IRREVOCABLE LIFE INSURANCE TRUSTS: A CONCISE GUIDE FOR FINANCIAL ADVISORS AND HUMAN RESOURCES PROFESSIONALS

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I. INTRODUCTION

The Internal Revenue Code (I.R.C. or Code) provides that life insurance proceeds payable to beneficiaries are included in the settlor’s gross estate if a taxpayer retains the right to alter, amend, revoke, or terminate life insurance or a life insurance trust.1 However, if the life insurance is owned by someone other than the insured, and the insured possesses no incident of ownership,2 then the policy cash buildup is not subject to income tax3 and the proceeds are not subject to estate tax at the insured’s death.4

Those who purchase insurance to protect their family against financial loss due to the insured’s premature death may, at no additional cost, place the insurance in an irrevocable life insurance trust (ILIT) managed by an independent trustee, receive life insurance protection, and avoid substantial estate tax at death.5 Ability to modify or terminate the ILIT can be retained

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2 Treas. Reg. § 20.2042–1(c)(2) provides, “[g]enerally speaking, the term [incident of ownership] has reference to the right of the insured or his estate to the economic benefits of the policy.”
4 There is no income tax liability on cash buildup retained in the policy at the time of the insured’s death, I.R.C. § 101(a)(1), or proceeds paid to beneficiaries at the insured’s death, I.R.C. § 101(a). Life insurance dividends are not taxed until total dividends withdrawn exceed premiums paid (basis), I.R.C. § 72(e)(5). Basis is deemed withdrawn first; cash value buildup is not taxed unless borrowed or distributed during the insured’s life after basis has been withdrawn, I.R.C. § 72.
by careful planning and drafting of the trust agreement so that the arrangement can be modified, in the event the settlor’s estate remains too small to pay estate tax, or the estate is large enough to have to pay estate tax but conditions require changes in the plan. Many young insureds fail to take advantage of these benefits because they are not made aware that they can.

Financial advisors, insurance professionals, accountants, bankers, and human resources professionals too often fail to explain the benefits of ILITs to life insurance buyers and recipients of group life insurance from their employers. Few understand what an ILIT is and even fewer educate young clients about the benefits of holding life insurance within an ILIT. ILITs are usually set up late in life by wealthy taxpayers concerned with minimizing their gross estate’s exposure to estate taxes. The cost of waiting is high because the cost of insurance rises with age. The following discussion explains what an ILIT is, how to establish one, and why it can provide substantial benefits at little cost to young professionals. It is a guide for those wanting to minimize lifetime tax liability by engaging in a lawful tax shelter to shield life insurance proceeds from the tax collector.

II. THE BENEFITS OF OWNING INSURANCE IN AN IRREVOCABLE LIFE INSURANCE TRUST

A. Life Insurance

“Insurance involves risk-shifting and risk-distributing … to shift and distribute risk of loss from premature death.” 6 Thus, a contract is life insurance if it redistributes the risk of premature death from the insured to another party, (the insurer).7 For tax purposes, the definition of life insurance is more restrictive.8 The Internal Revenue Service (IRS) requires that for a

Under the Common Law a trust is revocable unless the settlor otherwise provides, RESTATEMENT (SECOND) OF TRUSTS [] § 330. See La. Rev. Stat. § 9:2041; N.D. Cent. Code § 59–02–18; S.D. Codified Laws § 55–3–6. Some state statutes provide that a trust is irrevocable unless otherwise stated, see, e.g. N.M.S.A. § 46A-6-602(A) that provides, “Unless the terms of a trust expressly provide that the trust is irrevocable, the settlor may revoke or amend the trust. This subsection does not apply to a trust created under an instrument executed before July 1, 2003.” See Cal. Prob. Code § 15400, § 15401; Tex. Prop. Code § 112.051. 6 Helvering v. Le Gierse, 312 U.S. 531 (1941).
7 Id.
8 Unless required by state law, life insurance contracts need not be issued by a commercial insurance company for the IRS to treat the contract as insurance. Comm’r v. Treganowan, 183 F.2d 288 (2d Cir. 1950), rev’g sub nom. Estate of Strauss v. Comm’r, 13 T.C. 159 (1949); Rev. Rul. 65-222, 1965-2 C.B. 374. An employer’s survivor benefit paid to a decedent employee’s spouse is not life insurance and is subject to income taxation, Davis v. United States, 323 F. Supp. 858 (S.D. W. Va. 1971); Barnes v. United States, 801 F.2d 984 (7th Cir. 1986); however, an employee welfare benefit plan negotiated with a union that provides a
contract to qualify as life insurance it must meet the legal definition of insurance, qualify as life insurance under applicable state or foreign law,9 and meet the IRS’ cash value accumulation test, or guideline premium and cash value corridor tests10 for the duration of the contract.11 The restrictions are intended to prevent investments disguised as life insurance from benefiting from favored tax treatment reserved for life insurance proceeds. Under these tests, mortality charges that do not exceed the applicable charges in the National Association of Insurance Commissioners' 2001 Standard Ordinary Mortality Tables (2001 CSO Basic Mortality Tables) for policies issued after 2008,12 or The National Association of Insurance Commissioners' '80 Standard Ordinary Mortality Tables for male or female insureds, without select factors (1980 CSO Basic Mortality Tables) for policies issued prior to 2009 are deemed reasonable.13

B. Irrevocable Life Insurance Trusts

An ILIT is a separate legal entity, created by a settlor, that holds life insurance, cash, financial instruments, or real property, and that distributes these trust assets in accordance with the trust agreement. The trust agreement binds the trustee to act in accordance with the settlor’s written instructions. Benefits paid to beneficiaries on the insured’s death, including cash build-up, are not subject to income tax.14 Loans against a life insurance policy are not treated as amounts received and are not taxed.15 During the insured’s life, distributions to the owner that don’t exceed taxpayer’s investment in the policy are not included in gross income.

Notwithstanding its name, a properly designed ILIT may be revised by the trustee as necessary to accommodate changed circumstances. If an ILIT

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10 I.R.C. §§ 7702(a)(1), (2).
12 Notice 2006-95 § 4.03.
13 Notice 2006-95, §§ 1, 4.03, 2006-45; I.R.B. 848; Prop. Reg. § 1.7702-1(c)(1); Notice 88-128, 1988-2 CB 540. However, the 80 CSO Table Charges must continue to be used for states that have not adopted the 2001 CSO Table Charges, Notice 2006-95, Sec. 1, 2006-45 I.R.B. 848. See the additional rules contained in Prop. Reg. § 1.7702-1(c)(2) and Notice 88-128, 1988-2 CB 540 for policies issued prior to 1989.
14 I.R.C. § 101(a)(1). I.R.C. § 7702. Life insurance inside buildup (investment income earned within the policy) not distributed is not subject to income tax when paid as insurance proceeds to beneficiaries. Id.
15 I.R.C. § 72(e)(5).
is classified as a grantor trust and the trust agreement is properly drafted, the trust can be transferred to another trust with different terms.\(^{16}\) An independent trustee may transfer assets from one ILIT to another with different dispositive language by having the old ILIT sell the insurance policies to a new trust that is a grantor trust with respect to the insured.\(^{17}\) Either the old trust must permit distribution of the life insurance policy to a new trust or state law must permit a trustee to invade the principal to appoint such property in further trust for the benefit of the income beneficiaries.\(^{18}\) An ILIT may be terminated if neither insurance protection nor estate tax benefits are needed by simply ceasing to pay for the insurance.

**C. Estate Tax Benefits of an ILIT**

The proceeds of an ILIT are not included in the insured/decedent’s gross estate and are not subject to estate tax provided, 1) the insured/decedent does not possess any incidents of ownership,\(^{19}\) 2) once the trust agreement is drafted the insured/decedent does not possess any further power to alter the trust terms,\(^{20}\) 3) neither the insured nor the insured’s spouse possesses a general power of appointment over the trust,\(^{21}\) and 4) trust benefits to the spouse are limited by an *ascertainable standard*, which provides that the trustee may expend principal or income for the beneficiary’s health, support, maintenance, and education and allows the beneficiary a non-cumulative power to demand the greater of $5,000 or five percent of the value of the trust each calendar year.\(^{22}\)

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\(^{16}\) I.R.S. T.A.M. 8901004.  
\(^{17}\) This discussion is taken from Georgiana J. Slade, BNA No. 807-2nd, PERSONAL LIFE INSURANCE TRUSTS, V. D. 1.  
\(^{18}\) N.Y. [Estate, Powers & Trusts] Law § 10-6.6(b) (Consol. 2006).  
\(^{19}\) I.R.C. §§ 2036, 2038.  
\(^{20}\) I.R.C. § 2042.  
\(^{21}\) I.R.C. § 2041.  
\(^{22}\) Treas. Reg. § 20.2041-1(c)(2). Estate of Dietz v. Comm’r, 72 T.C.M (CCH) 1058 (1996); Covey, The Estate Planning Benefits Available Via a “$5,000 and 5%” Withdrawal Power, 34 J. TAX’N 90 (1971). Note that life insurance in a qualified ERISA plan (including a 401(k) or other self directed defined contribution plan) that otherwise would have to be surrendered may instead be transferred to a life insurance trust, Department of Labor Prohibited Transaction Exemption 92-6 (PTE 92-6). The value of the policy is determined pursuant to I.R.C. §§ 79, 83, 402. Treas. Reg. §§ 1.70-1, 1.83-3, 1.402(a)-1 specify how to determine the fair market value of the policy. See especially Treas. Reg. § 1.402(a)-1(a)(1)(iii) and the description in Rev. Proc 2005-25, 2005-17 I.R.B. 962.
III. GIFT TAX LIMITS ON ABILITY TO TRANSFER FUNDS TO AN ILIT

A. The Gift Tax Rules

Gift tax applies to all transfers other than those subject to statutory exceptions, “whether in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. . . .”23 Both transfer of insurance policies and transfer of cash to the ILIT to pay insurance premiums are treated as gifts to the beneficiaries and are subject to gift tax.24 Gifts of a present interest to each recipient are subject to a $13,000 ($26,000 for a married couple) annual exclusion from gift tax.25 Since life insurance premiums for a given amount of insurance are far lower for a young purchaser than for an older purchaser, far more insurance can be purchased in a young person’s ILIT. A person may also make gifts in excess of the exclusion by utilizing part or all of the lifetime $1 million gift tax credit.26

B. Conversion of Future Interests to Present Interests—The Crummey Power

A gift to an irrevocable trust is a gift of a future interest that can be converted into a present interest if the trust provides beneficiaries a Crummey power.27 A Crummey power is a provision in a trust that gives beneficiaries the power for a limited time to demand immediate possession and enjoyment of a contribution to the trust.28 The beneficiary must receive 1) prompt notice of the right to withdraw the gift and a reasonable

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23 I.R.C. § 2511(a).
24 I.R.C. § 2502(d). Transfers by gift are defined to include both direct and indirect gifts of both tangible and intangible property, including a gift to a trust, Treas. Reg. § 25.251101(a). Thus, an insurance policy purchased by a third party with the third party’s own funds is not subject to gift tax because no gift is involved. See Helvering v. Hutchings, 312 U.S. 393 (1941).
25 The gift tax exclusion is found at I.R.C. § 2513(a); see also Treas. Reg. § 2513-1(b). The present interest requirement is found at I.R.C. § 2503(b). A donee has a present interest if the donee has an unrestricted right to immediate use, possession, and enjoyment of the cash or property, Treas. Reg. § 25.2503-3(b). Life insurance can be funded using the exclusion, I.R.C. § 6019(a).
26 I.R.C. § 2505(a).
opportunity (usually sixty days) to exercise the right,29 2) notice including the amount of the contribution and of the withdrawal right,30 and 3) prompt written notice; waiver of notice is not sufficient.31 Both primary and contingent beneficiaries may receive Crummey powers.32 Guardians of minor children and grandchildren can exercise their ward’s right of withdrawal if local law permits; otherwise the minor may demand distribution.33 A right to withdraw an insurance policy meets the present interest requirement.34

C. Valuation of Gifts of Real Property, Financial Assets, and Life Insurance Policies to a Trust

Inter-vivos gifts are valued as of the date of the gift.35 Gifts of real property are valued at “the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts.”36 The value for gift tax purposes of a premium paid on a policy over


30 See I.R.S. P.L.R. 9030005; 8922062.

31 The Service holds that a waiver prevents withdrawal and the interest is, therefore, not a present interest, I.R.S. T.A.M. 9532001. Note, however, that the requirement is only reasonable notice, not current notice, so the position in the T.A.M. is inconsistent with other IRS rulings, and arguably with the reasoning in Fondren v. Comm’r, 324 U.S. 18 (1945) on which the T.A.M. relies. A trustee may provide a schedule of insurance premium payments to meet the requirement for notice of contributions to group-term life insurance policies that are made on a regular schedule, I.R.S. T.A.M. 9045002; see also P.L.R. 8143045, 8138102, 8133070, 8121069.

32 Estate of Kohlsaat v. Comm’r, 73 T.C. M. (CCH) 2732 (1997) (court upheld petitioner’s effort to treat 16 contingent beneficiaries' unrestricted right to demand immediate distributions from an irrevocable trust as present interests in property under I.R.C. § 2503(b)). A settlor cannot increase contributions subject to the annual exclusion by granting Crummey powers to individuals who have no interest in a trust, T.A.M. 9045002, 8727003.


34 Rev. Rul. 76-490, 1976–2 C.B. 300, I.R.S. P.L.R. 8111123 (present interest requirement satisfied by right to withdraw any assets including life insurance policies), I.R.S. P.L.R. 8134135, 8021058; however, I.R.S. P.L.R. 8118051 provides that the right to withdraw must be cash or assets reducible to cash, possibly including only life insurance policies with a cash value or refund of premium provision in an amount at least equal to the premium paid by settlor. Right to withdraw a group-term policy with premiums paid by the employer to the trust meets the withdrawal requirement, Cristofani Estate v. Comm’r, op. cit.

35 I.R.C. § 2512(a).

which the donor has relinquished all control is the premium. 37 The value of
an insurance policy is its replacement cost on the date of the gift, 38 or the
interpolated terminal reserve plus unused premium on the date of the gift. 39
The gift associated with a group term insurance policy assigned by the
employee to an ILIT is the imputed income amount. 40

D. Gifts to a Trust or Guardian to Purchase Life Insurance for the Benefit of
an Individual Minor Structured as Gifts of a Present Interest

No right of withdrawal is required for contributions to an ILIT with only
a minor as beneficiary because the contribution is a gift of a present interest 41
provided: 1) all trust property is expended by or for the benefit of the donee
before the donee reaches twenty-one or the donee may withdraw the trust
property at twenty-one; 42 2) if donee dies before age twenty-one, trust
property is payable to donee’s estate or donee has a general power of
appointment by will, 43 and 3) the trustee possesses unrestricted discretion to
distribute funds for the benefit of the minor beneficiary. 44 A requirement that
the trust pay premiums on life insurance in the trust is not considered to be a
substantial restriction. 45

1968); Rev. rul. 71-497, 1971-2 CB 329.
38 Treas. Reg. § 25.2512-6(a) Ex. 3 (value determined by sale price of comparable policies).
39 I.R.C. § 2512, Treas. Reg. § 25.2512-6(a), Ex. 4 (value determined by interpolated terminal
reserve at date of gift); I.R.S. P.L.R. 0930005; Guggenheim v. Rasquin, 312 U.S. 254 (1941).
See I.R.S. G.C.M. 38,110 (9/25/79); see also Wolket al., What is the Value of Life Insurance
40 Treas. Reg. § 1.70-3(d)(2); Rev. Rul. 84-147, 1984-2 C.B. 201. This was increased for
employees over sixty-three years of age. I.R.C. § 79(c).
41 I.R.C. § 2503(c) (the minor must have the right to demand trust corpus at age 21; however,
the right is not subject to the $5,000 or five percent rule). See Duncan v. United States, 368
F.2d 98 (5th Cir. 1966).
44 I.R.C. § 2503(c). Treas. Reg. § 25.2503-3(c), Ex. 6 Example (6); (“L pays premiums on a
policy of insurance on his life, all the incidents of ownership in the policy (including the right
to surrender the policy) are vested in M. The payment of premiums by L constitutes a gift of a
present interest in property.”); Rev. Rul. 76-490, 1976–2 C.B. 300 (Premium paid by X
Company as compensation to D, which D irrevocably assigned to trust caused an indirect
economic benefit to inure to the trust as assignee of the policy for purposes of I.R.C. § 2511
and is subject to gift tax imposed by I.R.C. § 2501. Since it is not a gift of a future interest in
property, it qualifies for the I.R.C. § 2503(b) annual exclusion). If the trust continues beyond
the settlor’s death without a Crummey provision, the gift is a gift of a future interest, Rev. Rul.
45 Duncan v. United States, 368 F.2d 98 (5th Cir. 1966); see also Ill. Nat'l Bank of Springfield
Insurance in an ILIT can provide protection for a spouse, child, or other relative.\textsuperscript{46} The spouse may act as the guardian of the minor so long as the trust has an independent trustee who may distribute net income to any of the beneficiaries.\textsuperscript{47} Both the insured and the insured’s spouse may transfer property to the trust so long as a Crummey notice of the right to withdraw is provided to all beneficiaries.\textsuperscript{48} Settlor’s spouse’s dual role as non-donor spouse consenting to gift splitting under I.R.C. § 2513 and guardian of the couple’s minor children possessing the withdrawal power does not prevent creation of a present interest and is not an incident of ownership.\textsuperscript{49}

IV. POTENTIAL ADVERSE ESTATE TAX CONSEQUENCES ON LAPSE OF A CRUMMEY POWER

When a trust donor grants a Crummey power to a beneficiary, the beneficiary receives a general power of appointment for the period during which the beneficiary may exercise the power.\textsuperscript{50} Unless the release of the power is subject to an ascertainable standard,\textsuperscript{51} when the beneficiary allows a general power of appointment to lapse, the beneficiary becomes the donor to the trust.\textsuperscript{52} The increase is treated as giving beneficiary ownership over owning an increasing portion of the trust each year.\textsuperscript{53} A \textit{hanging power}

\textsuperscript{46} I.R.C. § 2503; I.R.S. P.L.R. 8712014.
\textsuperscript{47} Id.
\textsuperscript{48} I.R.C. § 2501(a) imposes a gift tax subject to I.R.C. § 2503(b) exclusion of the first $13,000 ($26,000 per married couple) to each person per year, so long as it is a present interest pursuant to Treas. Reg. § 25.2503-3(b), and not a future interest, Reg. § 25.2503-3(a). Future interests are turned into present interest by using Crummey powers, \textit{Crummey v. Comm'r}, 397 F.2d 82 (9th Cir. 1968); and Rev. Rul. 81-7, 1981-1 C.B. 474 providing an adult beneficiary with notice and ability to demand and receive the gift has a present interest.
\textsuperscript{49} I.R.S. P.L.R. 8712014, interpreting I.R.C. § 2503 gift tax, exclusions from gift tax, and gifts held in trust for a minor. The applicable law on which the P.L.R. is based is I.R.C. § 2501(a), the calendar year gift tax; I.R.C. § 2503(b), $13,000 the exclusion rule; Treas. Reg. § 25.2503-3(a), (b) and \textit{Crummey v. Comm'r}, 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 73-405, 1973-2 C.B. 321; and Rev. Rul. 81-7, 1981-1 C.B. 474.
\textsuperscript{50} Treas. Reg. § 26.2652-1(a)(5), Ex. 5.
\textsuperscript{51} An ascertainable standard limits each beneficiary’s withdrawal right to the lesser of $5000 or five percent of the trust principal, I.R.C. § 2514(e); Treas. Reg. § 26.2652-2(b)(2), (3); Treas. Reg. § 26.2652-2(b)(2), (3). Otherwise, a release, exercise, or lapse of a Crummey general power of appointment that is not protected represents a transfer from the donor to the power holder, I.R.S. P.L.R. 9124018. I.R.C. § 678(a)(1); Rev. Rul. 67-241, 1967-2 CB 225.
\textsuperscript{52} I.R.C. § 2652. I.R.C. § 2041 provides that possession of a power of appointment results in property being included in decedent’s gross estate; I.R.C. § 2514 provides that release of a power of appointment is a transfer of property by the individual possessing such power to the party or trust to whom it is released.
\textsuperscript{53} I.R.C. § 678(a)(2). See I.R.S. P.L.R. 200022035 (five by five power vests in beneficiary a portion of trust corpus). Successive lapses of a beneficiary’s right to withdraw corpus from multiple trusts are aggregated for purposes of the $5,000 or five percent of assets rule, I.R.C. §
permits all amounts in excess of $5,000 or five percent of the trust principal to continue to be withdrawable in future years without being treated as a further taxable gift.\(^{54}\)

A *vested trust*, which is an irrevocable trust with one beneficiary who is entitled to receive all trust distributions and who is granted a Crummey power, is not a completed gift.\(^{55}\) All property flows either to the beneficiary or to the beneficiary’s estate.\(^{56}\)

V. CONDITIONS CAUSING INCLUSION IN DECEDENT’S ESTATE OF INSURANCE OWNED BY DECEDENT OR OVER WHICH DECEDENT POSSESSED INCIDENTS OF OWNERSHIP

Inter-vivos revocable trust assets are included in an insured/decedent’s gross estate,\(^{57}\) as are irrevocable transfers with a retained life estate.\(^{58}\) Similarly, a testamentary life insurance trust, created when a will specifies that life insurance is payable to the insured’s estate and that the estate utilize specified life insurance proceeds to fund a trust for the benefit of specified beneficiaries, is included in the estate because it is revocable until the testator dies.\(^{59}\)

A. Inclusion Rules for Direct Incidents of Ownership of Insurance Policies

Incidents of ownership refers to rights to economic benefits retained by the settlor including the power to 1) change beneficiaries, even if exercisable with the consent of the policy owner,\(^{60}\) 2) cancel, assign, or revoke

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\(^{54}\) I.R.C. § 2514(e).

\(^{55}\) I.R.S. P.L.R. 81-42061.

\(^{56}\) Treas. Reg. § 25.2511-2(b); P.L.R. 90-30005, 85-45076, 85-17052, 82-29097.

\(^{57}\) I.R.C. § 2038 (revocable transfers included).

\(^{58}\) I.R.C. § 2036.

\(^{59}\) I.R.C. §§ 2038, 2042, Treas. Reg. § 20.42-1. For a possible exception, see Estate of Friedberg v. Comm’r, 63 T.C.M. (CCH) 3080 (1992). See the definition of “incidents of ownership” at Treas. Reg. § 20.2042-1(c)(2), and Boston Safe Deposit & Trust Company v. Comm’r, 100 F.2d. 266 (1st Cir. 1938). The unlimited marital deduction can be used to postpone payment of estate tax on a testamentary insurance trust for the benefit of a spouse until the death of the surviving spouse, I.R.C. § 2056(a).

\(^{60}\) Nance v. United States, 430 F.2d 662 (9th Cir. 1970); Broderick v. Keefe, 112 F.2d 293 (1st Cir. 1940); Estate of Newbold v. Comm’r, 4 T.C.M. 568 (1945), rev’d on other grounds, 158 F.2d 694 (2d Cir. 1946). Note, however, that the power to change beneficiaries in the event of divorce is not an incident of ownership, I.R.S. T.A.M. 8819001.
assignment of the policy, 61 3) use the policy (or its cash surrender value) as collateral for a loan, 62 4) change the time or manner in which beneficiaries’ proceeds are received, 63 5) retain the right to repurchase the policy from an assignee, 64 or 6) possess a reversionary interest in a policy or in proceeds which, immediately before death, exceeds five percent of the value of the property. 65 However, neither the right to convert a group term life insurance policy into an individual policy if the insured ceases to be employed nor the right to receive policy dividends are incidents of ownership. 66 The proceeds of a life insurance policy in an ILIT subject to a legally binding obligation to pay debts of the insured’s estate are included in the gross estate; 67 however, if the ILIT trustee is authorized but not required, to pay the estate debts, the proceeds of the trust are not includible 68 unless payments to the estate are actually made. 69

61 Schwager v. Comm’r, 64 T.C. 781 (1975); I.R.S. T.A.M. 9349002 (control over an exercise of incidents of ownership by another is incident of ownership).
63 Estate of Lumpkin v. United States, 474 F.2d 1092 (5th Cir. 1973) (insured who has power to elect optional modes of settlement has an incident of ownership); see also Estate of Connelly v. United States, 551 F.2d 545 (3d Cir. 1977), Estate of Chapman v. Comm’r, 56 T.C.M. (CCH) 1451 (1989).
64 I.R.S. T.A.M. 9128008, 9127007. However, a right to reacquire trust property by substituting another property of equivalent value is not an incident of ownership, P.L.R. 9413045, 9548013; 9504024.
69 I.R.C. § 2042(1). See Bintliff v. United States, 462 F.2d 403 (5th Cir. 1972); Hooper v. Comm’r, 41 B.T.A. 114 (1940); Morton v. Comm’r, 23 B.T.A. 236 (1931); see also I.R.S. P.L.R. 200147039 (proceeds from a second-to-die policy payable to an irrevocable life insurance trust not included in decedent’s gross estate because trustee has discretion to pay decedent’s estate tax from proceeds); Rev. Rul. 77–157, 1977–1 C.B. 279; I.R.S. G.C.M. 36995 (2/4/77); Estate of Wade v. Comm’r, 47 B.T.A. 21 (1942), acq., 1942 C.B. 1; Old Colony Trust Co. v. Comm’r, 39 B.T.A. 871 (1939); Estate of Salsbury v. Comm’r, 34 T.C.M. (CCH) 1441 (1975).
B. Incidents of Ownership Attributed to the Insured by Virtue of the Insured’s More Than Fifty Percent Ownership of a Corporation or Partnership

Insurance owned by a business in which the insured is a majority owner is attributed to the owner (i.e., an individual with more than fifty percent combined voting power) unless the proceeds are 1) paid to the corporation, 2) paid to a third party in satisfaction of a business debt, or 3) group term life insurance purchased by the corporation pursuant to I.R.C. § 79.70 Proceeds of life insurance insuring a partner’s life purchased by a general partnership are generally not includible in the insured partner’s estate.71 Proceeds of a life insurance policy insuring a majority limited partner and owned by limited partnership, where the insured cannot exercise incidents of ownership in the policy, are not included in the limited partner’s estate under I.R.C. § 2042.72

C. Application of the Creditors’ Rights Doctrine

Under the creditors’ rights doctrine if creditors can reach settlor’s trust assets, the settlor/insured’s gift to the trust is not complete.73 Treas. Reg. § 25.2511-2(b) provides, in pertinent part, “[i]f a grantor's interest in a trust is either enforceable by the grantor or on the grantor's behalf (e.g., by


creditors), then the grantor will not be considered to have parted with
dominion and control over the property transferred to the trust and the
grantor will not be deemed to have made a completed gift; therefore, the
property will be includible in the grantor’s estate."\(^{74}\)

Whether a creditor can recover from an ILIT is determined by state
law.\(^{75}\) To the extent trustee’s right to pay principal or interest to the settlor is
not enforceable by the settlor or on the settlor’s behalf under state law, the
transfer to the trust is a completed gift.\(^{76}\) Treatment of an insured’s right to
income from a trust as beneficiary at the sole discretion of the trustee is not
an incident of ownership.\(^{77}\)

D. Treatment of Reversionary Interests

A reversionary interest is “the possibility that the policy, or the
proceeds of the policy, may return to the decedent or his estate, or be subject
to a power of disposition by him . . . . An incident of ownership includes a
reversionary interest . . . only if the value of such reversionary interest
exceeded five percent of the value of the policy immediately before the death
of the decedent.”\(^{78}\)

If someone other than the insured can change the beneficiary or cancel
the policy up to the moment of the beneficiary’s death, the beneficiary does
not have a five percent probability of reversion.\(^{79}\) In addition, if the policy
was originally acquired by a trustee, or someone other than the insured, the
interest was never held by the insured and, thus, cannot revert back to the


\(^{75}\) See, e.g., N.Y. Est. Powers & Trusts Law § 7-3.1, (creditors can reach trust assets where
settlor is also income beneficiary); see also Uhl Est. v. Comr., 241 F.2d 867 (7th Cir. 1957)
same result under Indiana law); a trust can be forced to pay creditors to the extent withdrawal
by a beneficiary is permitted under an ascertainable standard, I.R.S. P.L.R. 8752064.
However, see I.R.S. P.L.R. 9332006 (transfer to trust not reachable by creditors when treated
as completed gift under law, notwithstanding settlor's discretionary interest).

\(^{76}\) Rev. Rul. 77-378, 1977-2 C.B. 347. See, e.g., I.R.S. P.L.R. 8829030 (such property not
included in settlor/decedent’s gross estate); I.R.S. P.L.R. 8752064.

\(^{77}\) It does not fall within I.R.C. § 2042(2), which provides for inclusion if the insured has a
right to demand proceeds “exercisable either alone or in conjunction with any other person.”
See also Treas. Reg. § 20.2042–1(c)(2). If only the trustee has authority to provide proceeds,
the insured is not acting in conjunction with the trustee. Estate of Margrave v. Comm’r, 618
F.2d 34 (8th Cir. 1980); Rev. Rul. 81–166, 1981–1 C.B. 477. It is not an incident of
ownership for the settlor to have a right to income from the trust in excess of the income
needed to pay life insurance premiums, Estate of Jordahl v. Comm’r, 65 T.C. 92 (1975); Estate

\(^{78}\) I.R.C. § 2042(2).

\(^{79}\) Treas. Reg. § 20.2042–1(e)(3); Rev. Rul. 79–117, 1979–1 C.B. 305; Bettigole, Adding
insured. Finally, neither the trust nor the insurance policy is includible in a beneficiary’s estate under I.R.C. §§ 2036, 2038, or 2042(2) so long as an insured who is also a beneficiary does not make direct or indirect contributions to the trust and is not a trustee.

E. Incidents of Ownership in Community Property Jurisdictions

The general rule in community property states is that if a spouse purchases life insurance insuring the other spouse with his or her separate property, the policy is separate property; however, if the purchase was made with community assets, the policy is community property. In some states statutes or court decisions have determined whether the policy is separate or community property independent of the nature of the funds with which the policy is purchased. A power of surrender held by a decedent as agent for a spouse is insufficient to bring the remaining half of the policy into the decedent’s estate. In a community property state, once a life insurance policy or funding to purchase a policy is assigned to an ILIT, and both spouses give up all incidents of ownership, the proceeds are not included in the assignor decedent’s estate.

F. Transfer of Life Insurance Policies to Another Within Three Years of Transferor’s Death

The Economic Recovery Act of 1981 (ERTA) did not eliminate the “within three years of death” inclusionary rule for transfers of life

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80 I.R.S. P.L.R. 9602010 (irrevocable insurance trust created by father with independent trustee that paid income to daughters and gave daughters limited power of appointment, but denied them right to be trustees held to include no incidents of ownership attributable to daughters). I.R.S. P.L.R. 9451053 (irrevocable insurance trust with independent trustee created by settlor/insured for benefit of spouse and child held to create no incidents of ownership in settlor’s spouse). See also P.L.R. 9748029, 9748020, 9538035, 9434028, 9111028.
82 See, e.g., Estate of Cavanaugh v. Comm’r, 51 F.3d 597 (5th Cir. 1995); Estate of Crane v. Comm’r, 43 T.C.M. (CCH) 994 (1982); Estate of Meyer v. Comm’r, 66 T.C. 41 (1976); Bergman v. Comm’r, 66 T.C. 887 (1976); Daly v. United States, 75-1 U.S. Tax Cas. (CCH) P13,070 (D. Id. 1975). See also Estate of Cervin v. Comm’r, 111 F.3d 1252 (5th Cir. 1997).
83 Rev. Rul. 94–69, 1994–2 C.B. 241 (under Louisiana law ownership of the policy rather than source of funds used to purchase it controls). See Phillips v. Wellborn, 89 N.M. 340, 552 P.2d 471 (1976); 40-4-20 NMSA, (life insurance in New Mexico is community property unless purchased with separate assets).
84 I.R.C. § 2042; Treas. Rul. § 20.2042–1(c)(5).
insurance. A bona fide sale for an adequate and full consideration in money or money's worth is not subject to the three year inclusion rule. However, life insurance owned by a corporation on the life of a controlling shareholder and transferred to the shareholder’s ILIT for less than full consideration less than three years before the shareholder’s death is included in the shareholder’s gross estate. The three year rule does not apply to transfer of group term life insurance to an ILIT provided the policy contains an automatic right to renew without evidence of insurability, even if the employer changes the insurance carrier for identical coverage and the new policy is assigned to the trust.

VI. THE INSURED OR INSURED’S SPOUSE AS TRUSTEE

A. The Risks of Permitting the Insured to be a Fiduciary of an ILIT

In all jurisdictions an insured who is trustee of an insurance trust has an incident of ownership in an insurance policy if, alone or in conjunction with another person, the insured has the power, as trustee or otherwise, to change beneficial ownership in the policy or in its proceeds. In the Fifth Circuit, even the ability to alter the time and manner of beneficiaries’ enjoyment of insurance proceeds is sufficient for inclusion of the proceeds in the insured’s gross estate. The amount included is reduced proportionately with the proportion of premiums paid by the transferee, Estate of Silverman v. Comm’r, 61 T.C. 338, 343 (1973), aff’d on other grounds, 521 F.2d 574 (2d Cir.1975), acq., 1978–1 C.B. 2. See also I.R.S. T.A.M. 9128008; I.R.S. P.L.R. 8724014; Friedberg v. Comm’r, T.C. Memo 1992–310; I.R.S. G.C.M. 38110 (9/25/79); I.R.S. G.C.M. 37695 (9/27/78).

Defects in transfer resulting from scriveners’ errors that are corrected within three years of death do not violate I.R.C. § 2035(a), I.R.S. P.L.R. 200615025, I.R.S. P.L.R. 200314009. See I.R.S. T.A.M. 9141007 (policy proceeds includible in decedent's estate under § 2035(a) where decedent held right to convert policy and transferred that right within three years of death).


gross estate. In the Sixth Circuit, when a wife creates an ILIT insuring her husband, naming her husband as co-trustee, and listing the husband as beneficiary for life with remainder to wife’s issue, husband’s power as trustee to surrender the policies for their cash value is an economic benefit and an incident of ownership. In the Third and Eighth Circuits, to the extent an insured/trustee’s fiduciary powers only permitted the settlor/trustee to affect the timing and manner of enjoyment of beneficiaries’ interests, the powers were not incidents of ownership.

Making the settlor/insured a trustee is an invitation for litigation because the IRS’s position is that an insured/trustee possesses an incident of ownership if the insured transferred either the policy or consideration for purchasing the policy to the trust, or insured’s fiduciary powers as trustee could have been exercised for his or her benefit. The IRS concedes that the insured does not possess an incident of ownership when 1) the powers held in a fiduciary capacity are not exercisable for the insured’s personal benefit, 2) the insured neither transferred the policy nor provided consideration to purchase or maintain the policy from personal assets, and 3) the insured’s powers were not the result of a prearranged plan involving the insured. A settlor may retain a power to remove a trustee and appoint another if the successor is neither related nor subordinate to the settlor.

93 Rose v. United States, 511 F.2d 259 (5th Cir. 1975) (trustee insured’s ability to convert policies from whole life to limited payment life, withdraw dividends, and secure loans on policies held to be incidents of ownership because insured as fiduciary could alter manner of enjoyment). See also Estate of Lumpkin v. Comm’r, 474 F.2d 1092 (5th Cir. 1973); Estate of Bloch v. Comm’r, 78 T.C. 850 (1982); Estate of Jordahl v. Comm’r, 65 T.C. 92 (1975), acq., 1977–2 C.B. 1; Terriberry v. United States, 517 F.2d 286 (5th Cir. 1975), cert. denied, 424 U.S. 977 (1976). See I.R.C. § 2042(2).

94 Fruehauf Estate v. Comm’r, 427 F.2d 80 (6th Cir. 1970); Estate of Gesner v. Comm’r, 600 F.2d 1349 (Ct. Cl. 1979).

95 Hunter v. United States, 624 F.2d 833 (8th Cir. 1980); Estate of Rockwell v. Comm’r, 779 F.2d 931 (3d Cir. 1985); Estate of Connelly v. Comm’r, 551 F.2d 545 (3d Cir. 1977).


97 Id.

98 Rev. Rul. 95–58, 1995–2 C.B. 191. The I.R.C. § 672(c) grantor trust rules specify that a related or subordinate party includes a settlor's spouse, father, mother, issue, brother, or sister; an employee of the settlor; a corporation or an employee of a corporation in which the settlor possesses significant stock holdings; or a subordinate employee of a corporation in which the settlor is an executive. However, a party is not treated as related to the settlor or a subordinate party if the party is an adverse party, a person with substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power. See also P.L.R. 9735023, 9746007, 9735025, 9607008. The successor trustee may not be the settlor or any I.R.C. § 672 related or subordinate party to prevent inclusion under I.R.C. § 2042, see I.R.S. P.L.R. 200314009, I.R.S. P.L.R. 200615025.
B. Effect of Spouse, as Trustee of an ILIT, on the Other Spouse

A life insurance policy on a spouse, purchased by the other spouse’s irrevocable trust is not includible in the insured spouse’s estate if the insured spouse is not a co-trustee.\(^99\) In addition, so long as the surviving spouse is not an insured, the uninsured spouse may 1) be a trustee, 2) have Crummey withdrawal rights,\(^100\) 3) have interests in income and principal as a beneficiary at the discretion of an independent trustee (but not in the surviving spouse’s sole discretion), 4) have a lifetime testamentary limited power of appointment,\(^101\) and 5) have discretionary power over distributions to other beneficiaries of the trust.\(^102\) If the surviving spouse is an insured under a second-to-die life insurance policy held in an ILIT, neither spouse may have any incidents of ownership (i.e., none of the above powers).\(^103\)

VII. APPLICATION OF GENERATION SKIPPING TRANSFER TAX TO ILITS

A. The Generation Skipping Transfer Tax

When an ILIT provides benefits to multiple generations, a generation skipping transfer (GST) tax equal to the maximum federal estate tax rate is imposed on transfers to skip persons (persons more than one generation removed from the donor.)\(^104\) If settlor’s grandchild is the child of a

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\(^{99}\) I.R.S. P.L.R. 200617008; see also I.R.S. P.L.R. 200404013 (purchase by husband's irrevocable trust, of which wife was trustee of joint and survivor life insurance policy on husband and wife, proceeds payable to the trust, was not included in either husband’s or wife’s estate under I.R.C. § 2042(2)); see also G.C.M. 39333 (1/29/85), 39317 (12/12/84), 38751 (6/12/81). The IRS may, however, argue that the trust was pre-arranged. See Slade, supra note 17, at 807 III. C. 1 (b) (2007).

\(^{100}\) I.R.C. § 2042(2) (access to cash value of a policy is an incident of ownership).

\(^{101}\) Treas. Reg. § 20.2042–1(c)(4) (incident of ownership includes power to change beneficial ownership in the policy or its proceeds). However, see P.L.R. 9538035, 9434028.

\(^{102}\) Rev. Rul. 84–179, 1984–2 C.B. 195 (decedent may be a trustee holding powers over a life insurance trust in a fiduciary capacity, if the decedent did not 1) transfer the policy to the trust, 2) provide consideration for purchasing or maintaining the trust, and 3) the power is not exercisable for decedent’s personal benefit).

\(^{103}\) I.R.C. § 2042(2); I.R.S. P.L.R. 200127042 (second-to-die life insurance trust not includible in spouse's estate if spouse is not the trustee). I.R.S. P.L.R. 200404013 (husband's irrevocable life insurance trust purchased and maintained a second- to-die policy on husband and wife, proceeds not be included in either husband's or wife's estate under § 2042(2), even though wife was a trustee). The powers of a trustee spouse of the insured to manage the trust and pay principal to the income beneficiary were not held to be incidents of ownership because they could not be exercised for the trustee’s benefit, Treas. Reg. § 20.2042-1(c), Estate of Skifter v. Comm’r, 468 F.2d 699 (2d Cir. 1972).

\(^{104}\) I.R.C. §§ 2601, 2611, Treas. Reg. § 26.2611-1. A skip person is (1) a natural person assigned to a generation two or more generations below the transferor’s generation; or (2) a trust if all interests in the trust are held by skip persons or no person holds an interest in the
predeceased child when an ILIT is formed, the grandchild is treated as if the
grandchild were the transferor’s child.\footnote{I.R.C. § 2651(e) the generation assignment exceptions to I.R.C. § 2612 (taxable terminations), which also applies to collateral heirs if the transferor had no living lineal descendants when the transfer was made.)}

If child dies after formation of the trust, the generation assignment at formation continues to apply.\footnote{If a transfer to a trust would be a direct skip but for Treas. Reg. § 26.2612-1(a)(2), any generation assignment determined under this paragraph continues to apply in determining whether any subsequent distribution from (or termination of an interest in) the portion of the trust attributable to that transfer is a GST.}

A GST is 1) a \textit{taxable distribution},\footnote{A \textit{taxable distribution} is a transfer from a trust to or for the benefit of a person two or more generations below that of the transferor unless the distribution is a taxable termination or a direct skip, Treas. Reg. § 26.2612-1(c)(1); any distribution from a trust to a skip person (other than a taxable termination or a direct skip),” I.R.C. § 2612(b); or from a trust to or for the benefit of a person two or more generations below that of the transferor unless the distribution is a taxable termination or a direct skip, Treas. Reg. § 26.2612-1(b)(2).} 2) a \textit{taxable termination},\footnote{A \textit{taxable termination} occurs if, after the termination of a prior interest, all interests in the trust are held by or for the benefit of a person two or more generations below that of the transferor. Treas. Reg. § 26.2612-1(b)(1).} or 3) a \textit{direct skip}.\footnote{I.R.C. §§ 2601, 2611. Generation assignment is determined under rules contained in I.R.C. § 2651.}

Whether a transfer is a GST is measured from the date of the most recent transfer that was subject to either estate tax or gift tax.\footnote{Treas. Reg. § 26.2664.}

An inter-vivos transfer, whether made directly to an individual, to a trust for a beneficiary, or to a remainder person is subject to GST tax if the transfer is to a direct skip.\footnote{Treas. Reg. §§ 26.2601–1(a)(1), (2); 26.2601–1(b)(1).}

A GST to a trust is a transfer to any trust for which a skip person is a beneficiary unless one of the limited statutory exceptions applies.\footnote{The exceptions to the GST rules applicable to remainder persons who are skip persons are specified in I.R.C. § 2632(c)(3)(B).}

Each taxpayer is permitted an exclusion amount from the GST tax. For GST exclusion allocation purposes, proceeds are valued at the time the allocation is made.\footnote{Treas. Reg. §§ 26.2642–2(b)(2), (3); 26.2642-2(c).}

\section*{B. GST Tax Rules Applying to ILITs}

If the initial beneficiaries of a trust are non-skip persons and the remainder interests accrue to skip persons, distributions to skip persons are
subject to GST tax when the transfer occurs. Contributions to a trust from multiple transferors are treated as if they were contributions to separate trusts with respect to determining whether GST tax is applicable. Upon a taxable termination GST tax is imposed on trust assets distributed to the skip person. Termination of an interest in property caused by the death of a lineal descendant of the transferor that results in a specified portion of a trust being distributed to or for the benefit of one or more skip persons is a partial taxable termination.

When settlor’s ILIT provides for income to spouse for life, remainder to granddaughter pursuant to a qualified terminable interest property (QTIP) trust, the transfer is not to a skip person. However, at the spouse’s death, the property transferred to the granddaughter, a skip person, is included in the spouse’s gross estate. Wife’s GST exemption applies to the transfer since wife is the transferor to the granddaughter. If husband (or his estate) makes a reverse QTIP election, husband is treated as the transferor when wife dies and there is a taxable termination at the wife’s death rather than a direct skip.

A settlor may utilize the non-taxable gift exclusion when making a gift to a trust with a skip person beneficiary if 1) only the skip person may be a beneficiary of the trust, 2) during the skip person’s life neither corpus nor income may be distributed to any person other than such skip person, and 3) when the trust terminates, the assets all revert to the skip person, or if the skip person dies prior to termination, the trust assets are included in the skip person’s gross estate. The gift exclusion only applies to a transfer of a

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114 I.R.C. § 2612(a), (b); I.R.S. P.L.R. 8924068. A taxable termination is a termination of an interest in a trust unless, immediately after the termination, the person receiving the proceeds is not a skip person and no future distributions from the trust are made to a skip person, I.R.C. 2612(a), Treas. Reg. § 26.2612-1(f), Ex. 9. At less than five percent, the possibility of a transfer to a skip person is ignored, Treas. Reg. § 26.2612–1(b)(1)(iii).
115 I.R.C. §§ 645, 2654(b).
116 I.R.C. § 2612(b).
117 Income to daughter for life, remainder to granddaughter, causes a taxable termination when daughter’s interest terminates and trust corpus passes to granddaughter who is a skip person, I.R.C. § 2612(a)(2); Treas. Reg. § 26.2612-1(b)(2).
118 I.R.C. § 2056(b)(7).
119 Id.
120 Id.
121 I.R.C. § 2642(c).
122 I.R.C. § 2642(c)(2).
123 The gift tax exclusion is I.R.C. § 2503(b). The applicability of the gift tax exclusion to GST is found at I.R.C. § 2642(c).
current interest to a skip person\textsuperscript{124} (such as a cash or property gift to a grandchild).\textsuperscript{125}

Where discretionary beneficiaries of an ILIT include non-skip persons (such as a spouse or children) as well as skip persons (such as grandchildren) transfers to such trusts are not transfers to direct skips. Unless the settlor utilizes a \textit{double Crummey power}, all distributions to skip persons will either be taxable distributions when made or taxable when there is a taxable termination.\textsuperscript{126} A double Crummey power is a gift to the ILIT that gives a child a Crummey power (which the child allows to lapse) and gives the grandchild a Crummey power (which the grandchild also allows to lapse). Since a Crummey power is a general power of appointment, when the child allows the withdrawal right to lapse, the child has made a gift of the exclusion amount to the child’s child (the settlor’s grandchild) (the grandchild’s Crummey withdrawal right makes the gift from child to grandchild a present interest). Because the gift is given by a parent rather than a grandparent there is no GST tax due.\textsuperscript{127}

C. GST Tax Exemption, Allocation Rules, and Inclusion Ratios

The GST inclusion ratio\textsuperscript{128} is the percentage of a transfer to a skip person that is subject to GST tax.\textsuperscript{129} No GST tax is assessed against a transfer from a skip person ILIT when the settlor allocates a portion of lifetime GST exemption equal to the amount of the transfer. An individual’s estate may allocate the GST exemption at any time on or before the date for filing the estate tax return (taking extensions into account), even if no return is filed.\textsuperscript{130} Married couples can treat a transfer as made one-half by each spouse, thus doubling the exemption.\textsuperscript{131} The GST tax exemption is

\textsuperscript{124} A \textit{direct skip} is a transfer subject to tax imposed by chapter 11 or 12 of an interest in property to a skip person. I.R.C. § 2612(c), 26-2612-1(a), (d).
\textsuperscript{125} I.R.C. §§ 2642(c)(1) (“In the case of a direct skip which is a nontaxable gift, the inclusion ratio shall be zero.”).
\textsuperscript{126} See the examples in Treas. Reg. § 26.2612-1(f); Treas. Reg. § 26.2652–1(a)(5), Ex. 5.
\textsuperscript{128} I.R.C. § 2632 provides the rules for allocation of the GST exemption to different trusts; I.R.C. § 2642 explains the description and function of the inclusion ratio applied to property in a GST.
\textsuperscript{129} I.R.C. § 2642.
\textsuperscript{130} I.R.C. § 2632(a)(1).
\textsuperscript{131} I.R.C. § 2513, I.R.C. § 2652(a)(2) permits donors to treat one-half of a gift as being made by each spouse. Once filed, an allocation may not be revoked. See Treas. Reg. § 26.2632-1(c)(1) (at the termination of inclusion of a gift in the donor’s estate, the taxpayer may allocate gift tax exclusion). See also Prop. Treas. Reg. § 262642-7, REG-147775-06, 73 Fed. Reg. 20870 (4/17/08), on extensions of time for filing where the taxpayer acted reasonably and in good faith and did not prejudice the government.
automatically allocated to gifts to an irrevocable trust, all of whose current beneficiaries are skip persons unless the settlor elects out of the automatic allocation. The automatic allocation also applies to an exempt gift unless the settlor opts out or the gift is to an irrevocable trust with only a single skip person beneficiary.

Forming a direct skip ILIT and allocating GST exemption to the annual gifts as contributed permits large transfers of life insurance proceeds to skip persons with small allocations of GST exemption. The valuation of a gift to an ILIT for GST tax purposes is its value for gift tax purposes if the allocation is made when the gift is made, and is the value of the property when the exemption allocation is made if the allocation is made at a later time. A bequest at death is valued for GST exemption purposes at its value for estate tax purposes. The value of a gift subject to a late-filed GST exemption filing is valued as of the first day of the month in which the late filing is made. When property is transferred in a GST on which GST tax is paid, the basis of the property is increased (but not above its fair market value) by the GST tax. Any changes in basis are limited by multiplying the change by the inclusion ratio.

If the settlor/insured’s ILIT purchases the policy before April 15, and dies before the next April 15, the executor can allocate sufficient GST exemption by April 15 of the year following the year in which the premium was paid to cover the gift of the purchase price of the term insurance. However, the exemption allocation must be large enough to cover the proceeds at death instead of only covering each premium. For GST purposes, the value of a life insurance policy transferred to a trust is generally the interpolated terminal reserve plus the unused portion of the gross premium last paid which covers the period extending beyond the

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133 The gift tax return filing requirements are found at Treas. Reg. § 26.2632-1(b)(1), (2) requiring filing on April 15. See also Treas. Reg. § 301.9100-2(b) (election out of automatic GST allocation, once made, is irrevocable); the exception is found at I.R.C. § 2642(c)(3)(b).
134 Treas. Reg. § 26.2612–1(f) Ex. 1, 2. The result, if the ILIT is not a skip person ILIT, is illustrated in Treas. Reg. § 26.2612-1(f) Ex. 4.
135 I.R.C. § 2642(b)(1).
136 I.R.C. § 2642(b)(3).
139 I.R.C. § 2654(a)(1).
140 I.R.C. § 2654(a)(2).
142 Treas. Reg. § 26.2642-2(a)(2). A late allocation after the insured/settlor’s death must be made based on the amount of proceeds rather than on the cost of the insurance. Id.
transfer. In ILITs where the settlor's spouse is a beneficiary under the attribution rules, granting a hanging Crummey power to the transferor’s spouse causes an estate tax inclusion period for the settlor that lasts for the duration of the hanging power. To avoid the problem, when one allocates a GST exemption to an ILIT that qualifies for the annual gift tax exemption, the spouse should only be granted a withdrawal power of the greater of $5,000 or five percent of the trust corpus and the power should lapse in sixty days.

Allocation of a GST exemption is made to an entire direct skip trust, not just to specific property allocated to the trust. A trust may be severed to reflect the separate trusts deemed to exist under the above rule, or the settlor may establish separate trusts, each with a separate GST tax exemption allocation, to allocate a GST tax exemption to specific property. GST tax exemptions not allocated before death are automatically deemed to be allocated first to property that is subject of a direct skip at death, then to those of decedent’s trusts that could make a taxable distribution or taxable termination.

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143 Treas. Reg. § 25.2512-6(a), Ex. 3. Gifts of subsequent premiums are equal to the amount of the premiums, Rev. Rul. 84–147, 1984–2 C.B. 201; I.R.C. § 2512; Treas. Reg. § 25.2512–1. “[W]hen the gift is of a contract which has been in force for some time and on which further premium payments are to be made, the value may be approximated by adding to the interpolated terminal reserve [generally the cash value of the policy] at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date.” Treas. Reg. § 2512-6(a); see also Treas. Reg. § 20.2031-8(a)(2).

144 I.R.C. § 2642(f)(4). The power would be includible in the spouse’s estate because it is a general power of appointment under I.R.C. § 2041 that is not limited to the greater of $5,000 or five percent of the trust corpus so as to fall under the exception in Treas. Reg. § 26.2632-1(c)(2)(ii)(B).

145 Id.


147 Treas. Reg. § 26.2654-1(a) (settlor may create separate trusts).

148 As opposed to transfers of specific property to a recipient, each of which is treated as a separate gift to which a GST tax exemption may be applied, Treas. Reg. § 26.2632-1(a).

However, see Treas. Reg. § 26.2654-1(a) (settlor may create separate trusts). See I.R.S. P.L.R. 200841023, Oct. 10, 2008 (pursuant to I.R.C. § 2642, a trust may be divided and the GST exclusion ratio applicable to the original trust will apply to the sub-trusts thereby created); see also I.R.S. P.L.R. 200738005; I.R.S. P.L.R. 200724020.

VIII. TREATMENT OF ILITs WITH REMAINERS TO GRANDCHILD OR GREAT GRANDCHILD

If settlor’s executor elects to treat as QTIP property settlor’s ILIT paying income to spouse for life, remainder to grandchild, the remainder is not a direct skip because spouse, a person who is not a skip person, holds a present right to receive income from the trust. If settlor’s testamentary trust provides that income is paid to spouse for life, remainder to grandchild, a taxable termination occurs at spouse’s death. At spouse's death, the trust property is included in the spouse’s gross estate, the remainder passes to a skip person and becomes subject to GST tax at that time unless covered by the spouse’s exclusion. If a skip person has a right to withdraw funds before the non-skip person’s death, funds withdrawn by the skip person are subject to GST tax as a taxable distribution.

A partial taxable termination occurs if, after the death of one of two children, the trustee makes an elective distribution of part of the trust assets to a grandchild (a skip person). If the trustee distributes all trust principal to a great grandchild after child dies, the distribution results in a taxable termination because the grandchild's interest terminates as a result of the distribution of all trust property. On the other hand, if a settlor’s ILIT provides for income to two children, payment of half of the principal to grandchildren on the death of the first child and payment of the remainder to grandchildren on the death of the second child, the distribution occurring at the death of the first child is a taxable termination. It is not a taxable distribution because the distribution is of a portion of the trust that occurs as a result of the death of a child who is a lineal descendant of the settlor.

A taxable distribution that is neither a taxable termination nor a direct skip occurs when an ILIT provides for trust income to settlor's child for life; however, when settlor's grandchild attains thirty-five years of age and child is alive, grandchild is to receive one-half of the principal. The distribution to grandchild is a taxable termination because it is a distribution to a skip person and is neither a taxable termination nor a direct skip. If the grandchild holds a continuing right to withdraw trust principal and the

151 I.R.C. § 2056(b)(7).
152 Treas. Reg. § 26.2612–1(f), Ex. 5.
153 Treas. Reg. § 26.2612–1(f), Ex. 11. Treas. Reg. § 26.2642–1(d), Example 3 explains that if a gift in excess of the exclusion amount is given, the excess amount is subject to GST tax. See also Treas. Reg. § 26.2612-1(f) Ex. 5.
grandchild withdraws less than all of the assets, the withdrawal is a taxable distribution to grandchild.157

IX. INCOME TAX TREATMENT OF ILIT INCOME

A. The Grantor Trust Rules for Settlors, Other Grantors, and Beneficiaries

The settlor of a revocable trust is treated as owner of any portion of a trust the settlor may re vest in himself or herself158 and is taxed on trust income, including any income earned by a life insurance policy in the trust.159 The general rule is that the settlor of an inter-vivos ILIT is generally not taxed on trust income because the trust itself or a person other than the settlor is treated as owner of the trust if that person may vest corpus or income in himself or herself, or the person released or modified a power but retains control within the meaning of I.R.C. §§ 671-677.160 However, ILITs may be taxed as grantor trusts for income tax purposes under I.R.C. § 677(a)(3).161 The rule applies even if the trustee purchased the insurance after creation of the trust.162

One can include provisions in a trust to make it a grantor trust for income tax purposes but not for estate tax purposes to create a defective trust. This increases cash available to the trust by having the settlor rather than the trust pay income tax. Under I.R.C. § 677(a)(3) a trust should be defective to the extent its income is used to pay insurance premiums. In addition, retaining a right to exchange assets in the trust for other assets pursuant to I.R.C. § 675(4)(C) also causes the settlor to be treated as owner of the trust for income tax purposes. Finally, one can give a non-adverse party power to add charities or other beneficiaries which causes attribution of income to the settlor under I.R.C. §674.

A person other than settlor is treated as substantial 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 there from in himself163 or such

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158 I.R.C. § 676.
159 I.R.C. § 677(a)(3).
160 Id.
161 I.R.C. § 677(a)(3); settlor treated as owner of portion of trust whose income, without approval or consent of an adverse party, may be “applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse. . . .”). An adverse party is any person with a substantial beneficial interest in a trust who would be adversely affected by the exercise or non-exercise of a power a person possesses respecting the trust, I.R.C. § 672(a). See also Rev. Rul. 66–313, 1966–2 C.B. 245; Strockstrom v. Comm’r, 3 T.C. 664 (1944).
162 Strockstrom v. Comm’r, 3 T.C. 664 (1944).
163 I.R.C. § 678(a)(1).
person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of I.R.C. §§ 671 – 677, inclusive, subject grantor of a trust to treatment as the owner thereof.” 164 The rule does not apply where the settlor/grantor is taxable. 165 In addition, the general rule does not apply “with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.” 166

B. Crummey Power Holder’s Liability for Income Tax on Trust Assets

Unless an ILIT is a grantor trust for income tax purposes, so long as a Crummey withdrawal power remains in force, it causes income from the amount of the trust that could be withdrawn pursuant to the power to be taxed to the trust beneficiary (a Mallinckrodt power). 167 The IRS also reasons that a person other than a trust’s settlor is treated as owner of that portion of a trust to which the non-settlor “previously released or otherwise modified such power [to vest corpus or income in himself or herself] and after release or modification retains such control as would, within the principles of I.R.C. §§ 671 – 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.” 168 Because trustee may either distribute to the holder of the lapsed Crummey power or accumulate for future distribution, I.R.C. § 678(a)(2) applies to make the holder liable for income tax on that portion of income, deduction, and credits after release. 169

The IRS argues that the beneficiary is taxable on the part of corpus subject to the withdrawal power, and also taxable on the growing portion of trust corpus over which beneficiary failed to exercise the withdrawal

164 I.R.C. § 678(a)(2).
165 I.R.C. § 678(b).
166 I.R.C. § 678(d).
167 I.R.C. § 678(a)(1) (person other than granter treated as owner of portion of trust over which person has sole power to vest corpus or income in himself or herself); Rev. Rul.67–241, 1967–2 C.B. 225; I.R.S. P.L.R. 9745010, 9625031, 9541029, 9535047, 9504024, 9450014, 8142061. See also Mallinckrodt v. Comm’r, 2 T.C. 1128 (1943), aff’d, 146 F.2d 1 (8th Cir. 1945), acq 1944 CB 18.
168 I.R.C. § 678(a)(1); I.R.C. § 678(a)(2) (holder of Crummey power who fails to exercise it treated as if holder partially released power to withdraw portion of trust corpus); Treas. Reg. § 1.671–3). I.R.S. P.L.R. 8142061 (amount taxable to a beneficiary who holds a $5,000 or five percent power must account for the time for which the power is held); I.R.S. P.L.R. 9745010, 9625031, 9535047, 9523029, 9504024, 9034004, 8701007, 8521060, 8517052, 8326074, 8142061.
power. Courts have arguably supported the position. Slade concludes: “If the IRS' position is correct, under § 678(b), it is implied that the holders of withdrawal powers over corpus — or beneficiaries whose withdrawal powers over corpus have lapsed — will be treated as the owners of a portion of the trust, with the grantors treated as the owners of the remainder under § 677.” However, if a settlor holds grantor trust status under I.R.C. §§ 673-677 and beneficiaries hold an I.R.C. § 678 power, such as a Crummey power over the income at the same time, the beneficiary’s power is disregarded under I.R.C. § 678(b). When a trust ceases to be treated as a grantor trust on the death of the settlor/insured, the trust is treated by the Service as a separate taxpayer for income tax purposes, rather than the holders of hanging or lapsed powers being treated as the owners of trust income.

C. Effect of the Transfer–For–Value Rule on Income Tax Liability

The transfer-for-value rule states that when life insurance is transferred for valuable consideration, the proceeds of the policy that exceed the sum of actual consideration and premiums paid may not be excluded from gross income. The rule does not apply when the transfer is to the insured, a partner of the insured, a partnership in which the insured is partner, or to a corporation in which the insured is a shareholder or officer. When one transfers life insurance on one’s own life to an ILIT for no consideration, the transfer-for-value rule is not triggered. Sale to an ILIT for other than full

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170 “During each succeeding year in which beneficiary fails to exercise his or her power, beneficiary will be treated as the owner of an increasing portion of corpus of T.” I.R.S. P.L.R. 9034004. See also P.L.R. 20022035, 200104005.
172 Slade, supra note 17, at V. B. 2.
175 I.R.C. § 101(a)(2). If the policy is encumbered, the analysis becomes more complicated, see Diana S.C. Zeydel, The Transfer-for-value Rule: Developments and Clarifications, 134 TR. & EST. 75 (Apr. 1995).
177 Treas. Reg. § 1.101–1(b)(2).
value does come under the transfer-for-value rule because it is a sale for valuable consideration.\textsuperscript{178}

\textbf{X. IRREVOCABLE INSURANCE TRUSTS IN SPLIT-DOLLAR ARRANGEMENTS}

\textbf{A. Description of a Split-Dollar Arrangement}

A \textit{split-dollar} insurance arrangement is any arrangement between an owner and non-owner of a life insurance policy where 1) one or both parties pay all or a portion of premiums, 2) a party making payments has a right to recover all or a portion of those payments, and 3) the arrangement is not part of a group term life insurance plan (other than one providing permanent benefits).\textsuperscript{179} Split-dollar life insurance can split ownership between 1) employer and employee, 2) different family members, 3) a corporation and a stockholder, or 4) an LLC and an LLC member. There are two separate structures under which split-dollar life insurance arrangements are taxed, \textsuperscript{180} the \textit{economic benefit regime},\textsuperscript{181} and the \textit{loan regime}.\textsuperscript{182} Under each regime gift or income taxes must be paid on transfers from the provider of economic benefits to the recipient to the extent not recovered with interest by the provider.

\textbf{B. The Economic Benefit Regime Rules}

Under the economic benefit regime rules, the owner is the donor of the life insurance that provides economic benefits to the non-owner donee. The employer or donor reports to the IRS the economic benefits the donee receives, which are subject to income tax on the employee’s benefit or gift tax paid on the taxable value of current life insurance protection, policy cash value increase, and dividends or withdrawals received by the donee and not repaid.\textsuperscript{183}

\begin{footnotesize}
\textsuperscript{178} Rev. Rul.85–13, 1985–1 C.B. 184; however, I.R.S. P.L.R. 8718046, 8636053; 200514001, 200514002 provide that transfer for consideration of life insurance policies from one grantor trust to another are disregarded for income tax purposes.
\textsuperscript{179} Treas. Reg. § 1.61-22(b)(1).
\textsuperscript{181} Treas. Reg. § 1.61-22.
\textsuperscript{182} Treas. Reg. § 1.7872-15.
\textsuperscript{183} Treas. Reg. § 1.61-22. Note that a transfer of the life insurance contract owned by an employer to an employee is taxed as income under I.R.C. § 83.
\end{footnotesize}
C. The Loan Regime Rules

Under the split-dollar loan regime rules, benefits are provided by the non-owner donor to the insurance company, which are treated as loans to the donee employee or gift recipient. To the extent the owner does not repay the loan with market interest, the shortfall is treated as either income or as a gift to the recipient. If the non-owner is required to repay the split-dollar loan amount, general income tax rules governing below market loans apply to the premium payments made by the non-owner on the owner's behalf.

D. Structuring Private Split-Dollar Arrangements to Avoid Gift Tax

Gift tax on the value of a transfer can be avoided if a taxpayer, taxpayer's spouse, and ILIT enter into a private reverse split-dollar arrangement for the benefit of children where trustee executes a collateral assignment split-dollar agreement with the taxpayer's spouse under which trustee, as owner, pays the portion of the annual policy premiums equal to the lesser of the applicable amount provided in the IRS’s tables or published premium rates for individual one-year term life insurance available to standard risk insureds. Spouse agrees to pay the balance of the annual premium from separate property. If the collateral assignment is terminated by taxpayer or spouse prior to the taxpayer's death, spouse is entitled to the cash value net of indebtedness secured by the policy.

At taxpayer's death, the spouse will receive the greater of the policy’s cash value immediately prior to taxpayer's death or the total premiums that she has paid less indebtedness received by the spouse and secured by the policy. Payment of the policy premium by the trustee and spouse pursuant to the terms of this split-dollar agreement will not result in a gift or deemed gift to the trust by the taxpayer's spouse because in consideration for paying a portion of premiums the spouse will receive the cash value of the policy.

184 Below market loans are subject to the I.R.C. § 7872 rules, and to the Original Issue Discount rules of I.R.C. §§ 1271-1275; Treas. Reg. § 1.7872-15.
185 Treas. Reg. § 1.7872-15. Income is imputed whenever the imputed interest rate is below the market rate, which is defined as an interest rate that equals or exceeds the blended applicable federal rate (AFR) published for July of each year. I.R.C. § 7872 (annual additional income imputed equals loan amount times the difference between stated interest and AFR).
186 Preamble to TD 9092.
187 Rev. Rul. 81-198, 1981-2 C.B. 188. Prior to September 18, 2003, a split dollar insurance arrangement was valued in the same manner as cash value life insurance policies, interpolated terminal reserve plus the unused portion of the last premium paid. Since September 18, 2003, the economic benefit rules apply if the donor is owner, Treas. Reg. § 1.612-2(d) - (g), and the loan rules apply if the donor receives a collateral assignment and the trust is the owner, Treas. Reg. § 1.7872-15(b)(1).
Payment by both husband and wife of premiums for two life insurance policies, which are owned by the trust and are subject to a split-dollar arrangement, won't result in a gift or deemed gift to the trust either under I.R.C. §§ 2501 or 2511. Insurance proceeds payable to the trust won't be includible in gross estate of surviving spouse under I.R.C. § 2042.188

XI. CONCLUSION

An ILIT can provide the same protection for an insured’s family in the event of premature death as conventional life insurance. In addition, an ILIT can be an attractive means of minimizing estate taxes if the insured lives to normal life expectancy and becomes subject to estate tax. The cost of establishing an ILIT can be minimal and the benefits substantial, making an ILIT attractive for many, even given the uncertainty, both as to whether there will be an estate tax after 2010 and, if so, the size of the credit. For those receiving company provided life insurance there is virtually no disadvantage to placing the insurance in an ILIT. A properly designed ILIT can be modified or terminated if it becomes apparent that the estate tax is unlikely to be a consideration. The only decision that is clearly wrong is not to consider whether establishment of an ILIT would be beneficial to the insured and the insured’s family.

188 The payment neither results in a gift or a deemed gift to trust under either under I.R.C. § 2501 or I.R.C. § 2511; insurance proceeds payable to trust are not includible in gross estate of surviving spouse under I.R.C. § 2042; I.R.S. P.L.R. 200822003, 9636033, and 9745019. In addition I.R.S. P.L.R. 9636033 and 9745019 illustrate a structure where the insureds enter into a split-dollar arrangement for the benefit of their children that is designed to avoid gift taxes. See also I.R.S. P.L.R. 200822003.