to the trust exceeds the annual exclusion under Section 2503(b) (currently set at $12,000) and what remains of the grantor's lifetime exclusion under Section 2505(a) (currently set at $1 million), the grantor may owe gift tax. Moreover, the transfer will not qualify as a present interest gift to the trust unless one or more of the beneficiaries of the trust have the ability to withdraw the value of the gift currently. [7]

Typically, the grantor will overcome this obstacle by giving the beneficiaries a noncumulative right to withdraw the value of the gift for a limited period. The right to withdraw the value of the gift is called a "Crummey power," named after the case [8] in which this type of structure was first sanctioned by the courts.

For example, a grantor might transfer to a trust sufficient funds for the trust to acquire a life insurance policy on the grantor's life. The grantor might then make annual contributions to the trust to cover the premiums on the

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policy. By having the trust acquire the life insurance policy rather than the grantor acquiring the policy and transferring it to the trust, the grantor avoids the risk that the proceeds from the policy will be included in his or her estate if he or she dies within three years of the transfer. Moreover, as long as the money contributed to the trust is less than the grantor's annual gift tax exclusion, the grantor will not incur any gift tax on the transfer.

The accrued value of the life insurance policy will increase free of any income tax during the grantor's life. Furthermore, when the grantor dies, the proceeds from the policy will go to the trust free of any income or estate tax.

Rev. Rul. 2007-13

As with mice and men, the best laid plans of tax lawyers and their clients are apt to go astray. For various reasons, a client may decide that he or she no longer wants a particular individual to enjoy the benefits of the life insurance owned by the irrevocable life insurance trust. Because of the irrevocable nature of a life insurance trust and the transfer for value rule, the client may have difficulty removing the beneficiary. The irrevocable

nature of the life insurance trust limits the client's ability to name a new trust beneficiary, and the transfer for value rule limits the trustee's ability to sell the policy.

To see how this problem might arise, suppose a client originally designated her grandchildren as the beneficiaries of an irrevocable life insurance trust. Several years later, the client decides that she wants to leave the lion's share of her wealth to her dog, Trouble, rather than to her grandchildren (assume such a trust would be respected for state law purposes). As the grantor of the trust, the client faces these restrictions:

- Because all the incidents of ownership were transferred to the trust (to avoid the life insurance policy being included in the grantor's estate and subjected to the estate tax), the grantor cannot change the name of the beneficiary on the policy.
- Because the life insurance policy was placed in an irrevocable trust, the grantor cannot change the beneficiaries on the trust.

Thus, the grantor's hands appear to be tied. However, what if the grantor creates a second trust designating Trouble as beneficiary and the trustee of the original trust sells the life insurance policy to the second trust? Now, the grantor can continue to make gifts in the amount of the insurance premium to the second trust, allowing the accrued value in the policy to grow tax-free, and the maximum amount the grandchildren will receive from the original trust will be the cash (and subsequent earnings) the original trust received from the sale of the policy.

While this solution solves the problem created by the irrevocable nature of the original trust, it still leaves open the possibility that some of the proceeds from the life insurance policy will be included in the second trust's income under the transfer for value rules. Prior to Rev. Rul. 2007-13, the IRS had not provided any authoritative guidance on whether the second trust would have recognized taxable income on the receipt of the insurance proceeds on the death of the grantor under the transfer for value rules. In Rev. Rul. 2007-13, however, the IRS ruled that, as long as both trusts are grantor trusts (i.e., generally, any trust in which the grantor retains certain powers over or benefits in the trust), [9] the sale of the life insurance policy will not be treated as a transfer for valuable consideration within the meaning of Section 101(a)(2). Consequently, the receipt of insurance proceeds on the grantor's death by the second trust will not be subject to income tax.

Rev. Rul. 2007-13 involved two different scenarios. In the first scenario, two trusts, both treated as wholly owned by the grantor, engaged in a sale and purchase of an irrevocable life insurance policy. One trust owned a life insurance policy on the life of the grantor. The trust that

owned the life insurance policy transferred the life insurance policy to the other trust in exchange for cash. The second scenario was identical to the first except the trust that owned the life insurance policy was not a grantor trust.

Expanding on Rev. Rul. 85-13, [10] which held that sales between a grantor and his or her grantor trust are disregarded for income tax purposes, the IRS reasoned:

> because [the grantor] is treated as the owner of both [trusts] for federal income tax purposes, [the grantor] is treated as the owner of all the assets of both trusts, including both the life insurance con tract and the cash received for it, both before and after the exchange. Accordingly, in Situation 1 there has been no transfer of the contract within the meaning of §101(a)(2).
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> In Situation 2, because [the grantor] is treated as the owner of all the assets of [the grantor trust] but

not of [the nongrantor trust] for federal income tax purposes, [the grantor] is treated as the owner of the cash (but not the life insurance contract) before the exchange, and as the owner of the life insur ance contract (but not the cash) after the exchange. Accordingly, in Situation 2 there has been a trans fer of the life insurance contract for a valuable consideration within the meaning of §101(a)(2). Nevertheless, the transfer for value limitations of §101(a)(2) do not apply, because the transfer to [the grantor trust] is treated as a transfer to [the grantor], the insured, within the meaning of §101(a)(2)(B).

Conclusion

Rev. Rul. 2007-13 provides tax advisors and their clients with a way to resolve the problem created by the transfer for value rule. A taxpayer can create a second grantor trust, designating as beneficiary the individual he or she now wishes to receive his or her insurance proceeds. If the trustee of the original grantor trust sells the life insurance policy to the second trust, the second trust will not be taxed on the full cash value and earnings build-up within the policy under the transfer for value rule. Moreover, the maximum amount the original beneficiaries will receive from the original trust will be limited to the cash the original trust received from the sale of the policy plus any investment income earned on the cash over the life of the trust. Although the interaction between the transfer for value rules and the grantor trust rules is complicated, Rev. Rul. 2007-13 provides tax advisors and their clients with a valuable new tool they can use to unwind an irrevocable life insurance trust and build additional flexibility into their estate plans.

[1] 2007-11 IRB 684.
[2] See Section 72(e)(1).
[3] See Section 101(a)(2).
[4] See Reg. 20.2042-1(c)(2).
[5] See Section 2035(a)(2).
[6] See Reg. 20.2042-1(c)(1).
[7] See Section 2503(b)(1).
[8] Crummey, 22 AFTR 2d 6023, 397 F2d 82, 68-2 USTC 12541 (CA-9, 1968).
[9] See Sections 671-679.
[10] 1985-1 CB 184.

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