Estate Tax Inclusion Rules

In general, life insurance proceeds will be included in an insured's estate if:
(1) the life insurance proceeds are payable to the insured's estate;
(2) the insured possesses any incidents of ownership in the policy at the time of death; or
(3) the insured transferred his or her interest in an insurance policy within three years of his or her death.

(1) Insurance Proceeds Payable to the Insured's Estate

Life insurance proceeds from insurance policies on the decedent's life will be included in a decedent's estate under Internal Revenue Code ("IRC") § 2042(1) if the insurance proceeds are receivable by the executor of the decedent's estate. Moreover, Treas. Reg. § 2042-1(b)(1) provides "if under the terms of an insurance policy the proceeds are receivable by another beneficiary but are subject to an obligation, legally binding upon the other beneficiary, to pay taxes, debts, or other charges enforceable against the estate, then the amount of such proceeds required for the payment in full … of such taxes, debts, or other charges is includible in the gross estate." Thus, insurance proceeds will be included in the decedent's estate under IRC § 2042(1) whenever insurance proceeds are payable to the decedent's estate or for the benefit of the decedent's estate.

➔ **Planning Point:** If the decedent has created an Irrevocable Life Insurance Trust ("ILIT") and has named the ILIT as owner and beneficiary of the policy, the ILIT should never require the trust to pay obligations of the decedent's estate, because such a provision will cause inclusion in the decedent's estate under IRC § 2042. Treas. Reg. § 20.2042-1(b)(1). In PLR 200147039, the Internal Revenue Service ("IRS") ruled that a provision in a trust giving the trustee *discretion* to use trust assets to pay taxes and expenses due on the death of the insured would not cause inclusion in the decedent's estate, because there was no legally binding obligation to do so. One should note, however, that the IRS did not rule on what the result would be had the trustee in fact exercised his discretion to pay such taxes or expenses. The regulations under IRC § 2042 do not preclude the IRS from taxing insurance proceeds under other Code sections that might apply. The ILIT, rather than distributing property to the estate to enable it to pay taxes and expenses, could use the insurance proceeds to purchase assets from the decedent's estate (at fair market value) as a means of providing liquidity to the decedent's estate without risking estate tax inclusion. Typically, the step-up in basis rules for assets included in the decedent's estate will prevent the estate from incurring a capital gain upon the sale of assets to the ILIT. Alternatively, the ILIT can be drafted so that the trustee is permitted to lend money to the estate for a commercially reasonable amount of interest.

(2) Incidents of Ownership

Life insurance proceeds will also be includible in the decedent's estate under IRC § 2042(2) if the decedent possessed any "incidents of ownership" in the policy, either alone or in conjunction with any other person, at the time of the decedent's death. Treas. Reg. § 2042-1(c) provides that "the term 'incidents of ownership' is not limited in its meaning to ownership of the policy in the technical sense…. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc."

➔ **<u>Planning Point</u>:** The Regulation quoted above clarifies that even if the insured does not own the policy and the insurance proceeds are paid to someone other than the insured's estate, the insurance proceeds will be includible in the decedent's estate if the decedent held any "incidents of ownership" at the time of his or her death. Practitioners should plan carefully to avoid the application of IRC § 2042 because any incident of ownership held directly by the insured will cause inclusion of the *entire* proceeds in the decedent's estate, even if the right can only affect a *portion* of the policy (<u>See</u> Treas. Reg. § 20.2042-1(a)(3)).

<u>EXAMPLE</u>: Insured pledges a policy on his life to a bank to secure a loan. The insured is personally liable on the loan. Subsequently, the insured transfers ownership of the policy, subject to the loan, to an ILIT and the ILIT is named the beneficiary of the policy. The insured dies while the loan is outstanding. The insured has retained an incident of ownership, because he continued to benefit from the use of the policy as security for his loan. Accordingly, the *entire* proceeds of the life insurance would be includible in the insured's estate under IRC § 2042.

(3) The Three-Year Rule - IRC § 2035(d)(2)

Transfers by an insured of incidents of ownership in a life insurance policy within three years of the insured's death are included in the insured's gross estate under IRC § 2035.

<u>EXAMPLE</u>: Insured purchases a $1,000,000 term life insurance policy on his life, and names his wife as beneficiary of the policy. He transfers ownership of the policy to an ILIT and the ILIT is, in turn, named beneficiary of the policy. The insured dies two years after the transfer. The insurance proceeds are included in the insured's gross estate under IRC § 2035, because he transferred incidents of ownership in a life insurance policy within three years of his date of death.

➔ **<u>Planning Point</u>:** The result in the above example could be avoided simply by having the trustee of the ILIT purchase the insurance policy directly, rather than having the insured acquire the insurance and then transfer it to the ILIT. The 3-year rule will not apply if the transaction is structured in this manner because the decedent will never hold any incidents of ownership in the policy. Accordingly, the life insurance proceeds will be excluded from the insured's gross estate, even if the insured makes annual exclusion gifts to the ILIT to cover the costs of the annual insurance premiums (<u>See</u> *Leder Est. v. Comm'r*, 893 F.3d 237 (10th Cir. 1989) and *Headrick Est. v. Comm'r*, 918 F.2d 1263 (6th Cir. 1990), *acq. recommended*, AOD 1991-012). Nevertheless, the ILIT should be drafted to provide that the trustee may use these future contributions, but is not required to do so, to pay premiums.

Gifting Life Insurance

The key to removing life insurance from an individual's estate is to make sure that the individual does not possess any incidents of ownership. This is accomplished by giving the life insurance to a third party (and by the insured surviving the three-year rule). The question that arises is who is the appropriate donee of the life insurance: an individual vs. a trust?

<u>Spouse as Donee vs. ILIT</u>. If the insured intends for the life insurance proceeds to benefit his or her spouse, then an ILIT will almost always be preferable.

> **<u>EXAMPLE</u>:** Insured owns a $1,000,000 whole life policy on his life, with a cash value of $500,000 and his wife is named as beneficiary. The insured decides to transfer ownership of the policy to his wife. If the insured predeceases the spouse, the effect of this transfer is estate tax neutral, because there would be no estate tax due regardless of whether or not the transfer occurred. Assuming the insured survived the transfer by three years, the policy is removed from his estate; had the transfer not occurred, the proceeds would qualify for the estate tax marital deduction. In either case, the proceeds are still taxable in the surviving spouse's gross estate (unless dissipated by the surviving spouse). If, on the other hand, the insured transferred the policy to an appropriately designed ILIT, he could prevent the proceeds from being taxed in both his and his spouse's estate, while allowing his spouse to enjoy the benefits of the insurance proceeds as a trust beneficiary.

Children as Donee vs. ILIT. If the spouse will not be a beneficiary of the insurance proceeds and the insured's children (or other beneficiaries) are adults, transferring the policy directly to the children may be simpler than using an ILIT. Assuming the insured survives the transfer by three years, no part of the insurance proceeds should be includible in the insured's gross estate. In addition, if the insured pays the policy premiums by making gifts to the children, the gifts should automatically qualify for the IRC § 2503(b) gift tax annual exclusion.

Nevertheless, transferring ownership of the policy to a trust and naming the trust as beneficiary is definitely preferable if the children are minors, because the insured's spouse (or another trusted relative or friend) could act as trustee of the trust and thereby exercise a tremendous amount of control over the transferred property. In addition, transferring the insurance policy to a trust for the benefit of children provides numerous other advantages that are associated with trusts in general (*e.g.*, creditor protection, protection from a divorcing spouse, the client can control timing of outright distributions to descendants, and can determine who will manage the trust property (*i.e.*, the client appoints the trustee) in the event the children lack the financial acumen to do so themselves, etc.).

➔ **Planning Point:** If you decide to name children as beneficiaries of an insurance policy, the transaction should never be structured where the husband is the insured and the wife is the owner of the policy (or vice- versa), because, in this situation, upon the death of the husband (*i.e.*, the insured), the wife will be treated as having made a gift of the insurance proceeds to the children (see *Goodman v. Comm'r*, 156 F.2d 218 (2d Cir. 1946)). In fact, there is the potential for an inadvertent gift in any situation where three different parties are involved as owner, insured and beneficiary. To avoid this problem whenever the insured is not the policy owner, the policy owner should always be named as the policy beneficiary.

Advantages of ILITS.

As noted above, transferring the insured's insurance policy to an ILIT (and naming the trust as beneficiary) has a number of advantages over an outright transfer to an individual, including the following:

- If properly drafted, the ILIT will remove the life insurance from the insured's estate (assuming the insured survives the transfer by three years).

- The trust provides a flexible tool for the management and distribution of assets. For example, without causing inclusion in the surviving spouse's estate, the trust can provide that the surviving spouse and children are entitled to so much or all of the income and/or corpus as the trustee shall determine in the trustee's discretion (the spouse, however, should not be the trustee, unless distributions to the spouse are limited to an ascertainable standard).

- Ownership of the policy by an ILIT will permit the use of a "back-up" marital deduction provision, which will allow the proceeds to qualify for the estate tax marital deduction if the insured is married and the proceeds are includible in the insured's estate (because, for example, the insured dies within three years of assigning the policies).

- The ILIT can provide the insured's estate with liquidity to pay taxes and administration expenses, if the ILIT is drafted to provide the trustee with authority to purchase assets from the insured's estate or loan money to the insured's estate.

- The insurance proceeds will be protected from the beneficiaries' creditors and from claims of spouses.

While use of an ILIT has a number of advantages, it also creates additional complexity. The main cause of the additional complexity is the need to structure the ILIT to avoid incurring gift tax on (i) the transfer of the life insurance policy to the trust and (ii) the transfer of cash to pay the annual policy premiums. In order to qualify these transfers for the gift tax annual exclusion, it is necessary to grant the beneficiaries Crummey powers (*i.e.*, a right to withdraw the beneficiary's pro rata share of the property contributed to the trust).

Summary of ILITs

Estate planners traditionally have used two techniques to remove the value of a life insurance policy from a client's estate for federal estate tax purposes. Where a client already owns a policy, an attorney might suggest that the client transfer the policy to some other owner, such as the Trustee of an irrevocable life insurance trust ("ILIT"). While generally effective, if the client dies within three years of the transfer, the value of the policy will be brought back into his or her estate under IRC § 2035. Alternatively, where a client does not already own life insurance but is contemplating the purchase of a policy, attorneys should recommend that the policy be acquired by the Trustee of an ILIT. This second technique avoids the potential for inclusion under IRC § 2035 because the insured never makes a transfer of the policy.

While ILITs are an effective way of removing the value of a policy from an insured's gross estate, because the governing instruments must be carefully drafted to limit the insured's power over the policy and the beneficial enjoyment of the trust property, the insured typically will not have a means of obtaining access to the insurance policy or its proceeds. This is not generally problematic where the purpose of the trust and the policy is to provide for trust beneficiaries after the insured's death. However, if the insured has unanticipated cash flow needs during his or her life (e.g., for substantial medical or long-term care expenses), a life settlement, which otherwise might seem an appropriate solution to this problem, may be unavailable because the governing instruments of ILITs generally do not provide a means for life settlement proceeds (or any trust assets) to be distributed to the insured.

To prevent this result, attorneys should seek to build flexible terms into the governing instruments of ILITs. One obvious way to increase flexibility is to name the insured's spouse as beneficiary of the trust during the insured's life. By using this approach, if lifetime settlement becomes desirable, the trustee can distribute either the policy or the settlement proceeds to the beneficiary spouse, who can then transfer the policy or proceeds to the client pursuant to the unlimited federal gift tax marital deduction (or use the proceeds for the benefit of the client). Another way to increase flexibility is to grant a special power of appointment to an individual and name the insured in the class of permissible appointees so that the insurance policy (or proceeds from a life settlement) may be appointed to the insured if necessary.

In addition, the terms of the ILIT should confer on the trustee express powers to sell any life insurance policy held in the trust and move the trust's situs to another jurisdiction. Such an approach will enable the trustee to engage in a life settlement that would otherwise be prohibited under the then applicable state law or to seek a jurisdiction that favorably regulates life settlements.

Common Income Tax Issues

The governing instrument of a typical irrevocable life insurance trust contains provisions that allow sprinkling of principal and income to family members during the life of the insured. After the insured's death, the trust may pay out immediately to the family members, or be retained in further trust, possibly even as a dynasty trust. Obviously, the insured should not be the trustee. If the insured has control over the insurance policy through the trust, he or she will have "incidents of ownership," which will cause the policy proceeds to be included in the insured's taxable estate under IRC § 2042. Inclusion of ascertainable standards is of no avail in avoiding inclusion under IRC § 2042. If the trust holds a second-to-die policy, neither insured should be a trustee.

What if the spouse of the insured acts as trustee and the trust holds a single-life policy on the life on the grantor? If the spouse can distribute property to herself, not subject to an ascertainable standard, he or she would be deemed to have a general power of appointment. This would cause all trust income to be taxed to the spouse under IRC § 678 and the trust property to be included in the spouse's taxable estate under IRC § 2041.

What if the distributions were subject to an ascertainable standard? Even assuming the spouse did not contribute any property to the trust, the trust would be a grantor trust as to the grantor since the exception of IRC § 674(d) would not be met because the trustee was the spouse of the grantor. For this purpose, a spouse's deemed gift to an irrevocable insurance trust because of a gift-splitting election does not make her a donor for purposes of IRC §§ 673-677, 2036 or 2038. PLR 200130030.

Of course, income tax consequences regarding ILIT are not ordinarily a serious concern because most if not all income in such a trust typically occurs inside one or more life insurance policies, and such income ordinarily does not lead to income taxes.