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RECLAIM LIFE INSURANCE FROM YOUR INSURANCE TRUST? NOW YOU CAN!

Earlier this month, the IRS officially ruled that the existence and/or exercise of an insured's right to (re)purchase an insurance policy from his or her life insurance trust does not cause the policy proceeds to be subject to estate tax.

Individuals typically create and fund irrevocable life insurance trusts for the purpose of removing life insurance proceeds from their taxable estates. If an individual at death owns an insurance policy on his or her life, or has "incidents of ownership" in the policy, the proceeds will be includible in the individual's estate for estate tax purposes, even though the proceeds are paid directly to designated beneficiaries by the insurance company. Unless an exemption or deduction is applicable to those proceeds, they will be subject to Federal, and possibly state, estate taxes.

"Incidents of ownership" in a life insurance policy are rights to the economic benefits of the policy, including the power to name and change the beneficiaries; the power to assign, surrender or cancel the policy; and the power to access policy value by borrowing against it from the insurance company or pledging the policy for a third-party loan.

To avoid estate inclusion, individuals often will transfer ownership of policies on their lives to others. For example, a husband may assign a policy on his life to his wife or to his children. So long as the ownership transfer is complete and the husband does not retain any rights with respect to the policy, the proceeds will be excluded from his estate upon his death (subject only to a 3-year survival requirement for assignments by gift). To be clear, in order avoid estate taxes on the policy proceeds, it is critical that ownership itself is transferred so that the insured no longer has any continuing rights in the policy (including the power to change the beneficiaries); it is not sufficient merely to designate family members or others as beneficiaries of the policy.

A common strategy recommended to clients by professional advisors is for the insured to transfer ownership of life insurance policies to an irrevocable trust. In the most efficient plans, the trust is created even before the insurance is purchased and the

insured arranges for the trustees to purchase the policy from the insurance company in the first place. The trustees then designate the trust as the beneficiary to receive the policy proceeds upon the insured's death. Since at the insured's death, the trust, and not the insured, owns the policy, the proceeds may be excluded from the insured's taxable estate. To the extent that the policy proceeds are intended to provide liquidity to pay estate taxes on the insured's other assets, the trust can make funds available to the estate (such as by lending to, or purchasing assets from, the estate) for that purpose.

Advisors know to be especially careful when structuring insurance trusts in order to avoid any potential IRS argument that an insured retained "incidents of ownership" in a life insurance policy held through a trust. The "incidents of ownership" standard has been more strictly applied than the principles that determine whether other assets are includible in a client's estate for estate tax purposes. As a result, the scope of trust powers which advisors will allow clients to retain with respect to an insurance trust is far more limited than for a trust holding other assets.

For example, trustees of an insurance trust typically will not be given the power to make loans to the insured (even at market rates), the insured will not be allowed to remove and replace the trustees of the insurance trust, and, until now, the insured would not be given the power to purchase, or reacquire, assets (including insurance policies) from the trust. These are all powers that a client may safely retain over a trust designed to hold assets other than life insurance.

Because of these restrictions, estate planning with certain types of life insurance policies has, historically, been more complicated. Clients may be reluctant to give up "incidents of ownership" with respect to insurance policies that accumulate cash value, because they want the ability to access the cash value should they ever need the liquidity it can provide, whether for business or personal reasons. Indeed, many whole life and other cash value policies are sold to clients on the premise of personal savings and investment, and the promise of access to policy cash value. Now these advantages may be reconciled with estate planning goals.

In Revenue Ruling 2011-28, published on December 5, the IRS held that an insured's retention, in a non-fiduciary capacity, of the power to acquire life insurance policies from his or her irrevocable life insurance trust by substituting other assets of equivalent value is not, by itself, an "incident of ownership" in the policies. In the Ruling, the IRS equated life insurance with other assets with respect to the power to substitute assets. The IRS stated that so long as the power may only be exercised in an arms' length manner – that is, the assets substituted by the insured are equal in value to the policy

or policies withdrawn from the trust (and a few other requirements are met), the existence of the power and the insured's exercise of the power will not result in adverse estate tax consequences. Estate planning professionals have long argued that this should be the correct result, but practitioners were disinclined to draft trust agreements which provided the insured with a power to substitute assets until the IRS formally agreed with the conclusion.

In light of this Revenue Ruling, there is now more flexibility for an insured to reclaim and access the value of a life insurance policy from an insurance trust, provided the trust is drafted properly to include a power to substitute assets. If an insured desires to borrow against cash value to meet liquidity needs, the insured can simply purchase the policy from the trust at its current value and assign to the trust illiquid personally-held assets in payment of the purchase price. Then, later, when personal liquidity is restored and the loan repaid, the insured can return the policy to the trust and recover the illiquid assets previously sold to the trust. In each of these transactions, accurate valuation of the assets involved in the swap (including the life insurance policy) in accordance with applicable IRS rules will be critical to a successful transaction and to the avoidance of tax risk.

To the extent that an insured has an existing life insurance trust that does not include a substitution power, it may be possible to retrofit the trust for this new flexibility notwithstanding the trust's irrevocability.

We are available to advise our clients in determining whether and to what extent this Revenue Ruling is meaningful to their particular situation, or to discuss any other estate planning matter.

The above material was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. Federal tax law.

Happy Holidays!