Finseca Report
Marketplace

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Life Insurance Mistakes that Keep Attorneys Up at Night – Looking Back at 2021

2021 was a strange and difficult year in the estate and tax planning field, particularly when planning with life insurance. Between COVID-19, which resulted in the sudden death of those who were young and healthy as well as those who were older but also not considered close to death; proposed legislation that threatened to change the whole estate and tax planning world which particularly affected ILITs; the potential loss of the Federal estate tax exemption (which, frankly, seems to be the case every year); and finally, general client fatigue over having to once again review estate plans, not due to changes in family circumstances but rather, due to changes in the law, 2021 was not an easy year for clients, advisors, and estate and tax practitioners alike.

Due to the concerns raised by these various factors, and in the rush to address and mitigate potential consequences before they came into existence, practitioners, advisors, and clients all made decisions and took actions which, in retrospect, may not have been most advisable, were just plain mistakes, or failed to plan for the problems that these actions had potential to cause in the future, regardless of whether any of the concerning factors came to fruition. This article describes many of these "mistakes" which occurred due to rushed planning and may serve as a warning if we are (and we will be) faced with similar situations in the future.

Mistakes that Trigger Gift Tax

During the fall of 2021, proposed legislation concerning grantor trusts created uncertainty over whether life insurance could continue to be held in ILITs as a means of keeping the policy outside of a client's taxable estate. As a result, the ownership of the policy (whether new or existing) and beneficiary of the

policy became particularly important. Where an individual is named the beneficiary of the policy, and no successor individual, trust, or other entity is identified as the contingent beneficiary, if the named beneficiary predeceases the insured, the policy death proceeds will be payable in accordance with the default terms of the policy, which is usually to the estate of the insured. However, naming multiple individuals (such as the insured's children) as the owners of a life insurance policy also may not be desirable due to potential gift tax consequences. Unlike gifting to an insurance trust where withdrawal powers allow gifts to qualify for the Federal gift tax annual exclusion amount, when gifting a policy (or premiums by paying the insurer directly) to a group of individuals (i.e., the children), there is a risk that the gift will not be considered a present interest gift to each of them for purposes of qualifying for the Federal gift tax annual exclusion, since the children would all need to act together in order to exercise their ownership rights. In any event, problems will arise if one owner dies, divorces, goes bankrupt, or becomes incompetent before the insured's death, or one owner merely decides not to contribute his or her share of the premiums.

In personal insurance planning, any time an insurance policy has two or more parties involved as owner, insured, and beneficiary, there is a potential for an inadvertent gift by the policy owner of the entire policy proceeds at the insured's death. In circumstances where an insurance trust is not necessary or advisable, oftentimes insureds will designate a spouse as owner, and children as beneficiaries. This strategy is problematic, however, as evidenced by the holding in *Goodman v. Commissioner.*[1/] In *Goodman,* upon the insured's death, the surviving spouse who owned the policy was considered to have made a gift of the entire policy death proceeds to the children, since, as the owner, the spouse could have designated herself as the beneficiary.

Mistakes that Trigger Income Tax

Another potential problem that arises in personal insurance planning is the creation of phantom income by surrendering a policy (or letting a policy lapse) which was subject to an outstanding loan. In light of the 2021 proposed tax law changes affecting grantor trusts, surrendering a policy held in an insurance trust may have been a knee-jerk reaction in order to avoid potential consequences of the proposed legislation. However, aside from the fiduciary issues in doing so, any amount received in a single sum under a life insurance contract on its complete surrender, redemption, lapse, or maturity is includible in the gross income of the policy owner (i.e., the trust), as ordinary income to the extent that that amount exceeds his or her "investment in the contract",[2] a basis-like concept. Since an ILIT owning a policy is

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1/ Goodman v. Commissioner, 156 F.2d 218 (2nd Cir. 1946).

2/ Code Section 72(e)(5)(a) and (3); Treas. Reg. Sec.1.72-11(d)(1).

likely to be a grantor trust, the income tax consequences of surrendering the policy would be attributable to the insured. For purposes of the income tax calculations, “investment in the contract” is the aggregate amount of premiums or other consideration paid for the contract, less any amount received under the contract, to the extent that amount was excludable from gross income (such as dividends received on a participating policy or withdrawals from a universal life insurance policy, so long as they don’t exceed basis).[3]

Another factor that may trigger income tax consequences is the existence of a policy loan at the time of the surrender or lapse of a policy. Under Treasury Regulation Section 1.1001-2(a), the amount realized from a sale or other disposition of property (including a life insurance policy) includes the amount of any nonrecourse liabilities from which the transferor is discharged (such as the policy loan) as a result of the sale or disposition. Accordingly, any policy loan will be a part of the consideration received by the taxpayer on a policy surrender or lapse, generating ordinary income[4/] – without generating any cash in the case of a lapse, or potentially not enough cash to pay the tax, in the case of a surrender. Further, if the Trustee of an ILIT decided to distribute (rather than surrender) the policy to the trust beneficiaries as a means of avoiding the pending legislation, and had in the past borrowed against the policy to pay premiums, then borrowing against a policy in excess of the owner’s income tax basis and then transferring the policy subject to the loan as a gift to a new owner will result in taxable income to the trust and, as a grantor trust, to the insured.

Mistakes When Transferring a Policy

Setting aside the potential tax law changes that would affect grantor trusts, many advisors continued to plan for the proposed reduction in the Federal estate tax exemption, including to remove as many assets from a client’s taxable estate as possible. Accordingly, any life insurance policies owned by the insured or insured’s spouse (and all incidents of ownership thereon) would be transferred to an irrevocable trust by gift or by sale.

Often a sale from an insured to an ILIT may be preferable to gifting the policy because of the three-year estate inclusion rule under Code Section 2035. If the insured owns a policy on his or her life, a gift of the policy to an ILIT of all of his or her incidents in ownership in the policy will result in the inclusion of the death proceeds in the insured’s gross estate, if the insured dies within three years of the gift. Fortunately, there is an exception to this rule, if the policy is sold for adequate and full consideration.

3/ Code Sections 72(c)(1), 72(e)(6).

4/ See Barr v. CIR, T.C. Memo 2009-250, involving a surrender of a policy subject to a loan, in which the Tax Court rejected the taxpayer’s argument that gain on surrender should be capital. See also Reinert v. CIR, 2008-163 T.C. Summary Opinion, holding that gain on cancellation of a policy (lapse) was ordinary.

One caveat to the potential for a tax-free transfer of a life insurance policy from the insured to an ILIT by sale is that the sale must qualify for an exception to the transfer for value rule of Code Section 101(a)(2), otherwise the death proceeds in excess of the transferee's policy basis would be ordinary income to the beneficiary. If the insured sells the policy to an ILIT which is a grantor trust with respect to the insured, it is treated as a sale by the insured to himself or herself, and accordingly, is a non-taxable event. Thus, the insured's basis in the policy becomes the grantor trust's basis, qualifying for the carryover basis exception to transfer for value under Section 101(a)(2)(A).[5/] If, however, if the ILIT is not a grantor trust with respect to the insured, the ILIT must be a transferee which is exempt from the transfer for value rule, such as where the ILIT is a partner of the insured,[6/] but even in that case, a sale to a non-grantor trust, even though within a transfer for value exception, would be a taxable event and could result in a gain to the insured seller.

In the case of a gift of the policy rather than a sale, errors often arise when it comes to valuation of the policy for gift tax purposes. Under the Section 2512 Regulations,[7/] the gift tax value of a policy transferred during the insured's lifetime is determined by its "replacement" cost, the cost of a "comparable policy". However, applicable regulations recognize that for a policy that has been in force for some time (an undefined term) on which future premiums are due, obtaining the cost of a comparable policy would be difficult; accordingly, the regulations provide that, in this situation, the cost of a comparable policy <u>may</u> be (not <u>must</u> be) <u>approximated by</u> the so-called interpolated terminal reserve ("ITR") formula – the policy's ITR plus any prepaid premiums, which eliminates the need to consider the insured's age or health. As a result, in certain circumstances, consideration should be given to obtaining an actual appraisal or life settlement value to determine a policy's fair market value, based on a willing buyer/willing seller analysis.

While technically only traditional whole life policies allow for the calculation of ITR (because only they have stated cash values which increase at stated rates and fixed premiums), the ITR formula is used by carriers in reporting the gift tax values of policies transferred during the insured's lifetime, on a Form 712, for universal and variable policies (which don't have fixed premiums or stated cash values which increase at stated rates). Historically carriers only reported the gift tax value on Form 712, though more recently, some carriers have begun to report a series of possible values for a policy transferred during the insured's lifetime, including the policy's cash or accumulation value, its cash surrender value, its ITR value and its PERC value (a calculation required for transfers of policies in some income tax situations by the 2005 regulations issued under Section 83). Most carriers have determined that a policy's "fair market value" is a legal issue to be determined by counsel for the policy owner and its only role is to provide the range of values for counsel.

The warning here is that the fair market value of a policy for gift tax purposes may be significantly higher than its cash surrender value – for example, both no-lapse guarantee universal life policies and level term policies may literally have a zero cash surrender value, but a very large ITR value – the only way to know what the policy's potential gift tax value is to request a Form 712 from the issuing carrier, <u>before</u> the policy is transferred.

[5/] Rev. Rul. 2007-13, 2007-1 C.B. 684, in addition, under Situation 2 of the Ruling, the sale would be treated as if made to the insured, qualifying foranother transfer for value exception.

[6/] Section 101(a)(2)(B).

[7/] Reg. Sec. 25.2512-6.

Mistakes in Drafting Insurance Trusts

Why were ILITs a particular problem under the proposed legislation? It is often advantageous to have an ILIT be a grantor trust, so as to avoid transfer for value issues, avoid gain on sales to or from the settlor, avoid interest income on loans to or from the settlor, and depletion of trust assets by the trust paying its own income taxes, but sometimes the grantor does not want to be taxed on the trust income, despite the possible advantages. Where a trust has significant income-producing assets in addition to the life insurance policy on which the grantor would like to avoid a tax burden, or if the proposed legislation had passed, the ILIT would need to be drafted to avoid the grantor trust triggers of Sections 671-677. The most likely grantor trust trigger for an ILIT is the ubiquitous Section 677(a)(3) provision.

Section 677(a)(3) provides that an ILIT is a grantor trust to the extent trust income must be applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, so long as the policy is not irrevocably payable to a charity, or may be so applied and the application of the income does not depend upon the approval of an adverse party. If the ILIT is silent about payment of premiums with trust income, state law will probably authorize the trustee to make such payments, resulting in a grantor trust, but what if the ILIT prohibits the use of income to pay premiums and instead they are paid with principal or contributions to the trust? In the case, *Rand v. Commissioner* it was implied that, even if the trust prohibited the use of income to pay premiums, the breach of trust by the trustee who uses trust income to pay premiums would not prevent grantor trust status treatment.[8] Also, PLR 8839008 involved an ILIT which prohibited applying "trust income" to payment of premiums, but the IRS held that the trust was a grantor trust, since it construed the document as referring to accounting income and not taxable income.

Possible ways to ensure that an ILIT will be a non-grantor trust are for the ILIT to be drafted so that either income is automatically distributed to the beneficiaries upon receipt, or that income is segregated in a separate accrued income account which cannot, under the terms of the trust, be used to pay premiums. To avoid the rationale of PLR 8839008, the prohibition should expressly apply to taxable income. Another, and perhaps the best way to ensure that the ILIT won't be treated as a grantor trust under Section 677(a)(3) is to require that any discretionary use of trust income to pay premiums on a policy on the life of the grantor or the grantor's spouse be consented to by an "adverse party" as described in Code Section 672 – a trust beneficiary whose interest would be affected by such a use of trust income – and then not actually use trust income to pay premiums (or, preferably, get such an ongoing consent to do so).

Toggling-off grantor trust status of an existing ILIT is problematic because the Section 677(a)(3) power to use trust income to pay premiums is a power which cannot be given up by the grantor (since it isn't retained) nor by the trustee (since it would be a breach of trust, because it would impose a tax on the trust or its beneficiaries, which had been being paid by the grantor). Accordingly, if it is possible, based

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8/ Rand v. Commissioner, 40 B.T.A. 233 (1939), aff'd, 116 F.2d 326 (8th Cir. 1941).

on the planned funding of a trust, that is would be desirable to turn off grantor-trust status, then Section 677(a)(3) should be negated by requiring the discretionary use of trust income to pay premiums must be consented to by an adverse party (such as a beneficiary). Another grantor trust power, such as a swap power (held in a non-fiduciary capacity)[9] or a power to borrow without adequate security, both of which, as retained powers, could be given up by the grantor, if desired, could be used instead.

Another issue that arises when drafting an ILIT without sufficient forethought is the failure to include flexibility in the so-called Crummey powers. If the Crummey power provisions are drafted to apply only to gift transfers to an ILIT, the IRS could argue that premium payments directly to the life insurance carrier, while constituting an indirect taxable gift to the ILIT, do not trigger the Crummey power, since the premium was not actually given to the ILIT. However, at least for ILITs funded with group term policies, where the employer paying the premium directly to the insurance company, the IRS has approved Crummey powers which expressly applied to indirect gifts of premiums to the ILIT.[10/] Further, in Turner v. Commissioner,[11/] the Tax Court held that the Crummey withdrawal power were not illusory merely because the premium were paid directly to the carrier since the ILIT expressly provided that the power applied to "each direct or indirect transfer to the trust." In light of these potential issues, ILITs should be drafted to apply Crummey withdrawal powers to any "direct or indirect" gift transfers and, that premiums, if at all possible, should be funneled through a bank account of the ILIT and held for some period of time to support the presumption that the beneficiaries could actually exercise their withdrawal rights, if desired.

Conclusion

The events and proposed legislation of this past year created a level of uncertainty that opened the door for advisors and practitioners to recommend, and clients to implement, types of planning that, if viewed objectively, were rash and may end up putting the client in a worse position regardless of whether certain legislation passes. As 2021 was not the first year that proposed legislation caused a flurry of reactive planning (or proactive planning depending on how you view it), and certainly will not be the last, it is important to remember these common insurance planning mistakes that can carry significant consequences.

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[9] See Rev. Rul. 2011-28, 2011-49 IRB 830, holding that such a power, if appropriately limited, is not a retained Section 2042 power.

[10/] PLR 813074 ("contributions directly or indirectly transferred"). PLR 8138102 ("premiums…which are paid, by the settlor or any other person, rather than being paid to the trustee"). PLR 8138170 ("contributions…including…any premiums…that are paid by the taxpayer or any other person directly to the insurance company").

[11/] T.C. Memo 2011-209.

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