WRMarketplace
An AALU Washington Report

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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: Avoiding Incidents of Policy Ownership to Eliminate Estate Tax.

MARKET TREND: As planning approaches and products become more complex, care must be taken to avoid the retention or acquisition by the insured of powers over the policies that would cause the proceeds to be included in the insured's estate at death. Product sophistication using long term care riders and investment approaches with high cash value products has increased the array of planning options, offering insureds more flexibility but higher risks as well.

SYNOPSIS: Life insurance proceeds will be included in the insured's estate for federal estate tax purposes if, at death, the insured has any right to the economic benefits, so-called incidents of ownership, in the policy, even if the insured does not actually own the policy. "Incidents of ownership" include the power, directly or indirectly, to change the beneficiary or the contingent beneficiary, surrender or cancel the policy, assign the policy or to revoke an assignment, pledge the policy as collateral for a loan, and obtain a loan from the carrier against the surrender value of the policy. In order to avoid inclusion of the proceeds in the insured's estate, the insured must avoid holding any and all such incidents of ownership, even if attributed indirectly. For example, if the insured holds a controlling interest in a corporation that owns policies on the insured's life, the proceeds will be included in the insured's estate to the extent the proceeds are not payable to or for the benefit of the corporation. Policies purchased with community property funds also may cause both spouses to have incidents of ownership in the policies. Second-to-die policies may give both insureds incidents of ownership and generally should not be transferred to an ILIT of which one of the insureds is a beneficiary

TAKE AWAY: Inclusion of life insurance death benefits in the insured's estate will occur if the insured holds any incidents of ownership in the policy. "Incidents of ownership" encompass far more rights than actual policy ownership, including the ability to name policy beneficiaries or pledge a policy for a loan. In addition, incidents of ownership may be attributed to an insured indirectly depending on the acquisition or ownership structure, such as with a corporate-owned policy where the insured is a majority shareholder, or a trust-owned policy where an insured is a trustee of the trust. Thus, advisors can add value to the services they provide by helping clients identify situations where the insured may have retained or may acquire an incident of ownership

and reviewing alternatives to eliminate the possibility for incidents of ownership and the potential estate tax exposure.

MAJOR REFERENCES: ***IRC §2042; Private Letter Ruling 201327010; Chief Counsel Advice 201328030.***

Clients are frequently unaware that the death benefits of policies insuring the client's life will be included in the client's estate for federal estate tax purposes if the policies are owned by the client at death. Added to that, even if the client does not actually own the policy but has other so-called "**incidents of ownership**" in the policy, the proceeds can still be included in the client's taxable estate. Thus, the insurance planning process for wealthy clients includes structuring ownership of the policy in a manner that will avoid inclusion of the proceeds in the insured's estate for federal estate tax purposes. Such planning generally involves establishing an irrevocable life insurance trust ("**ILIT**") to own the policy, or issuing the policy in the name of someone other than the insured, such as the insured's spouse or child. Structuring a successful insurance plan requires careful consideration of the incidents of ownership that may be afforded to the insured under a policy and how to avoid them.

A recent Private Letter Ruling ("**PLR**") and a Chief Counsel Advice ("**CCA**") illustrate how complicated the incidents of ownership rules can be.

IRC § 2042 - Inclusion of Life Insurance Proceeds in Taxable Estate

IRC § 2042 provides that the value of a decedent's taxable estate for federal estate tax purposes includes life insurance proceeds on the decedent's life that are (i) receivable by or for the benefit of the decedent's estate, or (ii) receivable by other beneficiaries if the decedent possessed incidents of ownership in the policy that are exercisable by the decedent alone or in conjunction with any other person, at the date of his or her death.[1] Life insurance proceeds also are included in a decedent's estate if he or she transferred the policy or released any incidents of ownership in the policy within three years of death without full and adequate consideration.[2] Otherwise, life insurance proceeds should not be included in the insured's taxable estate for federal estate tax purposes under IRC § 2042.

Recent IRS Guidance[3]

PLR 201327010

Facts. The insured's spouse purchased several policies on the insured's life, naming the spouse's estate as the beneficiary. The insured did not pay any of the premiums on the policies and did not anticipate paying any future premiums on the policies.

Following the spouse's death, ownership of the policies passed to a Family Trust pursuant to the spouse's will. The Family Trust authorized the distribution of income and principal to the insured and the spouse's descendants in the discretion of the trustee. Upon the insured's death, the trustee of the Family Trust would distribute the remaining assets (including the proceeds under the policies) to persons that the insured appointed by will (if any), pursuant to a limited power of appointment. Otherwise, the remaining trust assets would pass to other individuals designated in the trust instrument. The insured was appointed as both the trustee and protector of

the Family Trust, with the power to remove and replace trustees. The insured possessed incidents of ownership in the policies as trustee and as a beneficiary of the trust.

Following the spouse's death, and as permitted under the trust instrument, the Family Trust was divided into two trusts - Family Trust 1 and Family Trust 2. Family Trust 1 was funded with the insurance policies, while Family Trust 2 was funded with the remaining assets. Concurrent with the division of Family Trust, the insured relinquished (i) his roles as trustee and protector of Family Trust 1, (ii) his ability to be reappointed as trustee of Family Trust 1, and (iii) his power of appointment over the assets of Family Trust 1. The insured retained his beneficial interest in Family Trust 1 as a permissible beneficiary of income and principal.

Issue and Holding. The issue debated in the PLR was whether, after the division of the Family Trust, the insured held incidents of ownership in the life insurance policies that would cause the proceeds to be included in the insured's gross estate at death. The IRS ruled that following the spouse's death, the insured held incidents of ownership in the policies because, (i) as trustee, he could control the ownership of the policy for his own benefit, and (ii) as an individual, he held a power of appointment over the proceeds. Following the division of the Family Trust, and the relinquishment of his trustee powers and the power of appointment over Family Trust 1 (the trust with the insurance policies), the IRS reasoned that the insured no longer held incidents of ownership in the policies, even though he continued to be a discretionary beneficiary of Family Trust 1. Accordingly, as long as the insured survived the three-year period following the release of his powers, the proceeds from the policies would not be included in his taxable estate at death.

- This PLR illustrates the importance of planning for the possibility that the non-insured owner may predecease the insured. If the spouse's trust had restricted the insured's powers over any policies in the trust on his life, there would have been no need for the insured to release such powers and the possible risk of estate tax inclusion in the event of the insured's death within three years of such release.

- This PLR also illustrates options that may be available to eliminate or release incidents of ownership that inadvertently pass to the insured following the death of a non-insured owner.

- There is no distinction between powers that are retained by the insured and powers that are acquired by the insured at a later date. The focus is on the powers over the policy that the insured possesses at death.

CCA 201328030

Facts. The insured and his former spouse, as part of their divorce proceedings, executed a property settlement agreement with respect to all of their marital and separate property. Under the agreement, the insured was to maintain certain life insurance policies for the sole benefit of his former spouse. The insured was to pay all premiums, dues and assessments on the policies. The insured could not borrow against or pledge the policies. However, the dividends from the policies belonged exclusively to the insured.

When the divorce was finalized, the court's judgment of dissolution incorporated the agreement and ordered that the property of the insured and his former spouse be distributed as set forth in the agreement.

Following the insured's subsequent death, the insurance proceeds were paid to the former spouse.

Issue and Holding. The issue debated in the CCA was whether, at death, the insured possessed an incident of ownership in the policies insuring his life, causing the insurance proceeds to be included in his estate for estate tax purposes. The CCA held that the insurance proceeds were not includible in the insured's gross estate because, at death, because he held only a right to receive the policies' dividends, which by itself is not an incident of ownership for purposes of IRC § 2042.

OTHER INCIDENTS OF OWNERSHIP

Whether an insured retains or acquires an incident of ownership is not always obvious or straightforward. Advisors can add value to the services they provide by helping clients identify situations where the insured may have retained or may acquire an incident of ownership.

Attribution of Incidents of Ownership Held by Corporation. If the insured holds a controlling interest (*i.e.*, 50% of the voting power) in a corporation that owns policies on the insured's life, the proceeds will be included in the insured's estate to the extent the proceeds are not payable to or for the benefit of the corporation (although the proceeds payable to or for the benefit of the corporation will increase the value of the insured's stock for estate tax purposes).

> *Example 1:* Insured owns 55% of the voting stock in ABC Corporation. Shareholder X owns 45% of the voting stock. The corporation purchases a $5,000,000 policy on Insured's life that names Shareholder X as the beneficiary. The proceeds will allow Shareholder X to purchase Insured's stock when Insured passes away. The proceeds are not payable to or for the benefit of the corporation. Accordingly, the $5,000,000 will be included in Insured's estate for estate tax purposes.

> *Example 2:* Insured, the CEO of XYZ Corporation, owns 51% of the voting stock in the corporation. The corporation purchases a $2,000,000 policy on Insured's life naming the corporation as the beneficiary. The proceeds will be used to hire a successor CEO in the event of Insured's death. The $2,000,000 will not be included in Insured's estate for estate tax purposes. However, the $2,000,000 will be treated as an asset of XYZ Corporation, increasing the value of Insured's stock.

Community Property. When policies are purchased with community property funds, the insurance policies and the proceeds generally also are community property, absent an agreement between spouses to the contrary. Each spouse will have an ownership interest in the policies and only one-half of the proceeds may be included in the insured's estate at death.

> *Example:* Insured and his spouse live and work in California, a community property state. As part of his benefits package, Insured is covered by a $500,000 group term life insurance policy. The premiums are paid by Insured's employer. The rights in the group term policy were acquired through Insured's efforts and are community property. Upon Insured's death, one-half ($250,000) of the proceeds are included in the Insured's estate and one-half ($250,000) of the

proceeds belong to the Insured's spouse. Similarly, if the spouse consents to naming the couple's daughter as the primary beneficiary, the spouse will be deemed to have made a gift to the daughter in the amount of $250,000 upon the Insured's death.

Power of Substitution. The power, held by the insured grantor of an ILIT in a non-fiduciary capacity, to reacquire policies insuring his or her life by substituting assets of equivalent value is not an incident of ownership as long as (i) the grantor does not serve a trustee of the ILIT, (ii) the trustee has a fiduciary obligation to ensure the substituted assets of are equivalent value, and (iii) the substitution power cannot be exercised in a manner that can shift benefits among the beneficiaries of the ILIT.[4] Unfortunately, neither the IRC nor the Treasury Regulations define what constitutes "equivalent value". If the value of the policy used for substitution purposes is incorrect, the insured runs the risk that he or she will be deemed to have an incident of ownership in the policy that will pull the proceeds into his or her estate for estate tax purposes. Best practices may dictate securing a professional appraisal of the policy.

Power to Remove and Replace Trustees of an ILIT. An insured grantor's power to remove and replace the trustee of his or her ILIT is not an incident of ownership as long as the successor trustee is not related or subordinate to the grantor.[5]

Insured as Trustee. An insured is considered to have incidents of ownership in an insurance policy on his or her life held in trust if, under the terms of the policy, the insured has the power as trustee to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment of the proceeds, even though the decedent has no beneficial interest in the trust. This point was reiterated in Revenue Ruling 84-179[6] where the IRS took the position that an insured will be deemed to have incidents of ownership in a policy insuring his or her life where the insured's powers are held in a fiduciary capacity and either (i) the insured decedent transferred the policy or consideration for purchasing and maintaining the policy to the trust, or (ii) the insured's powers as a fiduciary could be exercised for the insured's benefit. The ruling also provides, however, that an insured will not be deemed to have incidents of ownership in a policy insuring his or her life where (i) the insured's powers are held in a fiduciary capacity and are not exercisable for the insured's personal benefit, (ii) the insured did not transfer the policy or any of the consideration for purchasing or maintaining the policy to the trust from personal assets, and (iii) the devolution of the powers on the insured was not part of a prearranged plan involving the participation of insured.

Pledge The Policy For A Loan. The right of an insured to pledge the policy insuring his or her life as security for a loan, either for his or her own benefit or for the benefit of a third party, is an incident of ownership.[7]

Second-to-Die Policy in a Single Life ILIT. A second-to-die policy requires careful consideration as both insureds may have or acquire incidents of ownership in the policy. This is particularly challenging if the second-to-die policy is transferred to or acquired by an ILIT structured to hold a single life policy, which names the non-owner insured as a beneficiary. Incidents of ownership can be attributed to the beneficiary insured if, for example, he or she was an original owner of the policy, contributed funds to purchase the policy, has access to the cash value during his or her lifetime, serves as a trustee of the ILIT, has Crummey withdrawal powers with respect to contributions to the ILIT, or has a lifetime or testamentary power of appointment over the ILIT.

Ability to Exercise the Power. The fact that it may be impossible for the insured to actually exercise an incident of ownership before death is irrelevant (for example, if the insured is incapacitated and unable to exercise the power or right).

TAKE AWAYS

Inclusion of life insurance death benefits in the insured's estate will occur if the insured holds any incidents of ownership in the policy. "Incidents of ownership" encompass far more rights than actual policy ownership, including the ability to name policy beneficiaries or pledge a policy for a loan. In addition, incidents of ownership may be attributed to an insured indirectly depending on the acquisition or ownership structure, such as with a corporate-owned policy where the insured is a majority shareholder, or where an insured is a trustee of an ILIT. Thus, advisors can add value to the services they provide by helping clients identify situations where the insured may have retained or may acquire an incident of ownership and reviewing alternatives to eliminate the possibility for incidents of ownership and the potential estate tax exposure.

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NOTES

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[1] IRC § 2042.
[2] IRC § 2035.
[3] Private Letter Rulings and Chief Counsel Advice are directed only to the requesting taxpayer and may not be used or cited as precedent by other taxpayers.
[4] Rev. Rul. 2011-28, 2011-49 I.R.B. 830.
[5] Rev. Rul. 95-58, 1995-2 C.B. 191. The terms "related" and "subordinate" have the meaning defined in IRC § 672(c)
[6] 1984-2 C.B. 195.
[7] See, Treas. Regs. § 20.2042-1(c)(2).