Using Revenue Ruling 2007-13 to Fix Defective Insurance Trusts?

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The Grantor Trust rules of Internal Revenue Code Section 671 - 679 offer some interesting planning opportunities. For example, planners have long used "Income Defective Trusts" to take advantage of the differences between the income tax rules and the estate tax rules governing trusts. Such trusts are often designed to remove trust assets from the donor's taxable estate, while the donor remains responsible for the income taxes on the trust's taxable income. The IRS has even recognized the planning opportunities in this area. In Revenue Ruling 2004-64, the IRS ruled that a grantor's payment of the income taxes for his defective grantor trust was not a taxable gift to the trust, even though the payment of taxes by the grantor effectively added economic value to the trust.

With federal estate taxes affecting less than one (1%) percent of decedent estates (at least for a few more years), defective trust planning has taken a 180 degree turn. Increasingly, planners are considering the use of "Estate Defective Trusts" in which the trust income is taxable to the trust or its beneficiaries, while the trusts assets remain taxable in the donor's estate. Such trusts provide tax benefits which are similar to the old Clifford Trusts - which were effectively gutted in the mid-1980s by tax law changes. See: Scroggin, "Estate Defective Trusts," Taxes magazine, January, 2005.

In January 2007, the IRS issued Revenue Ruling 2007-13 (2007-11 IRB) which provided that in many instances, the sale of a life insurance policy from one grantor trust to another grantor trust would not violate the transfer-for-value rules and therefore does not result in the treatment of the insurance proceeds as ordinary income. While a number of PLRs had been issued on this topic in the past(e.g., PLRs 200228019, 200514001, 200514002), this was the first time a Revenue Ruling had directly addressed the issue. While many planners believed this was the proper interpretation of the tax code, the onerous income tax cost of being wrong caused most planners to avoid inter-trust sales between trusts, except in dire circumstances.

Before delving into the unexpected complexities of the Revenue Ruling, it is useful to examine the provisions of some of the applicable code sections:

- Code section 677(a) provides that *"the grantor shall be treated as the owner of <u>any portion of a trust</u>, ... whose <u>income</u> without the approval or consent of any adverse party is, or, in the discretion of the grantor or a non-adverse party, or both, may be...applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse..."*
- Code section 101(a) (1) provides that except in certain limited circumstances,

"*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."*

- Code section 101(a)(2)(B) provides that if there is a transfer for *"a valuable consideration, by assignment or otherwise, of a life insurance contract"* the proceeds of the policy are generally taxable as ordinary income unless the *"transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer."*

For years, planners have created irrevocable life insurance trusts ("ILITs") to move life insurance out of the taxable estate of the insured. Because the trust, not the insured, owns and controls the policy, the policy is kept out of the insured's state and federal taxable estate.

Although ILITs are often used by estate planners, that word "*irrevocable*" has created a lot of concerns for clients and practitioners over the years. Even though limited powers of appointment, trustee removal provisions and other trust terms can create significant flexibility in an ILIT, its fundamental irrevocablity can create problems when the expectations that occurred at the time of the creation of the trust are no longer valid.

For example, do you really want a belligerent ex-spouse as beneficiary of your life insurance trust? What happens when kids (who were three years old when you created the ILIT) have now gone bad and are strung out on drugs**?** There are a number of alternatives, including:

(1) The client can stop making payments on the policy. If it is a term policy, the policy will typically terminate within a year. If the trust has no other assets, it effectively will also terminate. If the insured is still insurable he can create a new policy in a new ILIT and start the process all over. But if the insured is uninsurable and/or the policy has a significant cash value, this approach is generally not viable.

(2) If permitted by the ILIT's terms, the trustee could distribute the policy to one or more beneficiaries. However, if the point of revising the insurance plan is to move the policy away from one or more beneficiaries (e.g., a wayward child or disgruntled ex-spouse), this may also not be viable.

(3) The trustees might sell the policy back to the insured/grantor. Assuming that issues of the policy's fair market value (see the discussion below) and arms length dealings can be overcome, this approach creates the problem that the life insurance proceeds are now includible in the donor's taxable estate for state and federal estate tax purposes. A subsequent gift of the policy out of the insured's hands, starts the running of a new three year rule under Code section 2035(a). Inclusion in the insured's estate may not be a gamble anyone wants to take.

(4) The trustees might sell the policy to a partnership or LLC in which the insured is a nominal, non-controlling partner. Code section 101(a)(2)(B) provides that the policy is cleansed from the transfer for value rules, but at least a percentage of the policy proceeds

will remain in the insured's taxable estate.

Revenue Ruling 2007-13 confirms that there is another device for moving the life insurance to a more desirable trust, without pulling the life insurance policy into the insured's estate, or causing the life insurance proceeds to be subject to income taxes. In the ruling, the Internal Revenue Service provided two simple fact patterns.

In the first situation, there were two trusts, "*both of which are treated as wholly owned*" by the grantor. The IRS ruled that the sale of a life insurance policy on the grantor from one trust to the other does not create a transfer for value under Code section 101(a)(2) because the insured/grantor *"is treated as owner of all assets of both trusts, including both the life insurance contract and the cash received for it.... accordingly there has been no transfer of the contract within the meaning of section 101(a)(2)*."

In the second situation, the original trust owning the policy was not a grantor trust that is wholly owned by the grantor. The ruling states that exchange of cash for the policy is "*a transfer of the life insurance contract for valuable consideration within the meaning of section 101(a)(2),*" but the transfer is treated as though it was made to insured/grantor (i.e., because the grantor is treated as wholly owning the purchasing trust) and therefore the sale did not create any transfer for value issues.

Effectively, this ruling confirms that within certain restraints, it is possible to fix defective ILITs. Clients can sell a life insurance policy from the old ILIT to a new ILIT. While the relatively short ruling appears to provide a quick and easy solution to the problem of a defective or out of date ILIT, it also carries a number of traps for the unwary. Among the traps are:

(1) Grantor Trust. The Revenue Ruling assumes that the trust which is the ultimate owner of the policy is "*treated as wholly owned by the grantor*." Look closely at section 677(a). A typical life insurance trust is treated as a grantor trust only for the portion of the trust whose income is used to buy life insurance on the grantor. It is not always *"wholly owned*" by the grantor. The Tax Court has taken the position that grantor trust status for income tax purposes does not exist unless the trust actually owns a life insurance policy on the grantor. Weil v. Comm'r, 3 TC 579 (1944), acq. 1944 CB 29.

To be "*wholly owned*" by the grantor other intentional violations of the 671-678 should occur. For example, one of the most common violations is to permit the grantor or another person to hold the non-fiduciary right to reacquire the trust corpus by substituting other property of equivalent value - a violation of Code section 675(4)©.

(2) Crummey Powers. Crummey powers are often used in ILITs to create"present interest" for purposes of the gift tax annual exclusion. Crummey withdrawal rights should be absolute and superior to any other power to truly qualify as a "present interest." But Crummey withdrawal rights can raise questions about who the deemed grantor is of the trust. Code section 678(a) provides that "*A person other than the grantor shall be treated*

as the owner of any portion of a trust with respect to which...such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself..."

The use of Crummey Powers in a defective trust raises the question of whether both the insured/grantor and the beneficiary are deemed co-owners of trust. See: Zaritsky & Leimberg, Tax Planning with Life Insurance: Analysis With Forms (WG&L), section 5.03(3)(k)(iii). It may be advisable to forgo Crummey Power (and expend some gift tax exemption) rather than raise the threat that the purchasing ILIT will not be treated as "*wholly owned by the grantor*."

(3) Fiduciary Breach. If the beneficiaries of each ILIT are not the same people or their benefits are significantly modified, each trustee of the original trust faces the question of whether the sale of that life insurance policy (and its diminution of the beneficiary's benefits) is a breach of fiduciary responsibility. This assertion of breach may be offset (particularly with term life insurance) by the trustees pointing out that they do not have the assets to continue to pay the premiums that would allow the policy to remain alive. Instead of retaining a lapsed policy, the sale preserves at least some assets in the original trust.

Each trustee may want to be indemnified by the insured/grantor who is probably the one promoting the transaction. Assuming it is a friendly transaction, it might also be worthwhile to have the beneficiaries (especially those who are losing benefits) irrevocably waive any claims or rights they might have against both the trustees and the insured. The insured/grantor may obtain this waiver by pointing out that "something is better than nothing" -the likely result if the insured does not continue to fund the policy in the first trust. Unfortunately, disinherited beneficiaries may not be moved by this argument.

(4) Fair Market Value. Both fiduciary responsibility and the "*full and adequate consideration*" requirements of section 2035(d) create the necessity of determining and paying the fair market value of the policy. But what is the true fair market value for the policy? Is it the interpolated terminal reserve value, some derivative of cash value, or are there other values that must be taken into account when the trustee is considering the sale?

Is the trustee breaching fiduciary duties if he or she does not offer the policy to one or more life settlement companies - who might pay more than the IRS determined values? Certainly if the insured's life expectancy is much shorter than what would otherwise be anticipated, the value of the policy may exceed the IRS values.

(5) Assets in the First Trust. If the policy has significant value, the sale will cause the sales proceeds to remain in the old ILIT. If the policy is a term policy, its value will generally be nominal. If the sale leaves significant cash in the ILIT, consider whether there is current right of distribution to the named beneficiaries. The proceeds might also be used to pay for some of the costs of the transaction.

(6) Taxable Transaction. Although Revenue Ruling 2007-13 may eliminate the issue of transfer for value on the sale between ILITs, if the original ILIT (which held the policy) is not a grantor trust, the sale of the policy could generate taxable income to the trust. If both trusts are grantor trusts a taxable sale will not occur because the grantor will be treated as though he sold the trust to himself.

(7) Step Transaction. Planners should also be wary of the potential application of the step-transaction doctrine. If a client creates the new ILIT and places money in the trust, immediately followed by the sale of the life insurance policy to the new ILIT, the IRS could argue that the creation of the new ILIT was nothing more than the indirect gift of the old life insurance policy, potentially triggering a new three year rule under Code Section 2035(a).

Planners would be wise to let some time elapse between the transactions and name different trustees in each of the ILITs who are exercising their own fiduciary responsibilities in each trust.

For clients with out of date ILITs, Revenue Ruling 2007-13 offers the opportunity of fixing the out-of-date or defective trusts. Some strong words of caution: maneuvering through this foggy area should not be attempted without a through understanding of the ambiguities and complexities of the differences between the income, estate and gift tax rules. Clients must be informed of the many uncharted regions in this planning area. While Revenue Ruling 2007-13 appears amazingly simple at first review - it carries a host of potential traps for the unwary.

Additional Resources on this Topic:

* Ratner, “How to Undo an ILIT if You Really Have to,” Trusts. & Estates, September 2006.
* Gans, Heilborn, & Blattmachr, “Some Goods News About Grantor Trusts: Revenue Ruling 2004-64,” Estate Planning Journal, October 2004.
* Huffaker & Kessell, “How the Disconnect Between the Income and Estate Tax Rules Created Planning for Grantor Trusts,” Estate Planning Journal, April 2004.
* Cushing, "Planning with Intentional Grantor Trusts," ALI-ABA Sophisticated Estate Planning Techniques, Boston, September 17, 1992.

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