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Irrevocable Life Insurance Trust Strategies Post-ATRA: Maximizing Tax and Non-Tax Benefits

Forming, Funding and Administering ILITs or Unwinding Unnecessary Trusts

TUESDAY, FEBRUARY 18, 2014

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Today's faculty features:

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Irrevocable Life Insurance Trust Strategies Post-ATRA: Maximizing Tax and Non-Tax Benefits

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A. ILIT – Overview of the Plan from an Estate Tax Objective

1. **Irrevocable trust owns life insurance on the decedent's life**

2. **Trust provides that during the insured's life, Trustees have discretion to pay income or principal to any one or more of a class of beneficiaries**

3. **Beneficiaries are given withdrawal rights of a limited time over contributions**

4. **Contributions made equal to the premium on the policy**

5. **Trustees send withdrawal notices to beneficiaries, thereby converting gift to trust to present interest and thus qualifying for the annual exclusion**

ILIT – Overview of the Plan from an Estate Tax Objective

6. **Insured's death – proceeds paid into trust and outside of decedent's gross estate**

7. **Estate/Revocable Trust assets receive a step up in basis to date of death value**

8. **Trustee of ILIT purchases assets from Estate/Revocable Trust; effect is only post-death appreciation/depreciation is triggered**

9. **Estate/Revocable Trust now has cash to satisfy taxing obligations**

B. Transfer Tax Effect

Premise – §2042

The value of the gross estate shall include the value of all property—

- **Receivable by the executor.**
  To the extent of the amount receivable by the executor as insurance under policies on the life of the decedent.

- **Receivable by other beneficiaries.**
  To 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 ownership, exercisable either alone or in conjunction with any other person.*

Incidents of ownership

- Refers to the right of the insured or his estate to the economic benefits of the policy.
- Treas. Reg. §20.2042-1(c)(2) - It includes the power
  - to change beneficiaries
  - to assign the policy
  - to revoke an assignment
  - to pledge the policy as security for a loan
  - to obtain a loan from the insurer against the policy's cash surrender value, or
  - to surrender or cancel the policy.

The Crummey Power

- **Case Overview of Crummey v. Commissioner**
- **Who may Possess Crummey Rights?**
  - **Cristofani and subsequent notices and rulings**
- **The Notice Right**

  Two key elements of notice:

  - **First, the trustee must give immediate notice of the demand right to the demand right beneficiaries.**
  - **Second, the demand right beneficiaries must have an adequate amount of time to exercise their demand right.**

Hanging Powers

- **Regular Withdrawal Right**
- **At the end of the year, the power lapses only to the extent of the greater of $5,000 or 5 percent of the trust principal. Any excess over that amount does not lapse but is carried forward ("hangs around" or "hangs over") to following years**
- **Balance at Beneficiary's death causes gross estate inclusion as to the beneficiary**
- **Planning Tip: Trust should forgive hanging balance if beneficiary predeceases the Settlor.**
- **Income Tax Issue: Does Hanging Balance convert trust to grantor trust status as to the beneficiary?**

GST and ILIT's

- **Unless the trust only provides for children, usually the trust will have a GST aspect associated with contributions.**

- **Typically, given the estate tax avoidance nature of the ILIT lends itself to the use of dynasty trusts.**

- **Prior to 2001's EGTRRA, allocation was optional**

GST and ILIT’s

- **§2632(c) – Deemed automatic allocation to Certain Lifetime Transfers to “GST Trusts”**
  - **§2632(c)(1) - In general - If any individual makes an indirect skip during such individual's lifetime, any unused portion of such individual's GST exemption shall be allocated to the property transferred to the extent necessary to make the inclusion ratio for such property zero.**
  - **What is a GST Trust? §2632(c)(3)(B)**
  - **Effect: if the transfers are deemed to be indirect skips, for which includes transfers to most ILIT’s, GST exemption is automatically allocated.**

GST and ILIT's

- **Opting Out - §2632(c)(5)(A)(i)**
- **Opting In - §2632(c)(5)(A)(ii)**
- **Opt In vs. Opt Out…When to Do Each?**

Premature Death of a Child for a Non-Exempt ILIT

§2642(a)(3)(A) and Treas. Reg § 26.2642-6(b) – The Qualified Severance

Steps for a Qualified Severance:

1. **the single trust is severed under the terms of the governing instrument, or under applicable local law**

2. **the severance is effective under local law**

Steps for a Qualified Severance:

3. the date of severance is either

   (a) the date selected by the trustee as of which the trust assets are to be valued in order to determine the funding of the resulting trusts, or

   (b) the court-imposed date of funding, in the case of an order of the local court with jurisdiction over the trust ordering the trustee to fund the resulting trusts on or as of a specific date.

4. the single trust was divided on a fractional basis; and

5. the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust

ILIT's and Policy Values

Value? What is the Value?

- **Under Treas. Reg. §20.2031-8 and §25.2512-6(a), the value for gift tax purposes of a life insurance contract issued by a company which regularly sells these contracts is its actual cost, or the cost of a comparable contract from that company.**

- **Value may also be the value <u>may</u> be approximated by adding to the interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date.**

- **Who determines Interpolated Terminal Reserve Value? The carrier on the Form 712.**

- **Calculating Interpolated Terminal Reserve Value**

- **Is this Accurate??? Methodology differs from carrier to carrier.**

- **Other options? Independent professional appraisal.**

- **ITRV can be used for income tax purposes, right? Possibly no – Matthies v. Commissioner**

C. Income Tax Rules

General Rule - §101(a), which provides that gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured.

“Transfer For Value” Exception: In 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 by paragraph (1) 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.

2 Exceptions to “Transfer For Value:

- **Basis in Transferee determined by basis in transferor**

- **Transfer to Insured, Partner of Insured, Partnership in which Insured is a Partner, or Corporation in which Insured is a Shareholder or Officer**

Rev. Rul. 2007-13 and PLR 201332001 - refine the second exception

D. Split Dollar Plans

Very useful in sharing the benefit of large premium policies – a split-dollar plan is a technique under which two parties agree to share one or more benefits, i.e., the insurance proceeds, and obligations, i.e., premiums, with respect to a life insurance contract. The insurance owned in this way has an insurance feature, i.e., term life insurance, and an investment feature, i.e., cash surrender value (CSV)

2003 and Treas. Reg. §1.61-22 and §1.7872-15 – Regulatory guidance on Split Dollar

Economic Benefit Regime – Treas. Reg. §1.61-22(b)(1)

Must satisfy the following three criteria:

- **Either party to the arrangement pays, directly or indirectly, all or any portion of the premiums on the life insurance contract, including a payment by means of a loan to the other party that is secured by the life insurance contract;**

- **At least one of the parties to the arrangement paying premiums under paragraph (b)(1)(i) of this section is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract; and**

- **The arrangement is not part of a group-term life insurance plan described in §79 unless the group-term life insurance plan provides permanent benefits to employees (as defined in §1.79-0).**

Loan Regime – Treas. Reg. §1.7872-15

A payment made pursuant to a split-dollar life insurance arrangement is treated as a loan for Federal tax purposes, and the owner and non-owner are treated, respectively, as the borrower and the lender, if—

- **The payment is made either directly or indirectly by the non-owner to the owner (including a premium payment made by the non-owner directly or indirectly to the insurance company with respect to the policy held by the owner);**

Loan Regime – Treas. Reg. §1.7872-15

- **The payment is a loan under general principles of Federal tax law or, if it is not a loan under general principles of Federal tax law (for example, because of the nonrecourse nature of the obligation or otherwise), a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest); and**

- **The repayment is to be made from, or is secured by, the policy's death benefit proceeds, the policy's cash surrender value, or both.**

<u>E. Reciprocal Trust Doctrine</u>

Problems arise when married clients create identical or nearly-identical trusts for each other.

***<u>Lehman v. Comm'r</u>*, 109 F.2d 99 (2nd Cir., 1940) –**

The following three stipulations when determining that the trusts were reciprocal and therefore would result in estate tax inclusion

- **The parties were left in the same economic position that existed before the trusts were established because each brother created a trust for the other brother and his descendants;**

- **There was a similarity of trust provisions (i.e. the trusts were interrelated); and**

- **There was a *quid pro quo* (i.e., consideration) for each brother to create a trust for the other brother.**

Reciprocal Trust Doctrine

- **Problems arise when married clients create identical or nearly-identical trusts for each other.**

- ***Lehman v. Comm'r*, 109 F.2d 99 (2nd Cir., 1940) –**

  The following three stipulations were used to determine that the trusts were reciprocal and therefore would result in estate tax inclusion

  - **The parties were effectively left in the same economic position that existed before the trusts were established;**

  - **There was a similarity of trust provisions (i.e. the trusts were interrelated); and**

  - **There was a *quid pro quo* (i.e., consideration) for each brother to create a trust for the other brother.**

Circuit Split – after *Lehman*,

Three cases *McLain v. Jarecki*, 232 F.2d 211 (7th Cir., 1956), *Newberry's Estate v. Comm'r*, 201 F.2d 874 (3rd Cir., 1953) and *In re Lueder's Estate*, 164 F.2d 128 (3rd Cir., 1947) , provided that only two requirements (instead of three) need be satisfied for a finding of reciprocal trusts:

- **The parties were left in the same economic position; and**
- **The trusts were interrelated.**

What is meant in the second prong's use of "interrelated" under these cases?

Some combination of the following factors were present:

- **The trusts were created at approximately the same period of time (i.e. part of the same plan);**
- **The trusts had substantially identical terms;**
- **The trusts had the same trustee (i.e., "reciprocal trustees"); and**
- **The trusts were funded with the same assets.**

U.S. Supreme Court Chimes In: *U.S. v. Grace*, 395 U.S. 316 (1969).

The Supreme Court determined that reciprocal trusts will be found if the trusts are:

- **Interrelated, i.e., created at the same time as part of the same plan and contain substantially the same terms; and**

- **Creation of the trusts put the settlors in the same economic position.**

Estate of Levy, T.C. Memo 1983-453 (1983)

Often cited as the case that is authority that one might easily break the interrelated factors by merely including a special power of appointment in one trust but not in the other trust.

Levy actually stands for the proposition that to avoid reciprocal trust doctrine, break the 2nd Grace prong and vary the provisions of the trust so that they are not substantially identical so that they are not in the same economic position.

Further Follow Ups:

- **PLR 9643013 – key was Husband does not name the wife as a beneficiary of the trust that he settles, but wife names the husband as a beneficiary of the trust that she settled**

- **PLR 200426008 and Reciprocal Beneficiaries – trusts nearly identical but because different assets were contributed, no reciprocity was found**

Creditor Issues:

Does reciprocal trust doctrine allow creditors to attach? Maybe - *Security Trust v. Sharp*, 77A.2d 543 (Del. Ch. 1950), a Delaware Chancery court held that creditors may reach the deemed settlor's interest in reciprocal trusts, under the theory that the trust is self-settled.

ILIT STRATEGIES POST-ATRA: MAXIMIZING TAX AND NON-TAX BENEFITS

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Non-Tax Planning

A. The liquidity problem:

Most clients underestimate liquidity – both in estate's cash needs and sources of liquidity. Insurance provides a relatively quick source of cash without the pressure of "what do we need to sell?"

Never had an estate with too much insurance!

Non-Tax Planning

1. **Estate's cash needs**:

   Cash requirements to go beyond the commonly anticipated needs of paying estate taxes, final income taxes and funeral expenses. Cash is also required to fund general bequests, professional fees (attorneys and accountants), carrying costs for estate assets (note the payment of and the deductibility for these cash payments are different issues) and your executor/administrator statutory commissions.

   a. <u>Example of underestimated sources of liquidity</u>: Marketable securities portfolio which drops in value from date of death – reluctance to sell and lock in the losses.

   - *<u>Practice Tip</u>*: In the intake of a new estate, prepare an executor's cash budget along with deadlines for the various payments.

   See sample executor's budget for illustration.

Non-Tax Planning

2. The Nuts & Bolts of Insurance Collection:

a. <u>Process of collection</u>: When working with an insurance agent, the agent will facilitate the death claim process and a death claim kit will be sent to the beneficiary. The beneficiary can also call the insurance carrier for the kit. For group insurance plans (especially with large companies), the beneficiary should start with contacting the human resources department where the decedent worked and they will either get the claim form, provide the contact details of the insurance carrier or provide a website to download the form/provide information on the death claims process. An original death certificate with a raised seal is almost always required.

- *<u>Planning point</u>*: When the decedent first dies, order between 10-15 death certificates from the funeral home as reordering them can take a longer than expected time.

Non-Tax Planning

b. <u>Timing of collection</u>: Although the collection process differs from one insurance carrier to another, insurance companies will generally pay the claim (where all necessary information is submitted) in less than 1 month. The insurance company will also send a claim form in the mail when requested.

- *<u>Practice point</u>*: Where the insured dies within 1 to 2 years from the issuance of the policy, it is common for the insurance company to investigate the claim first without paying.

  For example, if the insured said they were a non-smoker in the application process and they were indeed a smoker, the insurance company could deny the claim.

Non-Tax Planning

B. Asset protection planning: Avoiding the accidental disinheritance

Consider using continuous trusts for spouse and descendants even where spouse has/desires control. Not only for divorce and remarriage issues but unfortunately because of elder abuse and "new friends" who come on the scene after the death of the first spouse.

Non-Tax Planning

- *Practical consideration*: The National Center on Elder Abuse website reported that: 1 study estimated that only 1 in 14 cases of elder abuse ever comes to the attention of authorities; the New York State Elder Abuse Prevalence Study found that for every case known to programs and agencies, 24 were unknown; and major financial exploitation was self-reported at a rate of 41 per 1,000 surveyed, which was higher than self-reported rates of emotional, physical, and sexual abuse or neglect. http://www.ncea.aola.gov/Library/Data/index/aspx

Non-Tax Planning

C. Building in flexibility for the unknowns and what if's:

Trust terms can become stale over time but drafting continuing trusts with flexibility options can be value added for the client to address unknowns: a reversal of fortune or health issue necessitating Medicaid/governmental benefits, an after born child with special needs or a descendant with substance abuse, mental health or marital issues. Proving trust extension provisions (i.e. Crisis Clause) or full discretion to take advantage of decanting statutes are options to consider.

Non-Tax Planning

Building in flexibility for the unknowns and what if's:

Example: Insurance trust established by parents when children were young unmarried adults where on the parents' death, the assets are distributed to the grantor's issue per stirpes. Years later, one of the adult children is in an accident leaving him severely disabled. The family is able to get him on Medicaid. On the death of the surviving spouse, the funds will be distributed to the disabled child thereby affecting his Medicaid benefits. With the unlimited discretion given to the trustee in the ILIT, the trustee has the ability to decant the policy into a new trust where the funds instead will be held in a Medicaid exempt trust.

Best Practices in Establishing, Administering and Funding ILITs

1. <u>Establishing the trust</u>:

A. Number of execution copies (3 originals) – 1 to the client, 2 for the file;

B. Who receives a copy (grantor, each trustee and accountant);

C. Obtain a tax ID# (provide to all parties, especially the accountant);

Best Practices in Establishing, Administering and Funding ILITs

2. <u>Administration of the ILIT</u>

A. Transmittal Letter

Providing a detailed letter as to the Care and Maintenance of the ILIT (a transmittal letter) provides directions and guidance as to what is required to ensure that the trust is properly administered and to inform who is responsible for certain actions. Consider including a suggestion that the policy be viewed on an annual basis. (The trustee obtains the in force illustration). The letter is sent to the client, to each of the trustees, along with a copy to the accountant. Perhaps send a copy to the financial advisor if authorized by the client. A copy of the SS-4 which sets for the tax ID# for the ILIT can also be included.

Best Practices in Establishing, Administering and Funding ILITs

B. Sample Tax Withdrawal Notices

The “Crummey Notices” is based on the landmark case of *Crummey v. Comm’r*, 397 F.2d 82 (9th Cir. 1968) and is a mechanism that gives evidence that the beneficiaries received actual notice of their rights to withdraw his/her share of the contribution to the trust/premium payments so that such contributions qualify for the donor’s annual gift tax exclusion.

Best Practices in Establishing, Administering and Funding ILITs

C. Notice of Withdrawal Rights

In order for a gift to quality for the gift tax annual exclusion the recipient must have notice of the gift. Rev. Rul. 81-7, 1981-1 I.R.B. 27, 1981-1 C.B. 474. The Crummey Notice has been the standard method to prove that notice was given although it is not required that it be in writing. In the recent case, *Estate of Turner v. Commissioner*, T.C. Memo 2011-209, the Tax Court seemed to disregard the notice requirement. In *Turner*, the decedent's trust gave each of the beneficiaries the absolute right to demand withdrawals from the trust after each direct or indirect transfer to the trust. The decedent paid the premiums on the life insurance policies held by the trust directly to the insurance company thereby making indirect gifts to the beneficiaries, his children and grandchildren and did not give notice of the transfers to the beneficiaries. The U.S. Tax Court held that the premium payments were indirect gifts to the trust, were gifts of present interests and qualified for the decedent's annual gift tax exclusion. Citing, *Crummey* and *Cristofani v. Comm'r*, (another landmark case on the issue) the Tax Court reasoned "the fact that some or even all of the beneficiaries may not have known they had the right to demand withdrawals from the trust does not affect their legal right to do so."

Best Practices in Establishing, Administering and Funding ILITs

D. Notice challenges and thoughts from the field

Despite the recent *Turner* case, providing notice to ILIT beneficiaries of the transfers to the trust is key to avoid questions by the Service at the donor's death. Although there is no requirement that notice must be in writing, having and utilizing Crummey notices provide evidence that the trust beneficiaries received notice that they had the right to withdraw. Based upon experience from the field, some IRS estate tax attorneys (do not call them agents!) will ask for the notices and others will not. Experience has shown that Crummey notices are generally not a high priority item in the Service for audits.

Best Practices in Establishing, Administering and Funding ILITs

- ***Practical consideration*****:** The Crummey notice is the easiest way to prove notice and it is the standard method of proving notice. However, it is not the only method to prove notice. A client can have family meetings where notes are taken. Alternatively, upon audit, affidavits can be submitted to substantiate that notice was given from third parties or from the parties having the knowledge that notice was given. Providing annual notice is the common practice. Where no written notice was given, one option is to have a memorandum signed by the beneficiaries that they had actual notice of the transfers. While proving if notice was given will be determined on a case by case basis in audit, it is some evidence as opposed to having no evidence at all. Another observation from the field is that where the issue is raised in audit and there may be some evidence of notice, the issue is not settled in examination and goes to appeals. Then having some evidence gives appeals some basis to potentially offer a settlement.

Best Practices in Establishing, Administering and Funding ILITs

3. <u>Funding the trust</u>

A. Getting it done properly & who is responsible

Need to work with the client, trustee and the insurance professional to make clear both the owner **and** the beneficiary are the Trust – need clear direction as to who will be responsible. (Does the client wish to continue the representation to have you confirm the funding or does his financial advisor, his accountant or trustee wish to assume responsibility to cut costs?).

Best Practices in Establishing, Administering and Funding ILITs

B. Confirmation of proper funding

A letter from the insurance carrier or a copy of the declaration page from the policy that lists the policy's basic terms: the owner, the beneficiary and the death benefit among other items.

Practical point: Obtaining confirmation that the policy was issued/changed properly with both the owner and the beneficiary of the trust, can sometimes take longer than expected and a client may not wish to pay for continuous attorney follow-up. The client's financial advisor or a service oriented insurance professional will often assist in accomplishing this task in order to show value to the client.

Best Practices in Establishing, Administering and Funding ILITs

Practical point: The funding paperwork provided by the insurance company can be unclear. Where an existing insurance policy is being transferred to an ILIT (note the 3-year rule) insurance carriers can have separate forms for each action or one form. Careful attention must be paid that both parts are completed in order to avoid estate inclusion under IRC Section 2042. In addition, the insurance company form letters showing ownership/beneficiary can be misleading: once had a CPA who swore that the insurance company named him personally as the beneficiary vs. as trustee.

Best Practices in Establishing, Administering and Funding ILITs

C. Transmission of paperwork

Need to check with the particular carrier to see what form they accept the owner/beneficiary. With many financial transactions being accomplished on-line, email is increasingly becoming an option. Note: that with the filing of a death claim, sending in the paperwork by mail will likely be required as an original death certificate is needed.

Practice point: Consider sending in by secure mail in order to have a record.

Best Practices in Establishing, Administering and Funding ILITs

4. <u>Addressing mistake in funding</u>

Sometimes the insurance company does not record that the ILIT is both the owner and the beneficiary of the policy despite the client's intention that it do so. The result of this mistake could mean that the insurance policy is in the estate and thus subject to estate tax. There is the general rule and the exception to the general rule which provides relief to the taxpayer.

Best Practices in Establishing, Administering and Funding ILITs

A. General Rule: Policy Facts

The facts of the policy (how the insurance policy was issued) will override the intentions of the decedent. *Comm'r v. Estate of Noel*, 380 U.S. 678 (1965). In U.S. v. Rhode Island Hospital Trust Company, 355 F. 2d 7 (1st Cir. 1966), the decdent's father took out a policy on his son's life, paying all of the premiums and had physical possession of the policy. The decedent had all of the rights to the policy per its terms. The court held that the policy was part of the decedent's gross estate despite the father's intentions because of the actual policy terms which the father had acknowledged and failed to remedy.

Best Practices in Establishing, Administering and Funding ILITs

B. Agent's Mistake

If a decedent dies with incidents of ownership in a policy due only to the mistake of the insurance agent, then courts will hold that the decedent did not have incidents of ownership in the policy at death, and therefore, the policy will not be included in his gross estate. Where the insurance agent makes a mistake in the issuance or transfer of the policy, there will be no reserved incidents of ownership or estate tax inclusion. Several courts have held that the decedent did not possess incidents of ownership which would thereby create estate tax inclusion where the decedent instructed his agent to make a complete assignment of his rights but the agent, on his own initiative, reserved a power in the insured. *National Metropolitan Bank v. U.S.*, 87 F. Supp. 773 (Ct. Cl. 1950).

Unwinding Unnecessary ILITs

There are several methods to unwind or terminate an unnecessary ILIT:

A. Let it die on the vine

This method provides that the premiums cease being paid causing the insurance policy to naturally lapse which means that the trust remains an empty vessel. This approach could be considered where the insurance trust only held a term life insurance policy (which has no cash value).

Practice suggestion: Discuss this approach with your accountant to determine if any “final” 1041 tax filing may be due.

Unwinding Unnecessary ILITs

B. Decant

Many states have passed decanting statutes whereby if the trustee is given the appropriate discretion, the trustee can transfer the existing insurance policy from an old and unwanted trust to a new trust which contains more favorable provisions. For example: see New York (Estates, Powers and Trusts Law) EPTL Section 10-6.6.

C. Distribute policy to permitted beneficiary

Many trusts provide that the trustee during the grantor's life have full discretion to distribute trust income and principal to the trust's beneficiaries (typically the spouse and/or children). Some trusts even specifically state that the trustee can distribute the insurance policy itself recognizing that the trust typically holds un-matured life insurance policies during the life of the grantor.

Unwinding Unnecessary ILITs

D. Purchasing the policy from another trust

As an alternative to decanting, another solution is for the grantor to create a new ILIT with the desired terms and have the new trust buy the policy from the old/stale trust where the consideration paid is equal to the current fair market value of the policy. This value can be requested from the insurance company.

See Charles D. Fox IV, *How Revocable is Irrevocable? Obtaining Flexibility in Irrevocable Trusts*, 33 Ohio N.U.L. Rev. 943 (2007).

ILIT Strategies Post-ATRA:

Maximizing Tax and Non-Tax Benefits

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Table of Contents

FLP As Alternative To ILIT

FLP is revocable and amendable. Can be dissolved with the assets divided among the partners.

Section 2035 should not apply (no guaranty) to a contribution of a policy to a partnership. The insured will receive partnership interests in exchange for the policy, so the transfer should fall within the full and adequate consideration exception. Section 2035(d). Useful with an ill insured.

Need not be a gift on transfer to the partnership.

Premium payments should have no gift tax or GST implications.

Insured should not be GP as to the policy. Not a problem in our firm since we use a corporate GP owned by the heirs' trust.

ILIT can become an LP in an existing FLP.

Especially helpful in California now that LLCs have been degraded as asset protection vehicles.

ILITs as not being simply ILITs, but owning other assets which may generate the income to pay the premiums, e.g., FLP or FLLC interests; stock in "S" corporations.

"The Use of Partnerships in Planning for Life Insurance," Trusts and Estates (April, 1995). Rev. Rul. 83-147. PLR 9309021: must there be assets other than life insurance?

E&O Policies For ILIT Trustees

Having coverage is one item of evidence that the trust is truly independent of the grantor.

Is an indemnification agreement from the parents as grantors sufficient?

Do you represent the trustee? Shouldn't the trustee have independent counsel who closely scrutinizes the language in the trust instrument that protects the trustee? What about a successor trustee who takes over after the trust is already in existence?

In the event of a suit by a beneficiary, the trustee believes that the trustee will be able to pay for counsel using trust assets. However: (i) what if the ILIT has insufficient liquid assets to write a $25,000 retainer to counsel? and (ii) in response to a beneficiary's request, the court might tell the trustee to pay for defense personally and then, if successful, the trustee will be reimbursed out of the trust. If either of those is the case you will have a very unhappy trustee.

CPAs as trustees might be covered by their CPA malpractice policies.

In one case: $10,000,000 of primary coverage cost $38,000. Next $10,000,000 cost $31,000.

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TRUSTEES SUPPLEMENTAL APPLICATION

1. What type of Trust is being administered?

____

____

2. What is the value of the assets to be managed in the Trust? $__________

3. Is there any commingling of the Trust's funds with any other funds? ❒ Yes ❒ No

4. Is the Trustee a beneficiary? ❒ Yes ❒ No

5. Is the Trustee Court Appointed? ❒ Yes ❒ No

6. Does the Trustee have discretionary authority in the investment of the Trust's funds? If Yes, please attach full details. ❒ Yes ❒ No

7. Will there be co-administrators besides the Applicant? ❒ Yes ❒ No

   If Yes, will there be a requirement that these independent administrators carry their own Errors and Omissions insurance coverage? ❒ Yes ❒ No ❒ N/A

8. Will the Applicant be retaining independent professionals, such as lawyers, accountants or investment advisors, to assist in the administration of the assets? ❒ Yes ❒ No

If Yes, please indicate:

_______ Lawyers

_______ Accountants

_______ Investment Advisors

_______ Other, Please describe:

____

____

9. Do all retained professionals, referenced in question 8, carry errors and omissions insurance? ❒ Yes ❒ No ❒ N/A

10. Has there been any litigation between and amongst the beneficiaries of the Trust? ❒ Yes ❒ No ❒ N/A

11. As of the date of the signing of this application, has any beneficiary under the subject Trust retained a lawyer in connection with the Will or Trust? ❒ Yes ❒ No ❒ N/A

1 of 2

Business Risk Partners, Trustees Supplemental Application, 8/04

12. How many beneficiaries are there under the Trust? ____________

13. How many years will the Trust be in existence? ____________

14. Please attach the following:
    a. The Trust Document
    b. Resumes of all Trustees
    c. The most recent audited Financial Statements of the Trust

It is understood and agreed that this supplemental application shall become a part of the application for Professional Liability Errors & Omissions Insurance.

THE APPLICATION MUST BE SIGNED AND DATED BY AN OWNER, OFFICER OR PARTNER.

Applicant Signature: ______________________________ Date (Mo-Day-Yr): ____________________

Name and Title (Please Print): ____

Unwinding An ILIT: California Creditor Concerns

1. <u>TRUSTEE DETERMINES STANDARD OF LIVING</u>.

A creditor is entitled to **any amount** paid to the beneficiary **in excess of** the beneficiary's standard of living as determined by the **trustee**.

Specifically, Prob. Code §15307, entitled "*Satisfaction of Money Judgment Paid After Education and Support*," provides that - except for amounts needed to maintain the beneficiary's education and *standard of living:*

"any amount to which the beneficiary is entitled...or that the trustee [has discretionarily determined to] pay to the beneficiary...may be applied to [satisfy the creditor's] money judgment.... [T]he court may...order...the trustee to satisfy...the judgment out of the beneficiary's interest...."

This argues in favor of having completely discretionary trusts (meaning no required principal distribution (for example, 1/3rd at ages 25, 30 and 35)). This means the creditor can only get a portion of what is in fact distributed. In other words, a judge cannot force the trustee to make distributions.

Presumably the trustee, carefully chosen by the beneficiary's parent, will determine that the beneficiary needs **all** distributions to maintain the beneficiary's standard of living (and the creditor will get nothing under this Probate Code section).

Unwinding An ILIT: California Creditor Concerns (Cont'd)

2. <u>JUDGE DECIDES CHILD'S STANDARD OF LIVING</u>.

Assume the trustee determines that the beneficiary needs all of the trust's distributions to maintain the beneficiary's standard of living. What else can the judgment creditor do?

The judgment creditor can ask the **court** to determine the beneficiary's standard of living. Assume the judge determines the beneficiary needs **less** for "standard of living" than what the trustee decided. The judge can order the trustee to satisfy the judgment out of: "payments to which the beneficiary is entitled under the trust instrument or that the trustee, in the exercise of the trustee's discretion, has determined or determines in the future to pay to the beneficiary." Prob. Code §15306.5(a).

However, that order: "may **not** require that the trustee pay in satisfaction of the judgment an amount **exceeding 25%** of the payment that otherwise would be made to, or for the benefit of, the beneficiary." Prob. Code §15306.5(b).

Example. Again, assume the trust has $10,000,000 which generates $800,000 per year. Assume the trustee decides to distribute **all** of the income to the beneficiary. The judgment creditor who was victorious under §15306.5 cannot receive more than $200,000. If the trustee decides to accumulate $400,000 and only distribute $400,000, the creditor will get $100,000.

Creditor Concerns: ILITs In States With Favorable Asset Protection Legislation?

Assume a California judgment creditor; a California debtor; a California court where the only "asset" is the debtor's interest as a beneficiary in a Nevada ILIT(meaning a Nevada Trustee) which either has (i) a policy issued by a non-California carrier or (ii) matured and the assets are in the Bank of Nevada. When the California creditor tries to domesticate the judgment in Nevada, will the Nevada court give "full faith and credit" to the California judgment?

First, is anyone certain of the result? Jay Adkisson, Esq. tells us that "all remedies law is local." But how does that apply here? Second, the lack of certainty is enough to cause most creditors to want to settle for pennies on the dollar. Third, the argument in favor of Nevada rejecting enforcement of the order is that Nevada's has a public policy in favor of its asset protection trusts. Fourth, in any event, California's own law on irrevocable trusts is favorable for beneficiaries (maximum of 25% of what is actually distributed). Fifth, beware of cases like *In re Schwarzkopf*, 626 F. 3d 1032 (9th Cir.. 2010), in which the irrevocable trust was treated as the *alter ego* of the father.

Practical Aspects Of Split-Dollar Life Insurance

Split-dollar funding of life insurance can reduce or eliminate the value of the gift in funding life insurance premiums including annual exclusion gifts, lifetime exemption gifts and GSTTs. It can be made into a dynasty trust and may produce better results than other techniques (GRATs and sales to grantor trusts) in some circumstances.

Assume spouses 49 and 45; $8,000,000 survivor policy economic benefit split-dollar with the ILIT; $55,000 annual premium guaranteed for 20 years. The gift tax in the first year is $24.00. Instead assume the parents loan the ILIT $2,000,000 at 3.5% (current long-term AFR). If the ILIT earns 6.25% that is enough to pay the interest and the premiums and repay the loan without incurring a gift. If the earnings are short of 6.25%, the ILIT can borrow from the policy's cash surrender value to make up the difference.

Exit strategies: the term rates grow over time. For the 49 and 45 year olds, if one dies and the survivor is 70, the term rate is $165,000. If annual loans are made, each is at a new rate. So use a GRAT to pour into an ILIT. Use a large initial loan, especially with today's low AFRs. Switch from an economic benefit arrangement to a loan arrangement.

Practical Aspects Of Third Party Financing

Do you feel comfortable, as a tax lawyer, reviewing a $10,000,000 loan package from Deutsche Bank?

The client may be required to pay a $10,000 legal fee for the loan, and may be unprepared for that. (By contrast, a sophisticated client who borrows all the time may well expect it.)

Does the client understand that: (i) it is recourse? (ii) the client will have to post collateral above and beyond the policy's cash surrender value? (iii) the collateral may rise over the first decade or so of the loan? (iv) the interest rate on the loan is not fixed? (v) there is no guaranty that the loan will be renewed? (vi) the client may have to submit financial statements every year? (vii) the policy's internal performance may not keep up with the loan's interest rate? (viii) policy loans are not costless (what if the cash surrender value earns zero?)?

Note that this has absolutely nothing to do with STOLI!!!

In conclusion, third party financing is often involved in the acquisition of large policies. But the financing is, itself, an entire, large completely separate transaction fraught with its own business (non-tax) complexities which may require a completely separate lawyer, completely separate engagement agreement and completely separate disclosure document by the insurance agent.

Using An ILIT To Create A *Graegin* Note

The ILIT is an independent third party (independent from the taxable estate or from the decedent's trust). Therefore, it is perfectly reasonable for the executor of the estate or the trustees of the trust (who are the executors for purposes of IRC Section 2203) to get an interest-only, prepayment prohibited, 15 year loan from the ILIT.

IRC Section 2053(a)(2) provides that the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts for administration expenses. Reg. Section 20.2053-3(a) provides that the amounts deduction from a decedent's gross estate as "administration expenses" are limited to such expenses as are actually and necessarily incurred in the administration of the decedent's estate, that is, in the *collection of assets*, payment of debts and distribution of property to persons entitled to it. A loan is reasonably and necessarily incurred when it prevents the forced sale of assets. Rev. Rul. 84-75. *Estate of Cecil Graegin*, TC Memo 1988-477 (a corporation made a loan to the estate, approved by the probate court, prepayment of principal and interest prohibited; 15 year term). *Estate of McKee*, T.C. Memo 1996-362 (borrowed from a corporation owned in part by the estate). *Estate of Lasarzig*, T.C. Memo 1999-307 (taxpayer loss: realty already distributed to the beneficiaries and the estate tax had already been paid).

Generational Split Dollar

Step 1: Form an ILIT. Step 2: ILIT contracts to buy a policy on the life of child. Step 3. Parent agrees to provide funds needed by ILIT to pay premiums. In return for providing the funds, parent is entitled to be reimbursed an amount equal to the greater of (i) all premiums paid by parent on the ILIT's behalf or (ii) the policy cash value at the date of repayment. The policy is pledged as collateral, recorded with the carrier. Neither parent nor ILIT can unilaterally terminate the agreement nor require a prepayment of the amount parent is to receive. Therefore, the amount will be received on child's death. Step 4: parent secures loan from independent lender. Parent pays ILIT a guaranty fee in exchange for allowing the policy to be used as collateral. Step 5: the lender pays the premiums. Step 6: each year the ILIT pays parent the annual economic benefit amount (the annual death benefit cost).

If parent dies first, the agreement continues in force and the reimbursement right is an asset of parent's estate. The issue is: what is the value of the reimbursement right?

New ILIT To Buy Policy From Old ILIT

Mom and Dad have 2 sons and a daughter. Mom and Dad set up a children's trust to own a $2,000,000 policy on Dad. Mom dies first, Dad remarries. Daughter hates Wife #2. Dad wants to disinherit Daughter which, of course, he cannot do as to the children's trust since it is irrevocable and there is no "protector" who can change the allocation among the beneficiaries.

Dad sets up Children's Trust #2 the only beneficiaries of which are the two Sons. The cash surrender value of the policy is $200,000. Dad makes a gift of $200,000 to Trust #2. Trust #2 buys the policy from the Children's Trust #1. Both are grantor trusts. See IRC Section 101(a)(2)(B) and PLR 200228019, one of many confirming that Rev. Rul. 85-13 applies and, therefore, the grantor trust is ignored. And, of course, since fair market value was paid, we don't have to worry about the three year rule of Section 2035.

Moving A Policy From A Tax Qualified Employee Retirement Plan To An ILIT

October 10, 2003, Amendment To Prohibited Transaction Exemption 92-6 involving the transfer of individual life insurance contracts and annuities from employee benefit plans to plan participants, certain beneficiaries, personal trusts, employers and other employee benefit plans.

II. (a) Such participant is the insured under the contract;

(b) such relative is a ``relative'' as defined in §3(15) of the Act (or a ``member of the family'' as defined in Code §4975(e)(6)), or is a brother or sister of the insured (or a spouse of such brother or sister), and such relative or trust is the beneficiary under the contract;

(c) the contract would, but for the sale, be **surrendered** by the plan;

(d) as to sales of the policy to the employer, a relative of the insured, a **trust**, or another plan, the participant insured under the policy is first **informed of the proposed sale** and is given the opportunity to buy such contract from the plan, and delivers a written document to the plan stating that he or she elects not to buy the policy and consents to the sale by the plan of such policy to such employer, relative, trust or other plan;

(e) the amount received by the plan as consideration for the sale is at least equal to the amount necessary to put the plan in the **same cash position** as it would have been had it retained the contract, surrendered it, and made any distribution owing to the participant on his vested interest under the plan; and

(f) as to any plan which is an employee welfare benefit plan, such plan must not, as to such sale, discriminate in form or in operation in favor of participants who are officers, shareholders or highly compensated employees.

Flip Switch For An ILIT

What happens when what was an ILIT no longer uses trust income to pay premiums to pay policies on the life of the grantor and you don't want it to be a grantor trust?

Do you solve that problem with a protector?

Do you solve that problem with a "flip" or "toggle" switch?

CCA 200923024: conversion of nongrantor trust to grantor trust isn't a transfer for tax purposes of the property held by the nongrantor trust to the owner of the grantor trust that requires recognition of gain to the owner.

"Evaluating The Sometimes Surprising Impact of Grantor Trusts on Competing Strategies to Transfer Wealth," by Jerome M. Hesch, Estates & Trusts Section, Montgomery County Bar, Rockville, Maryland, March 23, 2009, Footnote 6 on toggling.

[6] The income tax consequences when the grantor's liability for income taxes is terminated when the power creating grantor trust status is terminated by the action of the grantor or by the action of the trustee has yet to be addressed in the Regulations, the IRS's administrative pronouncements or the case law except in the narrow situation of when an existing trust liability to an unrelated person is attributable to the grantor because of grantor trust status and that liability is deemed shifted to the trust as part of a sale or exchange when grantor trust status is terminated while the grantor is still alive. Treas. Reg. § 1.1001-2(c) Example 5; Rev. Rul. 77-402, 1977-2 C.B. 222 and *Madorin v. Commissioner*, 84 T.C. 667 (1985). Based on these authorities, an issue has been raised as to whether the grantor would incur discharge of indebtedness income under § 61(a)(12) when the grantor's obligation to pay the income taxes on the trust's income is shifted to the trust upon termination of grantor trust status, Since this issue has not been addressed, its resolution remains unclear at this time.

The IRS takes the position that the grantor does not make a gift when the grantor pays the income taxes on the trust's income because that liability is the grantor's liability, and the IRS concludes that one cannot make a gift by paying one's own liability. Rev. Rul. 2004-64, 2004-2 C.B. 7. Because the IRS's position in this Ruling recognizes the existence of this liability, it could lead one to the conclusion that when the grantor's liability is shifted to the trust, the grantor's liability is cancelled and therefore the grantor has to recognize discharge of indebtedness income § 61(a)(12) of the Code.

However, discharge of indebtedness income should not result. As noted above, the reason for attributing items of income, deduction, and credit to the grantor under § 671 is that the grantor is deemed to be the owner of the trust property. The IRS position of treating the grantor as the owner of the trust's assets is, therefore, consistent with and supported by the rationale in Rev. Rul. 85-13, 1985-1 C.B. 184. In other words, tax liability attaches to the owner of the property. As the deemed owner of the property, the grantor's payment of income tax is in discharge of his own obligation. The income tax cannot be an obligation owed to the trust, because the trust does not exist for Federal income tax purposes. The language

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of Rev. Rul. 2004-64, 2004-2 C.B. 7 supports this by stating that "any income tax [the grantor] pays that is attributable to Trust's income is paid in discharge of [the grantor's] own liability, imposed on [the grantor] by § 671."

It is only after grantor trust status terminates that the non-grantor trust springs into life as a separate entity for Federal income tax purposes. The grantor is deemed to relinquish ownership of the trust assets at that time. The trust, as owner of the assets must pay the resulting income tax liability. This transfer appears analogous to an individual who transfers income producing property by gift. While the individual owns the property, he reports the income from it, and thus pays the income tax on the income produced. Once the individual transfers the property to another person, he no longer reports its income, and thus has no corresponding obligation to pay the income taxes associated with the property. He does not, however, recognize any discharge of indebtedness income on the actual transfer of an income-producing asset by gift. Likewise, one should be treated similarly if there is a deemed transfer of an income-producing asset when grantor trust status is terminated.

Protector In An ILIT

Depending upon the powers given to a protector, e.g., the ability to add or remove beneficiaries, the trust will be a grantor trust due to Section 674 “Power to control beneficial enjoyment.” That is because “The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.” See Section 674(c), the flush language: “A power does not fall within the powers described in this subsection [meaning it causes grantor trust status] if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.”

So it is best, if you allow for protectors, to allow a way to get rid of them so that the trust can become a non-grantor trust.

Charitable Reverse Split Dollar: Section 170(f)(10)

No deduction shall be allowed "for any transfer to or for the use of [a charitable] organization…if in connection with such transfer (i) the organization, DIRECTLY OR INDIRECTLY pays, or has previously paid, any premium on any personal benefit contract with respect to the transferor, or (ii) there is an understanding or expectation that any person will directly or indirectly pay any premium on any personal benefit contract with respect to the transferor."

"Personal benefit contract" means "with respect to the transferor, any life insurance, annuity, or endowment contract if any DIRECT OR INDIRECT beneficiary under such contract is the transferor, any member of the transferor's family, or any other person (other than [the charitable] organization…) designated by the transferor."

How might it come up? In connection with a CLAT or a CRUT a policy is bought.

Bibliography

“How To Fix a `Broken’ Life Insurance Trust,” by Sebastian V. Grassi, Jr., 35 Estates, Gifts and Trusts Journal 90 (1/14/2010).

“The Use of Partnerships in Planning for Life Insurance,” Trusts and Estates (April, 1995). Rev. Rul. 83-147. PLR 9309021: must there be assets other than life insurance?