Six All-Too-Common Irrevocable Life Insurance Trust Traps
Journal of Financial Service Professionals
November 2017
Vol. 71, No. 6 | pp. 21-23

Estate Planning

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ABSTRACT
Illiquid estates and estate taxation are often what catapults estate planning clients into purchasing life insurance. The process should not be navigated without an expert in the various types of product and guidance on the most efficient way to finance it. But the need for advice does not stop there. In spite of the fact that irrevocable life insurance trusts have been used for decades, there remain serious traps in their construction and administration that will undermine achieving your clients' goals.

Life insurance can be a critical piece of a comprehensive estate plan—whether to balance inheritances among heirs or provide liquidity to pay estate tax. For tax and nontax reasons, a special form of irrevocable trust may be used to serve as owner (and beneficiary) of the insurance. These irrevocable life insurance trusts (ILITs) contain unique traps for the unwary.

Six of the Most Common

The many issues with life insurance planning emanate from everything from the complexities and sophistication of today's products to the vagaries of the markets. However, there also are potential pitfalls within the client's control. Clients rightfully rely on their expert advisors to navigate around or through the minefield, and many times the result places the fiduciary in an awkward position. Others can cause tax that could have been avoided. What follows is a brief survey of six of the most common tax-related drafting problems.

1. Spouse as Trust Beneficiary

Estate tax inclusion will occur any time there is an incident of ownership.[1] Under the regulations, receipt of an economic benefit constitutes an includible attribute. Thus, no insured should ever be a trust beneficiary. The most common instance for this trap to be sprung is when an ILIT containing a sprinkle power that includes the spouse as a potential discretionary beneficiary purchases second-to-die or survivorship insurance on the lives of the grantor and spouse. It is imperative to understand what type of insurance will be acquired when the trust is being drafted and to review carefully an existing ILIT that is contemplating a purchase.

2. Sequence When Purchasing a New Policy

IRC Sec. 2035 will cause estate tax inclusion for an individual who had transferred, or relinquished a power over, life insurance within 3 years before death. Therefore, if the insured purchases a policy and thereafter transfers it into an ILIT, the 3-year rule attaches. The better sequence will be for the ILIT to apply for, and purchase, the policy directly. If done this way, the rule won't attach, and the death benefit will be excluded from the estate regardless of how long the insured survives after the purchase date.

3. Paying the Trustee and Other Fees/Expenses

Clients often make gifts into the ILIT sufficient to pay the premiums on the insurance, but then it comes time to pay a trustee fee, accounting fee, or other trust expense. Since there are no funds in the trust, clients may wish to pay such costs directly, but doing so will be a gift tax event and should be avoided. This is because the value of the expense paid directly will be deemed first to have been given into the trust for gift tax purposes.

4. The (*Crummey*) Right of Withdrawal

Many times, clients wish to avail themselves of the gift tax annual exclusion for contributions into an ILIT to pay premiums. To accomplish this, the gift must be a present interest. In a court case about 40 years ago, it was determined that if the beneficiaries could withdraw their pro rata share of a gift, the transfer would have a present interest and thus qualify for the annual exclusion under IRC Sec. 2503(b).[2] Failure to include a right of withdraw may be problematic and defeat the ability to offset the gift by the annual exclusion. (Note, of course, that the right can be attached to a gift and thereby inserted into the trust, if this problem is diagnosed.)

But many times even when included these provisions needlessly are drafted to be narrow in scope such that the trustee only may satisfy out of the actual funds gifted. The challenge here is that often the gifts are made only shortly before the premiums come due, placing the trustee in a fiduciary duty conundrum. A simple drafting tip, permitting the trustee to satisfy a withdrawal right out of any trust asset, would alleviate this problem.

Granting a (time-limited) right of withdrawal creates another issue—the tax consequences when the holder of the power (the trust beneficiary) allows it to lapse. This is because the power to withdraw is a general power of appointment, and the lapse of a general power is a taxable event to the extent the value exceeds the greater of 5 percent or $5,000 annually.[3] In addition to the existence and scope of the withdrawal right, there thus is the need to provide for the situation when the gift exceeds the 5 and 5 power. Otherwise, a gift occurs to the extent the lapse (and note that the IRC treats lapses differently from releases) of a power that is greater than the larger of 5 percent of the assets that can be used to satisfy the right (i.e., the trust principal), and $5,000. Therefore, trusts should include hanging powers. These powers provide that to the extent the annual gift exceeds the 5 and 5 limitation, the withdrawal right does not lapse but is suspended and accrued, to be available (or absorbed) in the future (often when the principal of the trust grows large enough so that the 5 percent is in excess of the annual exclusion). So hanging

powers must be included to avoid a gift event by the trust beneficiaries, and someone must keep proper records to reconcile the amounts in the future.

5. Requiring the Payment or Reimbursement of Estate Taxes

If the ILIT contains a provision that obligates the trustee to pay the estate taxes of the decedent, or to reimburse the estate for such taxes, the death benefit will be included in the estate.[4] However, if the trustee merely has discretion to reimburse the estate for taxes, then the death benefit will remain outside the estate.[5] Of course, the IRS could challenge such discretion on the basis of a prearrangement or similar bad facts.

6. Hoping for the Best about Grantor Trust Status

A grantor is treated as owner of any portion of a trust whose income, without the approval or consent of any adverse party, is or in the discretion of the grantor or nonadverse party, may be applied to the payment of premiums for life insurance policies on the life of the grantor or the grantor's spouse.[6]

- The grantor is taxed on any trust income actually used to pay premiums on policies on the life of the grantor or the grantor's spouse.[7]
- Despite very broad wording of IRC Sec. 677(a)(3), however, cases have imposed restrictions on grantor trust status merely because of the power to pay life insurance premiums. For example, if the trust does not actually own a life insurance policy on the grantor's life, one case concluded that the mere power to purchase an insurance policy and to pay premiums from income would not be sufficient to cause grantor trust status.[8]
- Even if the trust owns policies on the grantor's life, some cases have concluded that the grantor will merely be treated as the owner of so much of the income as is actually used to pay premiums [e.g., *Weil v. Commissioner,* 3 T.C. 579 (1944), acq. 1944 C.B. 29].

Of course, the most common form of power used to provide grantor trust status for income tax purposes is the swap or substitution power under IRC Sec. 675(4)(C). But for many, there is a fear that a swap power will be deemed an incident of ownership triggering estate tax inclusion. This conundrum has set many ILITs adrift for income tax purposes—unnecessarily. If there will be other assets in the trust generating income, and if your client wants assurance of grantor trust status, it is quite possible to insure the same through the use of the swap power. The original swap power blessing came from the Treasury Department in Rev. Rul. 2008-22, but greater assurance was provided 3 years later when the Treasury Department gave specific guidance that a swap power over life insurance is not an incident of ownership (so long as the other requirements of a qualified swap power are met).[9]

Conclusion

Illiquid estates and estate taxation are often what catapults estate planning clients into purchasing life insurance. The process should not be navigated without an expert in the various types of product and guidance on the most efficient way to finance it. But the need for advice does not stop there. In spite of the fact that ILITs have been used for decades, there remain serious traps in their construction and administration that will undermine achieving your clients' goals.

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(1) IRC Sec. 2042.

(2) *Crummey v. Commissioner,* 397 F.2d 82 (9th Cir. 1968).

(3) IRC Sec. 2041(b).

(4) IRC Sec. 2042, IRC Sec. 2041.

(5) PLR 142721-01 (2001).

(6) IRC Sec. 677(a)(3).

(7) Treas. Reg. §1.677(a)-1(b)(2).

(8) *Corning v. Commissioner,* 104 F.2d 329 (6th Cir. 1939).

(9) Rev. Rul. 2011-28.

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