LIFE INSURANCE TRUSTS

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I. Introduction.

It is very common for an individual to have among his or her assets one or more life insurance policies. For example, an individual may have received life insurance as a fringe benefit from his or her employer (most commonly, group term insurance) or may have acquired one or more policies outside of his or her employment as an investment, or for other reasons. Some of the more common reasons include:

(a) Providing a means to replace for the benefit of his or her family the earnings which would be lost on his or her death;

(b) Providing funds to pay for debts, expenses and taxes upon such individual's death, including federal estate or inheritance taxes, funeral and burial expenses and medical expenses incurred during the individual's last illness;

(c) Providing funds to buy out such individual's ownership interest in a business upon such individual's death;

(d) Creating an estate to pass on to members of the individual's family or to charitable organizations; or

(e) Creating a forced savings fund to provide for such individual's retirement or to fund anticipated later expenses of the family, such as college education for such individual's children.

All too often, an insured takes no steps to take advantage of the available methods to minimize (and perhaps eliminate) the transfer tax consequences of passing the proceeds of a life insurance policy to the insured's intended beneficiaries. For example, most insureds simply complete the beneficiary designation form provided by the life insurance company and name one or more individuals or their own estate as the beneficiary of the policy. This procedure often has adverse federal and state transfer tax consequences and undesirable ramifications from a state law perspective, relating to, for example, the ability of creditors of the beneficiaries to attach the life insurance proceeds. All of these undesirable consequences could perhaps be avoided (or, at least lessened) by proper planning.

Most of the desirable federal and state tax consequences and the protection against creditors are achieved through the use of an inter vivos (created during the creator's lifetime) irrevocable trust which will own the life insurance policy. This outline, due to the brevity of the presentation and the impossibility of providing a comprehensive discussion on all matters and nuances relating to life insurance trusts, has been intentionally limited to two common fact pattern scenarios: (1) the use of an inter vivos irrevocable life insurance trust to provide for the surviving spouse and children and (ii) the use of an inter vivos irrevocable life insurance trust

to provide for the surviving spouse, children *and* grandchildren. Although limited to those common fact patterns, often the same analysis and rules apply to life insurance trusts not exactly falling within the fact patterns described.

II. General Principals of Tax Law Involved.

Our federal tax system imposes a tax on the transfer of assets, whether during lifetime or at death. Estate and gift taxes are unified under one rate schedule, with all transfers being added together to determine the ultimate tax liability.

A. Estate Tax Unified Credit. The American Taxpayer Relief Act of 2012 ("ATRA"), signed into law on January 2, 2013, made permanent the basic exclusion amount of $5,000,000 per person ($10,000,000 for a married couple), adjusted for inflation for decedents dying in 2013 and thereafter. With the inflation adjustment, the basic exclusion amount is $5,250,000 for 2013 and $5,340,000 for 2014. Other important features of ATRA include: (i) the generation-skipping transfer ("GST") exclusion is also $5,000,000, adjusted for inflation, (ii) the maximum estate tax and GST tax rate has been set at 40% and (iii) the so-called "portability" provision, where the surviving spouse may utilize the unused portion of the deceased spouse's estate tax exclusion amount, has been made permanent.

B. Gift Tax Credit. Starting for transfers made in 2013, ATRA makes the applicable exclusion amount for transfers by gift equal $5,000,000 for each taxpayer ($10,000,000 for a married couple), adjusted for inflation, the same as the estate tax exclusion amount (under a unified estate/gift tax structure).

C. Gift Tax Annual Exclusion. A taxpayer may currently make annual gifts of up to $14,000 for each donee without using any of such taxpayer's exemption amount. Accordingly, a married couple can make gifts of up to $28,000 per year to each donee without incurring any transfer tax. However, this annual exclusion does not apply to gifts of future interests in property and, thus, only applies to gifts of *present interests*.

D. Inclusion of Life Insurance Proceeds Into Estate. A decedent's gross estate includes the proceeds of life insurance policies on the life of the decedent to the extent of the amount receivable by the executor. A decedent's gross estate also includes the proceeds from life insurance policies on the life of the decedent receivable by all other beneficiaries if the decedent possessed at his death any of *the incidents of ownership* over any such policy, exercisable either alone or in conjunction with any other person. The term "*incidents of ownership*" includes, perhaps among other things, the power to (1) change the beneficiaries or contingent beneficiaries, (2) surrender or cancel the policy, (3) assign the policy, (4) revoke an assignment, (5) pledge the policy for a loan, (6) obtain from the insurer a loan against the surrender value of the policy, (7) change the time at or manner in which the proceeds will be received, (8) exercise an option to repurchase the policy from an assignee or (9) veto any change in beneficiary designation or an assignment or cancellation of the policy. Accordingly, an incomplete transfer of the life insurance policy will not result in a reduction in the transfer tax upon the insured's death.

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E. Three-Year Rule. The decedent's gross estate will include proceeds from life insurance policies on the life of the decedent to the extent of any interest therein of the decedent during the three-year period ending on the date of the decedent's death. Accordingly, to the extent the decedent's estate was the beneficiary of life insurance on the decedent's life or to the extent the decedent had any incident of ownership in such life insurance policies at any time within such three year period, such insurance proceeds will be includable in the decedent's estate and subject to transfer taxes.

F. Crummey Powers. By giving one or more beneficiaries of a life insurance trust the right to withdraw amounts contributed to the trust for a specified period of time after contribution, an insured can cause the cash gifts to such a trust for the payment of future life insurance premiums to qualify for the annual exclusion.

G. Lapse of Crummey Power. Since a *Crummey* power of withdrawal is generally not exercised, and not intended to be exercised, so that the contributions to the life insurance trust can, in fact, be used to make premium payments on life insurance policies within such trusts, the tax consequences associated with the failure of a beneficiary to exercise this right become important. First, any trust property still subject to a withdrawal power upon the beneficiary's death is includable in the beneficiary's gross estate as a general power of appointment. Also, the lapse of a withdrawal power is a taxable gift by the beneficiary subject to the transfer tax rules to the extent that, in any calendar year, the value of the property subject to the lapsed power exceeds the greater of $5,000.00 or five percent (5%) of the aggregate value of the assets out of which the lapsed power could have been satisfied. Accordingly, the grant of *Crummey* powers in order to qualify future trust contributions for the annual exclusion may create transfer taxes at the beneficiary level.

H. Generation-Skipping Transfer Tax Exemption. There is a generation-skipping tax on generation-skipping transfers ("GST") which include (1) a direct skip, (2) a taxable distribution or (3) a taxable termination. No tax is imposed on a GST that is protected by the annual gift exclusion or the generation-skipping transfer tax exemption ("GST Exemption"). However, gifts qualifying for annual exclusion through *Crummey* clauses with respect to life insurance trusts are not going to be exempt from the GST tax. Nonetheless, by filing a gift tax return at the time of making the *Crummey* gifts, the amount of the GST Exemption that is utilized can be determined as of such date, as opposed to the date of death, resulting in a much lower valuation based on the value of the policy or premium payment prior to death, rather than the full value of the life insurance proceeds.

III. **Life Insurance Trusts for Benefit of Surviving Spouse and Children**.

A. Gift Tax Considerations.

1. Transfer of Policy. For life insurance policies already in existence, there will be a taxable transfer for U.S. gift tax purposes upon the transfer of the policy from the insured to the life insurance trust equal to the fair market value of such policy.

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Generally, for a whole life policy, the value will equal the interpolated terminal reserve amount (usually roughly equivalent to the cash surrender value of such policy), plus any proportionate part of the gross premium last paid to the extent allocable to the period extending beyond the date of the gift. The value of a gift of a term life insurance policy, however, is unclear for gift tax purposes. Arguably, its value will equal the value of the pro rata portion of the premium for the unexpired portion of the term. Special rules relate to the transfer of group-term insurance assigned by an employee to a trust.

2. Continuing Premium Payments. If not structured appropriately, future premium payments made out of funds of the insured will generally be taxable as gifts, *without* offset by the annual exclusion. Two common exceptions to this rule relate to the use of Crummey withdrawal powers and minority trusts.

3. Crummey Withdrawal Powers. In an attempt to obtain the use of the annual exclusion for cash gifts to a trust for the payment of future life insurance premiums, a very common drafting technique is to give one or more beneficiaries the right to withdraw amounts contributed to the trust for a specified period of time after contributed. This unrestricted right to the immediate use, possession and enjoyment of the contribution to the trust, *whether or not exercised*, makes the transfer one of a present interest, thus, qualifying for the annual exclusion. Such a right is known as a "*Crummey*" power after a famous tax court case *Crummey v. Commissioner* (1968). Generally, the most formidable task in qualifying for the annual exclusion through the use of *Crummey* withdrawal powers is the requirement of reasonable opportunity to exercise. In Private Letter Rulings, the IRS has indicated that thirty (30) days constitutes a reasonable time between notice of the withdrawal right and its lapse. See e.g., PLR 9030005; PLR 8712014; PLR 8134135; PLR 8103074. This generally is not a problem; however, the IRS has indicated through other Private Letter Rulings that when the holders of *Crummey* withdrawal powers are minors, the period between notice and lapse of the withdrawal right should be sufficient to permit the appointment of a guardian under state law. *See e.g.*, PLR 8022048; PLR 7922107. A suggestion for maintaining the favorable thirty (30) day requirement, while giving credence to the IRS position requiring a sufficient time to permit the appointment of a guardian for minor beneficiaries, may be to provide for the thirty (30) day period coupled with a provision that if guardianship provisions are initiated within that thirty (30) day period, the right to exercise withdrawal powers shall be extended until thirty (30) days after the appointment of any such guardian.

4. Lapse of Crummey Power. Almost always the *Crummey* withdrawal power in a life insurance trust is not exercised and the contribution to the trust is, in fact, used to pay for the life insurance premiums. The failure to exercise this right has potential adverse tax consequences for the holder of the withdrawal right. First, any trust property still subject to a withdrawal power upon the beneficiary's death is includable in the beneficiary's gross estate as a general power of appointment. Second, the lapse of a withdrawal power may be a taxable gift by the beneficiary because the

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right to withdraw trust property is treated as a general power of appointment, the release or lapse of which constitutes a transfer of the property by the individual possessing the power for gift and estate tax purposes. A major exception to the taxability of a lapse of a withdrawal power are the so-called "5 and 5" rules. These rules exclude as a taxable transfer the amount of any lapsed withdrawal power to the extent that during any calendar year the value of the property subject to the lapsed powers are less than or equal to the greater of $5,000 or five percent (5%) of the aggregate value of the assets out of which the lapsed power could have been satisfied. When the premium obligation is too large to fall under the "5 and 5" rules, various techniques have been developed to avoid a tax lapse with respect to the beneficiary's withdrawal right. These techniques include hanging powers, use of trusts with limited testamentary powers of appointment, vested trusts and funded trusts. Use of multiple trusts have fallen in disfavor by the IRS.

5. Minority Trusts. Another method to secure the annual exclusions for contributions to a life insurance trust is to use an IRC §2503(c) minority trust. The minority trust has limited use, however, because the beneficiary must be under the age of twenty-one and the trust must terminate upon the attainment of such age by the beneficiary. This alternative, thus, will not be practical if the life insurance trust is to benefit other people, for example, the spouse. The minority trust is a good vehicle when the insured desires to only benefit his or her minor children and is willing to have the life insurance policy pass outright to the child upon his or her reaching age twenty-one.

B. Estate Tax Considerations.

1. Retention of Incidents of Ownership. The proceeds of an insurance policy on an insured's life will be includable in the insured's gross estate if the insured has an incident of ownership in the policy at death. As described above in this handout, almost any power affecting the life insurance policy or the trust that is retained by the insured will cause the inclusion of such proceeds into the insured's estate for U.S. estate tax purposes. Accordingly, the insured should retain no powers over the life insurance policy itself, such as the ability to change the beneficiaries or to surrender or cancel the policy. With respect to control over the trust, there has been much litigation over the extent to which an incident of ownership held by the insured in a fiduciary capacity, such as trustee of the trust, will cause inclusion of policy proceeds into the taxable estate. In view of these cases, where at all possible, an express statement prohibiting the appointment of the insured or the insured's spouse as trustee should be contained in the trust agreement. Furthermore, the IRS has taken the position that when the insured retains the power to remove and replace a trustee, all of the powers held by the trustee will be attributed to the grantor and thus, it is not advisable to allow the insured or the insured's spouse to have the power to remove and replace the trustee.

2. Community Property Considerations. In a community property jurisdiction, generally, a life insurance policy purchased with community property

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funds is treated as owned one-half by the insured and one-half by the insured's spouse. Accordingly, without special structuring, the contribution of a community property life insurance policy, and/or future community property cash contributions to the life insurance trust to fund future policy premiums, will be deemed to be made one-half each by the insured and the insured's spouse. Since the insured's spouse will often be a lifetime beneficiary of the life insurance trust, one-half of the life insurance proceeds would probably be includable in the insured's spouse's estate, as property in which the decedent had an interest or as a transfer with a retained life estate, regardless of whether the insured's spouse is a trustee of the trust. A common technique for avoiding this estate tax exposure is to clearly define the life insurance policy as the separate property of the insured before contribution to the life insurance trust and to fund future contributions to the trust for policy premiums out of separate property funds, rather than community property funds. If separate property funds are not already in existence, separate property can generally be created through appropriately drafted separate property agreements.

3. The Three-Year Rule. The general rule with respect to transfers of life insurance policies is that if the life insurance policy is transferred within three (3) years of death, it is automatically included in the gross estate of the insured. Much litigation arose when an insured created an irrevocable life insurance trust and had the trustee of that trust apply directly for the policy rather than having the insured acquire the insurance and then transfer it to the trust. The IRS through a series of earlier cases successfully argued that there was a "deemed" transfer of the life insurance policy since the insured was instrumental in creating the situation involving the purchase of the policy by the trust. In subsequent cases, the Tax Court rejected the IRC position and ruled that the insured must *directly* transfer an incident of ownership in a policy within such three year period in order for there to be an inclusion of the life insurance proceeds in the estate of the insured. In view of the later cases, most practitioners feel comfortable advising the insured to have the trust directly purchase the life insurance policy in order to avoid the three year rule.

IV. Life Insurance Trusts, Second Generation Planning.

A. In General. There is a generation-skipping tax on generation-skipping transfers ("GST") which include (1) a direct skip, (2) a taxable distribution or (3) a taxable termination. A direct skip occurs when a donor makes a direct transfer to a third generation beneficiary. A taxable distribution occurs when a donor makes a trust allowing for contingent distributions to be made to third generation beneficiaries and such contingency occurs. In most life insurance trusts scenarios, where the surviving spouse or children are income beneficiaries of the trust with sprinkling powers, there is a planned termination of the trust for the benefit of the third generation beneficiaries, which is a taxable termination. No tax is imposed on a GST that is protected by the annual gift exclusion or the generation-skipping transfer tax exemption ("GST Exemption").

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B. Unavailability of Annual Exclusion. The annual gift exclusion does not apply to any transfer to a trust for the benefit of an individual, unless the sole beneficiary of such trust is a third generation beneficiary. Since the traditional life insurance trust benefits not only grandchildren, but also the surviving spouse and children, it does not appear that the funding of future premium payments will be exempt from GST tax for this reason.

C. Use of the GST Exemption. Under the automatic allocation rules, transfers not involving direct skips are not automatically allocated a GST Exemption. Since the typical life insurance trust is not a direct skip transfer, since there are other beneficiaries besides the grandchildren, such as the surviving spouse and children, certain action steps must be taken to allocate the GST Exemption to the transfer of an existing life insurance policy to a life insurance trust, where the ultimate beneficiaries are the grandchildren, and/or the transfer of future contributions to fund subsequent premium payments. A taxpayer may elect to allocate all or a portion of his or her GST Exemption to transfers that are not direct skips by filing a gift tax return, in which case, the GST Exemption will be allocated based on the value at the time of the transfer (as opposed to later at the time of the taxable termination involving the larger proceeds amount). Generally, with respect to the transfer of an already existing life insurance policy, the amount of GST Exemption will generally equal the policy's cash surrender value plus any unused (or remaining) premium already paid. For later paid premiums, the amount of GST Exemption used should equal the amount of the premium.

V. Conclusion.

Most gift and estate tax planning revolves around the use of leveraging. In addition to the leveraging of the estate tax exemption amount and the annual gift tax exclusions, the exclusion of appreciated assets is a traditional tax savings technique. Life insurance, perhaps the ultimate appreciating asset, provides a unique opportunity to save substantial transfer taxes through appropriate planning. When the benefits of second generation planning are utilized, the total tax savings over three generations can be even more substantial.

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