WRMarketplace

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Inserting Flexibility into Irrevocable Life Insurance Trust Planning.

MARKET TREND: Recent private letter rulings involving trust-to-trust policy sales seem to indicate that the IRS may allow strategies that can offer some flexibility in "irrevocable" trust planning. Other techniques, such as trust decanting or grantor substitution powers, also may assist in adapting irrevocable plans to changed circumstances, assuming they are authorized under the trust instrument. Clients should understand the potential options for restructuring irrevocable insurance plans and the importance of a properly drafted trust agreement to take advantage of those options, if needed in the future.

SYNOPSIS: Death benefits paid under a life insurance policy generally are not subject to income tax, except when there is a so-called "transfer for value" of the policy. Then, death benefits received in excess of the consideration and subsequent premiums paid for the policy are subject to tax, with limited exceptions. In a recent private letter ruling, the IRS ruled that the proposed sale of a second-to-die life insurance policy from one irrevocable life insurance trust ("ILIT") to another would qualify for various exceptions to this transfer for value rule, since the insured husband was the grantor of the recipient ILIT for income tax purposes and a partner of the insured wife in an existing partnership. Thus, the treatment of death benefits paid under the policy without imposition of income tax upon the surviving insured's death would be preserved.

TAKE AWAYS: Insurance planning with ILITs inherently involves some limits on the ability to make future modifications. Fortunately, although not precedential guidance, this and other recent private letter rulings suggest a road map for adjusting an insurance plan to accommodate changing family needs and circumstances without jeopardizing the tax treatment of the policy death benefits. Such strategies, however, require strict compliance with the Code, properly drafted trust agreements, and accurate policy valuations to avoid both potential income and transfer tax exposure. They also must address non-tax issues, such as fiduciary considerations for trustees when trusts are involved. Thus, an experienced team of qualified insurance, tax, and legal professionals are critical to successfully navigating the process.

PRIOR REPORTS: 12-47; 11-105; 08-54; 07-23; 94-37.

MAJOR REFERENCES: *PLR 201332001.*

Following a trend in taxpayer-favorable private letter rulings on this issue, the IRS recently held that a proposed sale of a second-to-die life insurance contract from one irrevocable trust to another would qualify for various exceptions to the transfer for value rule, thus preserving the nature of death benefits paid under the policy without imposition of income tax. This private ruling trend provides some comfort that, with careful planning, clients can adjust insurance plans involving irrevocable trusts to adapt to major and unexpected changes in family circumstances or needs.

THE TRANSFER FOR VALUE CONCERN

Although death benefits paid under a life insurance policy generally are received by the beneficiary without imposition of income tax, Internal Revenue Code ("**Code**") § 101(a)(2) imposes income tax on the death benefits paid under a policy transferred for value, to the extent the death benefits exceed the consideration and subsequent premiums paid for the policy. Exceptions exist for transfers of a policy:

- To the insured;
- To a partner of the insured ("**insured-partner exception**");
- To a partnership or corporation of which the insured is a partner or shareholder, respectively; and
- In which the transferee takes the transferor's basis, in whole or in part (*e.g.*, as with a gift).

Transfers of a policy designed to address changed circumstances, such as from one trust to another with more preferable terms, may run afoul of the transfer for value rule if not carefully crafted to fall under at least one of the above exceptions.

PLR 201332001

Husband ("**H**") and wife ("**W**") created Trust 1, an irrevocable trust that purchased a survivorship policy insuring H and W (the "**Policy**"). Upon the death of the survivor, the trustee must distribute the trust principal (including the death benefits) outright to the beneficiaries. Subsequently, one of the beneficiaries developed an incapacitating disability. H then created Trust 2, an irrevocable trust, which H represents is a wholly-owned grantor trust with regard to him for federal income tax purposes. Trust 2 benefits the same beneficiaries as Trust 1 but provides that, after the death of the survivor of H and W, the trust principal will be held in perpetual trust, with a special needs provision included for the incapacitated beneficiary.

H wants Trust 2 to purchase the Policy from Trust 1 for an amount equal to the Policy's interpolated terminal reserve value, plus any unapplied premiums (relying on the valuation method provided in Treas. Reg. §25.2512-6). H will obtain this value from the carrier as of the date of sale. After the sale, Trust 2 will become the Policy's beneficiary. The private letter ruling also notes that H and W established and currently own interests in a separate partnership that holds several investment properties.

H, as taxpayer, solely requested a private letter ruling that the sale of the Policy from Trust 1 to Trust 2 would not constitute a transfer for value for income tax purposes or would fall under the exceptions to the transfer for value rule.

RULING – EXCEPTIONS TO TRANSFER FOR VALUE APPLY

The IRS ruled that the sale of the Policy from Trust 1 to Trust 2 was a transfer for value but was excepted in its entirety from application of the transfer for value rule based on the following:

- The sale of the portion of the Policy insuring H qualified as a transfer to the insured, since Trust 2 is a wholly-owned grantor trust with regard to H, and thus disregarded for income tax purposes;[1] and

- The sale of the portion of the Policy insuring W is being transferred to H as a partner of the insured, since H and W are partners in a partnership. (Note that application of this exception also relies on the grantor trust of Trust 2 with regard to H, since a non-grantor trust would not have qualified as a partner of W unless it directly held an interest in the partnership).

WHY THE PLR MATTERS

Planning Flexibility. Irrevocable trusts offer estate tax and creditor protection benefits but somewhat restrict future planning flexibility. A trust reformation or decanting, if available in the given jurisdiction, may generate significant expense, require judicial proceedings and/or cause litigation, and create tax uncertainties. Thus, a trust-to-trust policy sale may offer a more practical method for clients to modify an irrevocable plan while preserving irrevocable trust benefits. PLR 201332001, combined with other recent rulings (like PLR 20123506, as covered in *WRMarketplace* 12-47) provide non-binding guidance on how to implement such a sale without income or estate tax exposure.

Combination of Transfer for Value Exceptions. PLR 201332001 allows the taxpayer to combine exceptions to the transfer for value rule to protect policy death benefits in their entirety. Accordingly, clients and advisors can structure trust-to-trust policy sales that take advantage of multiple exceptions to the transfer for value rule to avoid potential income taxation of the benefits.

Transfer of a Survivorship Policy to a Single Grantor Trust. Unlike PLR 20123506 (which dealt with a single life policy), PLR 201332001 not only illustrates how to transfer a survivorship policy, but also how to make the transfer to a trust where only one insured is the grantor.

CRITICAL ISSUES NOT ADDRESSED

Policy Valuations and Estate, Gift and GST Tax Issues

- Ascertaining a policy's fair market value is critical when selling or transferring an existing policy to or from an ILIT. An inaccurate valuation can create gift tax exposure as well as generation-skipping transfer ("**GST**") tax exposure if the sale is to a GST-exempt trust to which insufficient GST tax exemption was timely allocated. There could also be estate tax issues if an inaccurate valuation results in a partial gift, creating the possibility of estate inclusion of the Policy proceeds if the insured taxpayer dies within three years of the transaction.

- PLR 201332001 merely notes the use of a sales price based on the Policy's "replacement value" as determined under Treas. Reg. §25.2512-6 (*i.e.*, interpolated terminal reserve, plus any unapplied premiums),[2] but the taxpayer did not request any ruling on the potential estate, gift, or GST tax issues. Another recent private ruling (PLR 201235006), however, did allow

the use of the replacement value in a policy sale and held that it would not raise income or estate tax issues. That private letter ruling may support the argument that a policy sale at replacement cost would be a bona fide sale for "full and adequate consideration" as needed to avoid the estate inclusion of death benefits from a gift of a policy made within three years of an insured's death.[3]

- Note that some carriers provide multiple policy values when responding to valuation requests (*e.g.,* replacement costs, "PERC" values, etc.). Advisors should initially obtain preliminary, verbal quotations before a carrier issues a final policy value and work closely with a carrier's advanced sales or legal department to ensure final reporting of an accurate value.

- Trustees in policy sales also must consider their fiduciary obligations in agreeing to a specific policy sale price or to transferring a policy to a trust with significantly different terms. Professional trustees especially in particular, may be very conservative regarding any actions that could create fiduciary liability. Thus, trustees should document the fiduciary considerations in implementing the sale and why a particular policy value was used (*e.g.,* based on IRS guidance and to preserve beneficial tax treatment for the policy proceeds).

Grantor Trust Creation

- PLR 201332001 did not address how or why Trust 2 was a wholly-owned grantor trust with regard to the taxpayer but appears to merely rely on his representation.

- As contained in its list of "no-rule" areas (see Rev. Proc. 2013-3), the IRS continues to avoid direct rulings on whether certain powers (*e.g.*, power to pay premiums for insurance on the grantor's life, power to use trust assets to make loans to the grantor, grantor's non-fiduciary power to substitute trust assets, etc.) will cause a grantor to be deemed the owner of a trust for income tax purposes.

- Here, however, grantor trust status was crucial to application of the various exceptions to the transfer for value rule. Thus, a conservative approach in creating a grantor trust designed to receive the transfer of an existing policy would use a combination of powers (such as the power to pay premiums on a policy insuring the grantor's life and a grantor's non-fiduciary power to substitute trust assets for assets of an equivalent value) to bolster a grantor trust position.

Requirements of Partnership for the Insured-Partner Exception

- PLR 201332001 notes that H and W were partners in a partnership that held investment property but does not go into any discussion about whether the particular facts of that partnership played a role in its ruling (*e.g.,* that it served other investment, business, and/or non-tax purposes apart from taking advantage of the insured-partner exception to the transfer for value rule). Thus, the IRS may scrutinize the creation of a partnership solely for purposes of avoiding the transfer for value rule, particularly if the partnership is created close in time to any new trust designed to purchase an existing life insurance policy.

Trust Drafting Considerations

- ILITs, as with any irrevocable trust, must be carefully drafted to provide planning benefits and to preserve options for later adjustments, if needed. For example, the selection of the

trust's jurisdiction can impact whether the trust can decant its assets to another trust and the scope of that decanting ability (*e.g.*, what changes in trust terms are permissible). The choice of trustee and the ability to remove and replace trustees can be particularly important for flexibility as well since some trustees, like professional and institutional fiduciaries, may be reluctant to take certain actions with regard to the trust for fear of liability. Decanting and grantor substitution powers also must be carefully crafted to follow applicable state law (in the case of decanting) and federal tax guidance (with regard to substitution powers). Given the above, a "cut and paste" ILIT agreement may not only limit future planning options but could result in unanticipated tax consequences.

TAKE-AWAYS

- Insurance planning with ILITs inherently involves some limits on the ability to make future modifications. Fortunately, although not precedential guidance, PLR 201332001 and other recent private letter rulings suggest a road map for adjusting an insurance plan to accommodate changing family needs and circumstances without jeopardizing the nature of policy death benefits without imposition of income tax.

- These strategies, however, require strict compliance with the Code and careful drafting of the ILIT agreements. Further, advisors and clients must address several other issues, including (1) obtaining accurate policy valuations, (2) reviewing potential estate, gift, and GST taxation, (3) ensuring grantor trust status for the purchasing trust, (4) ensuring implementation of the transaction in a way that will be respected by the IRS, and (5) finding trustees who are willing to address the potential fiduciary issues and accept any exposure resulting from the sale.

- The numerous tax and practical technicalities involved with trust-to-trust policy transfers emphasize the importance of working with an experienced team of qualified tax and insurance professionals to successfully navigate the process and implement the transaction.

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[1] Although not cited, the reasoning presumably relies on Rev. Rul. 85-13, which holds that a "grantor trust" is generally disregarded for federal tax purposes, and Rev. Rul. 2007-13, which holds that a sale from a non-grantor trust to a trust treated as a wholly-owned grantor trust with regard to the insured is a transfer for value but falls under an exception as a transfer of the policy to the insured, since the grantor trust is disregarded for federal tax purposes.

[2] An insured whose health is especially poor or whose death is imminent likely cannot use the interpolated terminal reserve plus unearned premiums for policy valuation.

[3] Note, however, that the IRS has ruled somewhat inconsistently on this issue. *See* PLR 8806004 ($1 million policy on a decedent's life was transferred within three years of his death for less than $1 million. The IRS ruled that the consideration was insufficient. Citing *U.S. v. Past* (347 F.2d 7 (9th Cir. 1965)) and *U.S. v. Allen* (293 F.2d 916 (10th Cir. 1961)), the IRS found that if a property interest that would be includible in the gross estate under the lifetime transfer rules is transferred before death, any consideration received for the transfer is not adequate and full unless it equals the value at which the property would have been included in the gross estate if it had been retained by the decedent) and FSA #632 (Sept. 3, 1993) (in a sale of stock in a corporation owning policies on the life of the seller/insured, in addition to other assets, to his daughter for "full and adequate consideration," the IRS noted that, under a "*Past/Allen* analysis," adequate consideration for the policies would be an amount equal to the proceeds payable at death). *But see* PLR 9413045 (Insurance policies from separate trusts of a husband and wife, which provided both with incidents of ownership over their respective policies, were sold to a single trust created by the husband and wife that did not produce such incidents of ownership. The IRS, citing the valuation standard for estate tax purposes (Treas. Reg. §20.2031-8), ruled that the interpolated terminal reserve plus unapplied premiums, was the full value of the policies for purposes of the "adequate and full consideration" exception).