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IRREVOCABLE LIFE INSURANCE TRUSTS IN THE ESTATE PLAN AFTER THE TAX REFORM ACT OF 1976

Henry G. Will*†

I. INTRODUCTION

Life insurance is a unique asset for estate planning purposes because its value appreciates so greatly at death.¹ This quality can be a two-edged sword, depending on how insurance is handled in the estate plan.

The insured generally gets little direct use from his life insurance policies during his lifetime, but upon his death they ripen into comparatively high-value assets which attract estate taxes and require a portion of the insurance proceeds themselves for payment. The insured's estate pays a disproportionately high amount of estate tax on life insurance

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1. Another unique feature of life insurance is that the appreciation at death is not included in the gross income of the recipient unless the policy has been transferred for a valuable consideration. *See* INT. REV. CODE § 101(a) [hereinafter cited as I.R.C.]. Also, the recipient has no carryover basis in the proceeds. I.R.C. § 1023(b)(2)(b). References to the I.R.C. are to the Internal Revenue Code of 1954, as amended, 26 U.S.C. §§ 1-7852, unless otherwise indicated.

compared with its utility during his lifetime. Nonetheless, insurance can be valuable to a decedent's estate as a source of cash for support of beneficiaries and for payment of debts, taxes and administration expenses. Its presence thereby can prevent untimely sales of other assets. Accordingly, the taxpayer who owns insurance enjoys little of its value during his lifetime but obtains liquidity at the price of the estate tax on the proceeds includable in his estate. Viewed another way, if life insurance is includable in a decedent's gross estate which is subject to estate tax, a portion of each premium dollar prepays a portion of the estate tax.

On the other hand, the dramatic appreciation of life insurance upon the death of the insured makes insurance an ideal asset for lifetime gifts. Its relatively low value before death enables a taxpayer to transfer, for the price of a gift tax, a comparatively large amount of cash. The gift tax will be assessed against the value of the insurance policy at the time of the gift.² If the taxpayer is successful in excluding the insurance from his estate when it is transferred, the appreciated value of the insurance need not be used to pay tax on the insurance itself and will be available for use by the taxpayer's beneficiaries. Accordingly, in the best of all estate planning worlds, by judicious use of irrevocable gifts of life insurance, the taxpayer's family can have the benefits of life insurance upon the taxpayer's death (i.e., its liquidity and substantial increase in value over the taxpayer's cost) without the burden of estate tax diminution of the cash provided.

Not all taxpayers need be concerned about transferring life insurance. Each situation must be closely analyzed to ascertain that transfers could be beneficial. For decedents dying after 1980 with a surviving spouse and an estate of no more than \$425,625.00 which includes life insurance, the insurance proceeds should not be reduced by federal estate taxes.³ However, for decedents' estates of more than \$425,625.00 after 1980, or those in which the maximum marital deduction will not be taken or available, there is a risk that federal estate taxes will diminish the proceeds of life insurance owned by the decedent.

2. Treas. Reg. §§ 25.2503-1, .2512-6 (1972).

3. This assumes that the maximum marital deduction will be available. After 1980 the unified credit of \$47,000 will apply. This is equivalent to an exemption of \$175,625. By utilizing a maximum marital deduction of \$250,000, a gross estate of \$425,625 could be exempt from federal estate taxes. For decedents dying in years prior to 1981, the unified credit phases in at the rate of \$30,000 in 1977, \$34,000 in 1978, \$38,000 in 1979 and \$42,500 in 1980 with exemption equivalents of \$120,000, \$134,000, \$147,000 and \$162,000 respectively. See [1976] 57 FED. TAXES (P-H) ¶ 252.

When it is determined that life insurance policies should be removed from the taxpayer's estate either by transfers or by arranging for ownership in another person or legal entity at the time of purchase, the primary question is who should be the owner of the policies. Although many arrangements are possible, the taxpayer's spouse frequently is selected to own the policies either at the time of original purchase or by assignment. Many times this is the most expedient and best arrangement considering all circumstances, but care must be taken to prevent the return of the policies or their proceeds to the taxpayer if the spouse is the first to die. Even if the spouse survives the taxpayer, and his estate does not include the insurance by operation of law,⁴ the surviving spouse may receive more cash from insurance proceeds than she can properly manage. More importantly for tax purposes, upon her subsequent death the proceeds of the insurance on her husband's life, transferred to her before his death, will be includable in her gross estate to the extent that they have not been expended or given away. If the surviving spouse's gross estate exceeds \$175,625.00 (for spouses dying after 1980) the insurance proceeds that remain could be subject to federal estate tax. This could result in more taxes on both estates than if no gift had been made by the husband originally.⁵ In the worst possible case, there could be double taxation of the insurance: one tax could be levied at the death of the husband whose life is insured (if the policies are included in his gross estate and his estate does not escape taxation on account of limits mentioned above) and, subsequently, a tax could be levied at the death of the surviving spouse if her estate is large enough. Accordingly, ownership of life insurance on the life of one spouse by the other may not be advisable when the combined estates of

4. Under I.R.C. § 2035, as amended by § 2001(a)(5) of the Tax Reform Act of 1976, transfers by the decedent for less than adequate consideration made within three years of death are includable in the decedent's gross estate unless they fall within the exception for present interest gifts set forward in I.R.C. § 2035(b)(2). Likewise some transfers may be subject to retained interests which will cause inclusion under I.R.C. § 2042.

5. To illustrate, assume that *H* dies in 1981 with an estate of \$1,000,000, \$250,000 of which consists of life insurance proceeds. If he leaves one-half of his \$1,000,000 estate to his wife, *W*, and one-half to a trust for the benefit of his children, upon *W*'s immediate subsequent death (without allowing for the credit for prior estate taxes paid) the federal estate taxes on both *H*'s estate and *W*'s estate would equal approximately \$157,600. But if *H*, more than three years prior to his death, had transferred \$250,000 of term life insurance to *W* outright and at death leaves \$375,000 each to *W* and to a trust for his children, the tax on *H*'s \$750,000 gross estate would be \$66,300, the tax at *W*'s death on a gross estate which includes the proceeds of the \$250,000 which was transferred to *W* would be \$155,050, and the total federal estate tax would be \$221,350, for a "loss" of \$63,750.

the two spouses are large enough to exceed the marital deduction and unified credit amounts allowed under the Tax Reform Act of 1976.⁶ In such situations, as well as others where it is desirable to eliminate the proceeds of life insurance from the gross estate of the insured and his spouse, irrevocable transfers to a third party other than the taxpayer's spouse (such as to an irrevocable life insurance trust) can save substantial amounts of estate tax depending on the amount and timing of the transfers and the relative sizes of the estates of the spouses.⁷

The purpose of this article is to examine the practicalities and pitfalls of using irrevocable life insurance trusts to exclude insurance proceeds from the decedent's gross estate. It is assumed that proper criteria have been wisely considered in determining whether a particular client's estate and personal situation is suited for a life insurance trust.⁸ This article will discuss matters to be considered once the estate planner has tentatively determined that it is appropriate to establish an irrevocable trust to receive life insurance policies. These include, generally, (1) making the transfer, (2) arranging for premium payments, (3) selecting a trustee, and (4) essential trust provisions. Throughout, consideration will be given to certain life insurance matters, federal gift taxation and handling risks peculiar to irrevocable life insurance trusts. However, no attempt will be made to cover the principles of income taxation of trusts, throwback rules or taxes on generation-skipping transfers. Prior

6. Tax Reform Act of 1976, §§ 2001, 2002.

7. In note 5 *supra*, if *H* transferred the \$250,000 of life insurance to an irrevocable trust instead of *W*, the tax on *H*'s \$375,000 gross estate would be approximately \$66,300; if *W* died shortly thereafter the tax on *W*'s gross estate of \$375,000 would be approximately \$66,300. Using the irrevocable trust instead of the maximum marital deduction would save approximately \$25,000 (the difference between \$157,600 and \$132,600).

An irrevocable life insurance trust may be used to accomplish other tax goals. For instance, many closely held corporations own "key man" life insurance on the life of the controlling or sole shareholder with proceeds payable to the corporation. Although such proceeds will not be includable directly in the gross estate of the shareholder upon his death (see Treas. Reg. § 20.2042-1(c)(6)), they will increase the value of the stock (see Treas. Reg. § 20.2031-2(f)) causing a greater gain to be recognized for income tax purposes upon redemption or sale of the stock after death due to the carryover basis provisions of IRC § 1023 (added by § 2005(a)(2) of the Tax Reform Act of 1976). It may be advisable to use an irrevocable life insurance trust to hold the insurance rather than the corporation. Also, various sections of the Code, such as IRC §§ 303, 2032A, 6166 and 6166A, provide that percentage tests must be met before certain estate tax elections are available to a decedent's estate. It may be desirable to remove life insurance from the taxpayer's gross estate (such as by a transfer to an irrevocable life insurance trust) in order to preserve one or more such elections.

8. Age, health, marital stability and the kinds of insurance involved should be considered by the estate planner before the decision is made to transfer policies to a trust that cannot be amended or revoked. In the author's experience, an irrevocable trust generally is not advisable unless the client is over 50 years old.

to such discussion, it is useful to consider how the removal of life insurance by way of transfer from a decedent's estate can reduce estate taxes under the Tax Reform Act of 1976.

II. BENEFITS OF REMOVING LIFE INSURANCE AFTER THE TAX REFORM ACT OF 1976

Under the estate tax provisions of the Internal Revenue Code in effect for transfers made prior to 1977, life insurance transferred by outright gift *more* than three years before a decedent's date of death was excluded from the computation of tax on the decedent's gross estate. Nothing in the new Act appears to change this result. Under new Code section 2001(b), assets transferred *more* than three years before death will be included in computing tax on the decedent's gross estate, but only to the extent of the value of the decedent's "adjusted taxable gifts." "Adjusted taxable gifts" means the "total amount of the taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts which are includable in the gross estate of the decedent."⁹ The effect of this provision is to allow gifted property which is not "taxable" under the gift tax provisions to escape the federal estate tax.

A present interest gift of life insurance of less than \$3,000 in value, transferred more than three years before death, should qualify for this treatment because none of the value of the gifted property at the time of the gift would be included in the "adjusted taxable gift." However, the value of a transfer made more than three years before death which is "taxable" under gift tax law will be includable in the gross estate, but the amount of the gift tax paid will be allowed as a deduction under IRC § 2012. Thus, whether or not the original gift made more than three years before death is "taxable" under the gift tax, the appreciation in value after the date of the gift should escape the estate tax. Under pre-Reform Act law, insurance transferred *within* three years of death was includable in the decedent's gross estate, subject to a showing that the taxpayer had significant life motives in making the transfer,¹⁰ a difficult but not impossible task.¹¹ Under a plain reading of new sec-

9. I.R.C. § 2001(b).

10. I.R.C. § 2035 (1954).

11. Life insurance is so closely associated with death that frequently it is difficult to demonstrate sufficient "life motives" to overcome the presumption of a transfer in contemplation of death. See *Berman v. United States*, 487 F.2d 70 (5th Cir. 1973). *But see Landorf v. United States*, 408 F.2d 461 (2d Cir. 1969).

tion 2035(b)(2) regarding transfers within three years of death, the Tax Reform Act of 1976 could actually improve the planner's task. Section 2035 of the Code, as amended, for deaths occurring after December 31, 1976, automatically includes most transfers made within three years of death regardless of the decedent's motive. But the section expressly excludes from this broad sweep: "[A]ny gift excludable in computing taxable gifts by reason of section 2503(b) (relating to \$3,000 annual exclusion for purposes of the gift tax) determined without regard to section 2513(a) [regarding gifts split between spouses]."¹² This provision could be read to exclude from the gross estate that portion of a gift made within three years of death which is not subject to gift tax because of the present interest exclusion rule. If read to mean that the gift tax value controls, this section could be particularly significant for life insurance transfers because a present interest gift of a life insurance policy having a value of less than \$3,000 at the time of the gift would have the effect of removing all proceeds of that policy from the gross estate, even if death occurs within a short time after the gift.¹³

In summary, the Tax Reform Act of 1976 could improve the possibilities for judicious transfers of life insurance by the insured at any time. However, Treasury regulations to be issued under the new Act may take a contrary position on some of the foregoing points, thereby setting the stage for litigation, particularly in the area of transfers made within three years of death. In addition, the new Act must be read in light of recent cases, discussed at a later point in this article, that may

12. I.R.C. § 2035(b)(2).

13. The confusion in this area may be stated as follows: On the one hand, if life insurance is included in the gross estate under I.R.C. § 2035, its appreciated value at the date of death or alternate valuation date would be included in the gross estate. See Treas. Reg. § 20.2035-1(e) (1958) which provides in part: "The value of an interest in transferred property includable in a decedent's gross estate under this section is the *value of the interest as of the applicable valuation date*. In this connection, see sections 2031, 2032, and the regulations thereunder." (Emphasis added). I.R.C. § 2031 provides that the "value at the time of his death" shall apply to all property includable in the decedent's gross estate under "this part" (I.R.C. §§ 2033-2044). I.R.C. § 2032 provides for valuation at a later date, if elected. On the other hand, if the value at the time of the gift controls so that a transfer is excluded from I.R.C. § 2035(a) by operation of I.R.C. § 2035(b)(2), the value of life insurance or any other asset at date of death would be irrelevant. Query, however, what treatment should be applied to a gift of more than \$3,000 within three years of death? Should the entire value at the date of death be includable under I.R.C. § 2035 or should the value of the property at death, less \$3,000, be includable? The Committee Reports on new I.R.C. § 2035 appear to contemplate including the entire value of life insurance *at date of death*, less the present interest value. See page 529 of the Joint Committee's General Explanation of the Tax Reform Act of 1976. However, the language of new I.R.C. § 2035(b)(2) is not clear on this point.

well undermine any supposed Tax Reform Act windfall to the taxpayer for transfers made within three years before death. If transfers of life insurance within three years of death are includable in the gross estate under amended section 2035, the value of the gross estate will be increased by the amount of the insurance proceeds at date of death, rather than by the amount of the policy's value at the time of the transfer¹⁴ and the credit for prior gift tax paid in most cases would not sufficiently offset the increase so as to avoid estate tax. Under this uncertain situation, one must continue to counsel with great caution when death is apt to occur within three years of a transfer of life insurance.

III. REMOVING LIFE INSURANCE FROM THE GROSS ESTATE

The Code provides that the value of the gross estate includes the value of life insurance:

(1) To extent of the amount receivable by the executor . . . [or]

(2) receivable by all other beneficiaries . . . under policies on the life of the decedent . . . with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person.¹⁵

The statute expressly includes a "reversionary interest" as an incident of ownership, but "only if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent."¹⁶ Payments "receivable by the executor" and reversionary interests are discussed elsewhere in this article.¹⁷

Removing the insured's life insurance from his gross estate requires that both subsections of section 2042 be avoided. This can be accomplished by either (a) transferring policies already owned by the taxpayer to a third party, or (b) arranging for original ownership thereof by another, and providing that the executor does not receive the proceeds in either case. Both techniques require careful consideration of the incidents of ownership of life insurance and awareness of the risk of a "transfer" within three years of death.

14. *Treas. Reg. § 20.2042-1(a)(2)* (1974).

15. *I.R.C. § 2042*.

16. *I.R.C. § 2042(2)*.

17. See Section V of this article.

A. INCIDENTS OF OWNERSHIP

General

The regulations under Code section 2042 make it clear that the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense: "Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy."¹⁸ Such right may appear in one or more forms, including but not limited to (1) the right to designate or change the beneficiary,¹⁹ (2) the right to surrender or cancel the policy, (3) the right to assign the policy, (4) the right to revoke an assignment, (5) the right to pledge the policy for a loan, (6) the right to obtain a policy loan, (7) the right to change contingent beneficiaries who are to receive benefits after the primary beneficiary's death,²⁰ (8) the right to change the time or manner of payment of proceeds to the beneficiary by electing, changing or revoking settlement options,²¹ and (9) the right to veto the assignment or change of beneficiary.²²

In the case of insurance acquired by a corporation of which the insured is the sole or controlling stockholder, "the corporation's incidents of ownership will not be attributed to the decedent through his stock ownership to the extent the proceeds of the policy are payable to the corporation."²³ If the proceeds are payable to a third party for a valid business purpose, they will be deemed payable to the corporation and the incidents of ownership will not be attributed to the stockholder, according to the Treasury Regulations.²⁴ However, the Regulations provide that incidents of ownership will be attributed to a stockholder who owns a controlling interest if the proceeds of the policy owned by the corporation are payable to a third party for a nonbusiness reason.²⁵

18. Treas. Reg. § 20.2042-1(c)(2) (1974).

19. See *Chase Nat'l Bank v. United States*, 278 U.S. 327 (1929).

20. See Treas. Reg. § 20.2042-1(c)(2) (1974).

21. See *Estate of Lumpkin v. Commissioner*, 474 F.2d 1092 (5th Cir. 1973), *vacating* 56 T.C. 815 (1971). But see *Swanson v. Commissioner*, 518 F.2d 59 (8th Cir. 1975); *Estate of Shifter v. Commissioner*, 468 F.2d 699 (2d Cir. 1972); *Estate of Freuhauf v. Commissioner*, 427 F.2d 80 (6th Cir. 1970); *Estate of Anders Jordahl*, 65 T.C. 92 (1975).

22. See Rev. Rul. 75-70, 1975-1 C.B. 301. Other incidents of ownership are listed and discussed in 111-3d TAX MNGM'T, LIFE INS. (BNA).

23. Treas. Reg. § 20.2042-1(c)(6) (1974). However, the value of the insurance received by the corporation will be considered in determining the value of its stock in the decedent's hands at death. Treas. Reg. § 20.2031-2(f); *Estate of John L. Huntsman*, 66 T.C. 861 (1976).

24. *Id.*

25. *Id.*

Where group term life insurance covering the employee is maintained by his employer, the power to surrender or cancel the policy will not be attributable to the employee through his stock ownership.²⁶

Policy Provisions That Preclude Removal

One may not assume that the absolute assignment of a policy is sufficient to remove all incidents of ownership from the insured's gross estate. The policy itself may reserve certain rights to the insured, preclude an assignment, or require a specific form of endorsement to accomplish the assignment. Despite taxpayer arguments that "intent facts" should override "policy facts," the Internal Revenue Service has frequently prevailed in establishing that incidents of ownership were retained due to policy provisions.

In *Commissioner v. Estate of Noel*,²⁷ decedent purchased two airline flight insurance policies on his own life in his own name, although the premium dollars were supplied by his wife. The decedent had instructed the sales clerk to give the policies to his wife and had apparently renounced all rights in them. The decedent died hours later in a plane crash. The United States Supreme Court held that the insurance was property includable in the decedent's gross estate because he had retained incidents of ownership under the contract, which reserved to the "owner" the right of assignment and power to change the beneficiary. The decedent was the "owner" because he had not made proper assignment of the policies by endorsement as required by their terms.

Decedents have retained incidents of ownership in other unexpected ways to which the estate planner should be alert. In *Estate of Sidney F. Bartlett*,²⁸ the group term policy covering the decedent by its terms was not assignable so that his attempted assignment was null and void, causing him to have retained incidents of ownership in the policy upon his death. Compare, however, *Estate of Max J. Gorby*,²⁹ where insurance certificates contained restrictions contrary to the provisions in the group master policy, but the master policy prevailed and assignment was determined to be effective.

In *Estate of Lumpkin v. Commissioner*,³⁰ decedent's assignment of

26. *Id.*

27. 380 U.S. 678 (1965).

28. 54 T.C. 1590 (1970).

29. 53 T.C. 80 (1969), *acq.* 1970-1 C.B. xvi.

30. 474 F.2d 1092 (5th Cir. 1973).

group term life insurance was held to be ineffective to remove all incidents of ownership where the group master policy provided a right in the insured employee to vary the timing of the receipt of insurance benefits, even though Mr. Lumpkin, the insured, could not thereby benefit himself or his estate or designate a new beneficiary for the proceeds. However, in *Estate of Connelly v. United States*,³¹ a federal district court sitting in New Jersey and the Court of Appeals for the Third Circuit³² rejected the rationale of *Lumpkin* as applied to the same group term life insurance policy. The court held that the non-assignable right contained in the master policy of a retired employee to elect to have the payments to his surviving spouse reduced in amount and payable over a longer term than provided in the standard policy provisions was not an incident of ownership sufficient to cause inclusion of the insurance proceeds in the gross estate.

Assignability of Group Life Insurance

Lumpkin notwithstanding, the Internal Revenue Service recognizes that group life insurance, as well as individual policies, can be irrevocably assigned and removed from the taxpayer's gross estate. In Revenue Ruling 69-54,³³ the Service emphasized that group insurance can be removed from the gross estate only if assignment thereof is permitted by provisions of local law on assignments of group policies and by applicable insurance policy provisions. Although Revenue Ruling 69-54 additionally held that the group term policy must permit conversion to ordinary life insurance upon an employee's termination of employment, and that such right must be assigned with all other policy rights, a subsequent ruling modified that position. Revenue Ruling 72-307³⁴ announced that where neither the policy nor state law gives an employee the right to convert and even where coverage ceases upon termination of

31. 398 F. Supp. 815 (D.N.J. 1975).

32. *Connelly v. United States*, No. 76-1149 (3d Cir. Feb. 17, 1976). The Fifth Circuit's view of I.R.C. § 2042, as stated in *Lumpkin*, *supra* note 29, is that mere possession of a right to effect policy benefits is an incident of ownership. The New Jersey district court emphatically rejected this approach in *Connelly* by determining that effective control over the policy benefits is necessary, a situation not present in *Connelly* where the insured-decedent had no surviving spouse. The divergent approaches to this matter have been commented upon extensively. See, e.g., R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE & GIFT TAX § 2042 (3d ed. 1974); Golden, *Life Insurance: Recent Cases Show How to Keep Insurance Proceeds Out of Estate*, 4 TAX. FOR LAW. 262 (1976); Huffaker, *Life Insurance Proceeds: Courts Split on Incidents-of-Ownership Criteria*, 43 J. TAX. 315 (1975).

33. 1969-1 C.B. 221.

34. 1972-1 C.B. 307.

employment, the absence of such provisions does not result in retention of incidents of ownership if the employee's interest is irrevocably assigned. Moreover, the court of claims in *Landorf v. United States*³⁵ held an assignment is sufficient to remove incidents of ownership from the gross estate, if state law does not prohibit assignments, even though the employee had the right to terminate the policy by terminating employment.³⁶

Removing Incidents of Ownership by Assignment

As can be seen from the foregoing discussion, at present the Commissioner has precedent for including life insurance in a decedent's gross estate if the slightest ownership rights are retained, even though the decedent made an absolute and irrevocable assignment of the policy before death. The careful estate planner should examine insurance policies (both individual and group) prior to assigning them to determine that the assignment is permitted under contract terms and to detect any incidents of ownership that might be retained by peculiar provisions in the policy. If assignment appears possible, the document of assignment should absolutely and irrevocably assign all of the insured's rights, title and interest under the policy, as owner and as insured, and should assign all conversion and renewal rights. Care should be taken to assure that terms of the policy itself do not retain or create reversionary rights in the insured.³⁷

B. TRANSFERS WITHIN THREE YEARS OF DEATH

As previously noted, the pre-1977 rules on transfers made in contemplation of death have been superseded by amended Code section 2035 for decedents dying after December 31, 1976.³⁸ The amended section provides that the value of the decedent's gross estate will include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the three-year period ending on the date of his death, except for "any bona fide sale for an adequate and full consideration in money or money's worth" and "any gift excludable in computing taxable gifts by

35. 408 F.2d 461 (Ct. Cl. 1969).

36. The Oklahoma Statutes expressly permit assignment of group term life insurance, including any conversion privilege. OKLA. STAT. tit. 36, § 3624.1 (Supp. 1976).

37. See the discussion in section V *infra* regarding retained and reversionary rights in a trust.

38. See section II *supra*.

reason of section 2503(b)" determined without regard to section 2513(a). If the analysis of subsection (b)(2) of section 2035, previously discussed at section II, is sustained, present interest transfers of life insurance made at any time prior to death will be excluded from the gross estate. However, cracks in the foundation of this analysis already exist, and the Commissioner may be expected to attempt to enlarge them vigorously.

The problems relate to the content of a "transfer" and the kind of insurance "transferred." Revenue Ruling 71-497 is a convenient starting point for review of the relevant authorities.³⁹ Ruling 71-497 announced the general rule that ordinary or five-year term life insurance transferred by the insured more than three years before death will not be includable in his gross estate for tax purposes although the premiums paid by the insured during the last three years of his life will be includable. The same ruling also states that one-year term accidental death insurance transferred within one year of the decedent's death will be includable in the insured's gross estate under section 2035 to the extent of its full value, not just to the extent of premiums paid. Accordingly, the term of an insurance policy to be transferred to a trust is crucial.

It may be speculated that annual renewable term life insurance should be excluded from the gross estate under section 2035 if the policy itself is transferred more than three years before death, even though the insurance is renewed from year to year. This is to be distinguished from term insurance which requires a new application and a new contract to be issued annually, although the distinction is rather formalistic. No rulings or cases have been found regarding annually renewable term insurance in the light of section 2035 under pre-1977 law. In the worst case, one might expect the Commissioner to take the position that each renewal of such insurance in a life insurance trust created by the insured is a new transfer each year when the insured pays the premiums thereon. If an annual "transfer" is found to have occurred in such cases, or if the decedent is found to have "transferred" any other kind of insurance within three years of his death, the Commissioner has considerable precedent for including all of the proceeds in the gross estate, less \$3,000 thereof, if a "present interest" transfer was made.

39. 1971-2 C.B. 329.

Precedent is derived from Revenue Ruling 71-497 and recent cases which have adopted the legal theory contained therein.⁴⁰ In discussing the one-year term accident insurance, Revenue Ruling 71-497 poses the situation where the insured paid the initial premium to acquire the insurance policy in the name of his son who was also the named beneficiary. The ruling holds that the actions of the insured effected an indirect transfer of the policy. The entire amount of the policy proceeds, not just the amount of the premium deposited by the insured, was includable in the gross estate of the insured, who died shortly after the policy was purchased. The ruling relied on *Chase National Bank v. United States*,⁴¹ which indicated that the word "transfer" was not limited to the passing of property directly but also encompassed donations procured through expenditures by a decedent with the purpose of having them pass to another at his death.

The theory that an indirect "transfer" of insurance proceeds occurs when the insured transfers the funds which are used to procure a policy has been adopted and applied under section 2035. In *Bel v. United States*⁴² the insured died within a year after paying all premiums to purchase a \$250,000 accidental death policy in the names of his three children as owners and beneficiaries. The district court excluded the proceeds from the insured's estate on the theory that the "premium payment test"⁴³ had been repealed by section 2042 of the Code, but the court of appeals reversed. The Fifth Circuit recognized that the decedent had never formally possessed any incidents of ownership in the policy purchased, but determined that the decedent alone controlled the

40. See text accompanying notes 41-49 *infra*.

41. 278 U.S. 327 (1929).

42. 452 F.2d 683 (5th Cir. 1971), *cert. denied*, 410 U.S. 929 (1973).

43. Premium Payment Test: In Rev. Rul. 67-463, 1967-2 C.B. 327, the Service held that each premium payment made by a decedent on an insurance policy on his life owned by another was a transfer of an interest in the policy measured by the proportion the premium so paid bears to the total premiums paid, so that the value of the proportionate part of the insurance proceeds that is attributable to those premiums paid within three years of death is includable in the decedent's gross estate under I.R.C. § 2035. After the rationale of Rev. Rul. 67-473 was rejected by the United States Court of Appeals for the Fifth Circuit in *First Nat'l Bank v. United States*, 423 F.2d 1286 (5th Cir. 1970), the Service reversed its position. In Rev. Rul. 71-497, 1971-2 C.B. 329, the Service held that no part of the proceeds of policies of either whole life insurance or "five-year term insurance" on the decedent's life which he transferred more than three years before his death would be includable in the decedent's gross estate. However, the premiums paid by the decedent on such insurance within three years of his death would be includable under section 2035. This rationale appears to be valid under the Tax Reform Act of 1976.

arrangement and had "beamed" the accidental death policy proceeds to his children. The court stated:

[W]e conclude that section 2042 and the incidents-of-ownership test are totally irrelevant to a proper application of section 2035. We think our focus should be on the control beam of the word "transfer." The decedent, and the decedent alone, beamed the accidental death policy at his children, for by paying the premium he designated ownership of the policy and created in his children all of the contractual rights to the insurance benefits. These were acts of transfer. The policy was not procured and ownership designated and designed by some goblin or hovering spirit. Without John Bel's conception, guidance, and payment, the proceeds of the policy in the context of this case would not have been the children's. His actions were not ethereally, spiritually, or occultly actuated. Rather, they constituted worldly acts which by any other name come out as a "transfer." Had the decedent, within three years of his death, procured the policy in his own name and immediately thereafter assigned all ownership rights to his children, there is no question but that the policy proceeds would have been included in his estate. In our opinion the decedent's mode of execution is functionally indistinguishable. Therefore, we hold that the action of the decedent constituted a "transfer" of the accidental death policy within the meaning of section 2035, and that the district court erred in failing to include John Bel's community share of the proceed value of the policy in his gross estate.⁴⁴

A factually similar case was similarly decided by the Court of Appeals for the Sixth Circuit shortly after *Bel*. In *Detroit Bank and Trust Co. v. United States*,⁴⁵ the insured had created an irrevocable trust, funded with \$9,600, and directed the trustee to acquire a \$100,000 life insurance policy on his life. Under the arrangement, the insured never was the applicant nor the owner; he merely paid the premiums on the policy. Death occurred shortly after the policy was purchased. The executor for the estate conceded that \$9,600 had been transferred in contemplation of death and should be includable under section 2035, but the Commissioner contended that the entire \$100,000 should be includable because the decedent had transferred "insurance protection" even though the decedent had never owned or retained any incidents of ownership. The district court excluded the proceeds of the insurance policy, holding that only the \$9,600 transferred to the trustee

44. 452 F.2d at 691-92.

45. 467 F.2d 964 (6th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973).

was a gift in contemplation of death.⁴⁶ The Court of Appeals for the Sixth Circuit, like the Fifth Circuit in *Bel*, viewed the case as one of substance over form and within the scope of section 2035. It included all of the proceeds in the decedent's gross estate on the theory that the trustee was an agent for the purchase of the insurance and the trust was a substitute for a testamentary disposition.

In another recent case, the Ninth Circuit Court of Appeals also has sided with the Commissioner on similar facts. In *First National Bank v. United States*,⁴⁷ the insured's wife applied for a twenty-year term insurance policy as owner and beneficiary but the insured paid all premiums and died accidentally within three years. Both the lower court and the appellate court held that the proceeds were includable under section 2035, on the theory that acquisition of the insurance by the wife was indistinguishable from the insured's procuring of the policies in his name and immediately transferring all ownership rights to her.⁴⁸

In *Bel*, *Detroit Bank*, and *First National Bank*, the insureds caused the policies to be purchased in another's name, paid the premiums thereon and died within three years of the purchase or the "transfer." A more recent case, *Estate of Silverman v. Commissioner*,⁴⁹ presents an interesting variation. The insured purchased insurance on his life in 1961, made 55 monthly premium payments, totaling \$2,893, and then assigned the insurance to his son. After the assignment and until his father's death, the son made seven monthly payments totaling \$368.20. The father died within three years after the transfer. The United States Tax Court, affirmed by the Second Circuit, held that the transfer was in contemplation of death, but that only 88.71% of the \$10,000 policy proceeds (\$8,871) was includable in the father's gross estate because the son had paid a portion of the total premiums.⁵⁰ The Second Circuit admitted that it was "uneasy" with this approach taken by the Tax Court in light of the payment of premiums controversy. It suggested that only the actual premiums paid by the son, rather than the pro-rata share of the proceeds attributable to the son's premium pay-

46. *Detroit Bank and Trust Co. v. United States*, 369 F. Supp. 672 (E.D. Mich. 1971).

47. 488 F.2d 575 (9th Cir. 1973).

48. Only in *Gorman v. United States*, 288 F. Supp. 225 (E.D. Mich. 1968) has the Commissioner lost in a case that was not appealed involving a fact situation similar to those in *Bel*, *Detroit Bank* and *First Nat'l Bank*. But *Gorman* was distinguished and criticized by each of the circuit court opinions.

49. 521 F.2d 574 (2d Cir. 1975).

50. *Estate of Morris R. Silverman*, 61 T.C. 338 (1973).

ments, should have been excluded from the decedent's gross estate. However, on appeal the Commissioner had elected not to dispute the Tax Court's interpretation, so the issue of whether \$368.20 should be excluded was not properly before the court.⁵¹ The holdings of both the Tax Court and the Second Circuit raise the old confusion of whether the premium payments test really has been laid to rest.⁵² It would appear, however, from the restriction of the case to its facts by the Tax Court and the Second Circuit, that policy transfers made more than three years prior to death will not be again susceptible to the pro-rata premium payments test in those courts.

The rationale of the *Bel* case, in particular, is foreboding for those who would hope to escape section 2035 by the present interest exception under section 2035 (b)(2), as amended. If the decedent's actions in arranging for a trust and paying premiums are deemed to be a transfer of the entire policy proceeds in that they are "beamed" to beneficiaries, only a small portion of the proceeds (*i.e.* \$3,000) will be excludable from the gross estate of any decedent who takes such actions within three years of death. At this writing, of course, it is impossible to predict how successful the Commissioner will be in obtaining judicial acceptance of the *Bel* theory of transferring life insurance proceeds. But the decisions of the courts in *Detroit Bank* and *First National Bank* appear generally sympathetic. The estate planner is well advised to take precautions by assuming for planning purposes that all direct and indirect transfers of life insurance within three years of death by the insured will be includable in his gross estate. How, then, should one proceed?

C. VARIATIONS ON GETTING INSURANCE INTO THE TRUST AND PAYING PREMIUMS

How can estate planners protect against a taxpayer's death within three years after a "transfer" of life insurance to the irrevocable life insurance trust?

All Transfers By the Insured

In light of Revenue Ruling 71-497, *Bel*, *Detroit Bank*, and *First National Bank*, it is likely that a client who establishes a trust, deposits initial premium dollars and directs the trustee to use the contribution for

51. 521 F.2d at 577, 578.

52. See note 42 *supra*.

the purchase of life insurance on his life, and who dies within three years probably will have the entire proceeds included in his gross estate by the Commissioner, on the theory that the decedent has made an indirect "transfer" of the policy proceeds. If the planner and his client are willing to run the risk of the policy proceeds being includable if death occurs within three years, and the insured pays all premiums, those premiums paid within three years of death will be includable in his gross estate; they might be gifts of future interests, depending on the trust provisions.⁵³ If the insurance in trust is annually renewable term life insurance, it would appear advisable for the insured to make gifts to the trust so that the trustee could pay premiums, in the trustee's discretion, rather than the insured making premium payments directly to the insurer. The suggested arrangement would make the insured appear less like he is renewing the policy annually. An even more desirable arrangement if term life insurance is in trust would be for the insured to fund the trust or to pay several years premiums in advance, for the same reason.

Trust Established and Premiums Paid by One Other Than Grantor

The *Silverman* case suggests that a successful alternative might be for a beneficiary of the trust to deposit the initial premium dollars in the irrevocable life insurance trust from funds which are not derived from the insured.⁵⁴ The premiums paid by such person would be a future interest gift to the trust remaindermen to the extent that they are not applicable to the payor-beneficiary's interest in the trust. Also, such person could be deemed to be a grantor of the trust with a retained life estate or other interest which could result in inclusion of a portion of the insurance proceeds in the estate of such "grantor" under section 2036. One variation would be for a third party who is not a beneficiary of the trust to establish the trust and deposit the premium dollars. If successful, the transaction would at least be viewed as a gift (possibly of a present interest if the trust provisions permit). But if the facts permit, and the reviewing agent for the Internal Revenue Service is sufficiently suspicious, the transaction could be viewed as payment for consideration if the party is unrelated to the trust beneficiaries. Such a position could result in the insurance proceeds being included in the gross income of the trust under section 101(b) of the Code. The transaction would

53. See discussion on gift taxation at section III.D. *infra*.

54. See note 48 *supra*.

probably be viewed as an act by an agent of the insured, as was seen in the *Detroit Bank* case.⁵⁵

Funded Life Insurance Trusts

If the insured is willing to transfer not only life insurance policies but also income producing assets sufficient to pay premiums, the transfer within three years of death risk will be compounded as to the initial transfer of property. However, the problem of the last three premiums paid prior to death being in the insured's gross estate under section 2035 would be eliminated if the insured survives the transfer of the property by more than three years. A gift tax upon transfer of the additional property is unlikely, due to the unified credit, but one should strive to get the present interest exclusion nonetheless, to reduce the amount of unified credit utilized and to be within the section 2035(b)(2) exceptions.⁵⁶ In a funded trust the grantor-insured will be treated as the owner of any portion of the trust, the income from which *may* be used to pay premiums on policies of insurance on his life.⁵⁷ This will result in the insured being taxed on a portion of the trust income.⁵⁸

Borrowing Against Policies

A modification of the funded trust approach to premium payments is to provide that the trustee can pay premiums by borrowing against the cash surrender values of the policies in trust. If the grantor of the trust is the insured, under sections 671 and 678 of the Code, the trust income will be taxable to the grantor if the premiums can be paid from the trust. The trust will be entitled to deduct the interest paid in connection therewith if the payment rules of Code section 264 have been met. It is possible for the grantor to obtain such deductions of interest by the appropriate drafting of the trust document so as to cause the grantor to be treated as the owner of the trust under section 675 of the Code.⁵⁹

Contingent Provisions in the Trust Instrument

Given the uncertainties of avoiding section 2035 if the insured dies within three years of "transferring" his life insurance to an irrevocable

55. See note 44 *supra*.

56. See text accompanying notes 37-38 *supra*.

57. I.R.C. § 677(a)(3).

58. I.R.C. § 671.

59. See Denenberg, *Implementing an Irrevocable Life Insurance Trust: An In-depth Analysis*, 42 J. TAX. 42 (1975).

trust, one should anticipate that all proceeds will be includable in the gross estate. In the ordinary case, the provisions of the trust probably would not qualify for the marital deduction because of the planner's desire to keep the proceeds out of the estate of the surviving spouse. In such event, the decedent's entire estate might not obtain the maximum marital deduction. Accordingly, one should provide in the trust instrument that if the life insurance proceeds are includable in the decedent's gross estate, the surviving spouse will have such rights under the trust as will be necessary to qualify the proceeds for the marital deduction.⁶⁰ Alternatively, the draftsman might provide a variation of a marital deduction formula clause which would cause only that portion of the proceeds to be subject to the marital deduction trust requirements as is necessary to obtain the amount of marital deduction desired. Finally, the planner could rely on his analysis of the overall value of the estate and not transfer life insurance to any irrevocable trust if it would cause the marital deduction to be underqualified if the proceeds are includable in the decedent's gross estate.

D. GIFT TAX ON TRANSFERS TO THE TRUST

The assignment of life insurance policies to the trust will constitute a gift subject to federal gift taxation. The tax (if any) will be imposed on the value of the property transferred at the time of the gift.⁶¹ The value of a gift of life insurance for gift tax purposes depends on attributes of the policy transferred. If the transfer is of a policy recently purchased from the insurer, the gift is the gross premium paid to the insurance company, *i.e.* its cost.⁶² If the gift is of a previously purchased single premium or paid-up policy, the value is the replacement cost of the policy which, in turn, is the amount the insurance company would charge for a single premium contract of the same specified amount on the life of a person of the age of the insured.⁶³ Where the policy transferred is ordinary life insurance on which future premiums remain to be paid, the value is established by adding the interpolated terminal reserve at the date of the gift and the value of the unearned portion of the last premium paid and subtracting the value of any policy loan which has not been repaid.⁶⁴ It should be noted that a policy's

60. See I.R.C. § 2056(b)(5) (1976) and related Regulations.

61. I.R.C. § 2512(a) (1976).

62. Treas. Reg. § 25.2512-6(a) (1974) (ex. 1).

63. *Id.* at ex. 3.

64. *Id.* at ex. 4.

cash surrender value in some cases may approximate, but is not precisely, the value prescribed by the Regulations for gift tax purposes.⁶⁶ Notwithstanding the foregoing general rules which are set forth in the gift tax Regulations, it has been held that the uninsurability of the donor at the time of the gift of a policy on his life will affect the value of the policy,⁶⁶ and that when an insured is terminally ill, the value of a policy on his life can be approximately the face amount of the policy.⁶⁷

The Regulations make no distinction for gifts of an insured's interest in a group term life insurance policy. Although the value conceivably could be determined under the group term cost payable as authorized by section 79, presumably the principles of section 25.2512-6(a) should apply. Revenue Ruling 76-490, issued in December, 1976, held that an employee's interest in his company's group term life insurance "had no ascertainable value at the time it was transferred since the employer could have simply failed to make further premium payments. Therefore, no taxable gift occurred."⁶⁸

Present Interest Exclusions

Standard principles of federal gift taxation apply to transfers of life insurance policies, premium payments and other property to an irrevocable trust. Accordingly, whether a gift is entitled to the \$3,000 per donee annual present interest exclusion depends on whether it is a gift of a present or a future interest in property within the meaning of Code section 2503(b).

1. Transfers of Policies

Outright transfers of life insurance policies are gifts of present interests, even though the policy will not mature until a later date,⁶⁹ and even though there is no cash surrender value at the time of the gift.⁷⁰ Code section 2503(b) does not define a transfer of a "present interest in property," but the Regulations at section 25.2503(b) provide "[a]n unrestricted right to the immediate use, possession or enjoyment of

65. The Supreme Court stated in *Guggenheim v. Rasquin*, 312 U.S. 254 (1941): "[T]he owner of a fully paid life insurance policy has more than the right to surrender it; he has the right to retain it for its investment virtues to receive the face amount upon the insured's death."

66. *United States v. Ryerson*, 312 U.S. 260, 262 (1941).

67. *Estate of James Stuart Pritchard*, 4 T.C. 204 (1944).

68. Rev. Rul. 76-490, 1976-50 I.R.B. 78.

69. See Treas. Reg. 25.2503-3(a) (1972).

70. See Rev. Rul. 55-408, 1955-1 C.B. 113.

property or the income from property (such as a life estate or a term certain)" is such an interest. But transfers of policies to an irrevocable trust which provides for payments to beneficiaries after the insured's death are expressly described as gifts of future interests in the Regulations.⁷¹

In order to insure flexibility in the estate plan and accomplish various desires of the taxpayer, it is quite likely that the provisions of a trust to which the insured's policies would be transferred will contain many discretionary rights in the trustee. Accordingly, most gifts to a life insurance trust will be future interest gifts. Unless the estate planner can arrange for a satisfactory method of obtaining the present interest exclusion, annual transfers of cash to pay life insurance premiums on the policies in trust, as well as the initial transfer of the policy, probably will result in the transferor either utilizing a portion of the unified credit against gift tax (allowed by new section 2505 of the Code for gifts made after December 31, 1976) or sustaining a gift tax in the year of transfer. Even though projected gifts of premium payments to the trust during a taxpayer's lifetime would indicate that no tax will be due because of the credit against gift tax, the taxpayer is still well advised to seek ways to obtain the present interest exclusion so that the credit will be available for other lifetime or death transfers. Perhaps of more importance is the fact that Code sections 2001(b) and 2035 exclude gifts of present interests from inclusion in the gross estate. To obtain full advantage of this potential benefit, the trust instrument should be drafted to allow a present interest exclusion if possible.

Unfortunately, taxpayers presently cannot be assured with certainty that the transfer of a policy to a trust or payments of premiums thereon will be present interest gifts. The United States Tax Court has held that the annual exclusion is not available when a gift is to a trust which holds insurance policies, even if there is a direction to pay all income to the beneficiary, because insurance policies are non-income producing and the direction is impossible of fulfillment.⁷² But, where a trust holds a paid-up insurance policy, the dividends on which are payable to the beneficiary, the Tax Court has determined that gifts to the trust are present interest gifts.⁷³ Accordingly, the availability of current income from the trust is critical. It has been suggested, although not tested in a

71. Treas. Reg. § 25.2503-3(c) (1972) (ex. 2).

72. Jessie S. Phillips, 12 T.C. 216 (1949). See also Rev. Rul. 69-344, 1969-1 C.B. 235.

73. Pauline Wilkins Tidemann, 1 T.C. 968 (1943).

direct case, that if the trust beneficiary is given the right to demand that the trustee convert insurance policies to income producing assets, the annual exclusion would be available up to the value of the beneficiary's income interest.⁷⁴

In *Estate of Charles C. Smith*,⁷⁵ the Tax Court implied that such a power, if present in a trust funded with insurance, would have qualified the transfer for the gift tax marital deduction. In a situation where group term life insurance is transferred to the trust, such an argument would seem inapplicable because of the difficulty of converting group term life insurance into income producing assets. On the other hand, however, the gift tax value of group term life insurance when transferred to the trust should be minimal and would not result in significant gift tax or utilization of the credit against gift tax.

The Commissioner has recently ruled that premium payments on group term insurance transferred to an irrevocable trust by an employee constitute present interest gifts to the beneficiaries of the trust where the beneficiary of the trust is to receive the full proceeds of the policy immediately upon the insured's death.⁷⁶ No mention is made in the ruling of any income producing assets being in the trust. The ruling thus appears to be a radical departure from prior theory of present interest exclusions and could be very beneficial to taxpayers. In light of the ruling, draftsmen of irrevocable life insurance trusts should consider making proceeds of insurance immediately payable to the beneficiary of the trust upon the insured's death in order to qualify the trust for the present interest exclusion.

2. Premium Payment Transfers

A method to obtain the present interest exclusion on payment of premiums does exist with a life insurance trust. In *Crummey v. Commissioner*,⁷⁷ the Court of Appeals for the Ninth Circuit held that where beneficiaries of a section 2503(c) trust had the right to demand annually the sum of \$4,000 or the amount of the transfer from the donor to the trust, whichever was less, a present interest had been created. Following such rationale, the insured who wishes to pay premiums on life insurance should consider the inclusion of a provision in the life insur-

74. See 111-3d TAX MNGM'T, *Life Ins.* at A-2 (BNA). See also N.Y.U. 28TH INST. ON FED. TAX. 790 (1970).

75. 23 T.C. 367 (1954).

76. Rev. Rul. 76-490, 1976-50 I.R.B. 28.

77. 397 F.2d 82 (1968).

ance trust which would enable a specified beneficiary to demand the lesser of \$5,000 or the amount of cash transferred to the trust annually for payment of premiums. Although the beneficiary would indeed have the right to make such withdrawal, the beneficiary's failure to do so should not result in a gift due to a lapse of a power of appointment under section 2514(a) of the Code. If more than the greater of \$5,000 or five percent of the principal in trust is available to the beneficiary for withdrawal, the annual exclusion still would be available. However, the value of the trust would be included in the life tenant's gross estate for estate tax purposes under section 2041(b)(1) and failure to exercise the power in each year would be considered a gift under section 2514(e). The same technique should also apply to policies transferred to trust if they have a cash surrender value which exceeds the aggregate value of withdrawal rights. It should be noted, however, that a beneficiary having such a withdrawal right would be regarded as the owner of a portion of the corpus and could be subject to income tax under IRC §671.

Gift Tax Marital Deduction

While the Tax Reform Act of 1976, by amendment of Code section 2523(a)(2), has altered the limits of the gift tax marital deduction, the availability of the deduction for gifts to spouses in trust remains unchanged from prior law. Under Code section 2523(b) it is possible to establish an estate type trust and, under Code section 2523(e), it is possible to establish a power of appointment type trust for the benefit of the donee spouse, which will be entitled to the marital deduction. However, with respect to the power of appointment type trust, the gift tax Regulations set forth five conditions which must be met,⁷⁸ the first of which generally will not be met when life insurance is the asset in trust. Such condition states that "[t]he donee spouse must be entitled for life to all of the income from the entire interest or a specific portion of the entire interest, or to a specific portion of all the income from the entire interest."⁷⁹ However, if the wife were given the right to require the trustee to convert the policies to income producing property, it might be possible for the trust to qualify for the marital deduction.⁸⁰ Frequently, however, life insurance trusts are designed so that surviving spouses will have only a terminable interest in the assets,

78. Treas. Reg. § 25.2523(e)-1(a) (1961).

79. Treas. Reg. § 25.2523(e)-1(a)(1) (1961).

80. See Estate of Charles C. Smith, 23 T.C. 367 (1954).

thereby excluding them from the surviving spouse's estate for tax purposes and making them unavailable for the gift tax marital deduction.

E. INCOME TAXATION OF THE TRUST

Section 101(b) of the Code exempts from income tax the proceeds of life insurance policies transferred other than for a valuable consideration. Accordingly, in the general situation, the receipt of life insurance proceeds by an irrevocable trust will not result in income tax. To avoid any questions about the policies being transferred to the trust for consideration, the transfer documents should merely assign them and should avoid use of the words "sell" and "exchange" which imply receipt of valuable consideration. Likewise, care should be taken that consideration is not inadvertently received. For instance, if a policy loan is assumed by the trust, the insured would be relieved from liability and would have received valuable consideration for the transfer. Likewise, if two parties create reciprocal trusts, each transferring a life insurance policy to a trust for the benefit of the other, consideration may be found for the transfers.

An irrevocable life insurance trust is taxable as a separate legal entity under the income tax provisions contained in sections 641-683 of the Code. Its income and deductions will be governed by such provisions.

IV. SELECTING A TRUSTEE

A. INSTITUTIONS VERSUS INDIVIDUALS

Selection of a trustee for an irrevocable life insurance trust should be made with care. The trust instrument will define in detail the duties of the trustee, both during the life of the insured as well as after death, and the trustee will be obligated to act as a fiduciary on behalf of the trust beneficiaries. It will be necessary for the trustee to take possession and control of the insurance policies, safeguard them, manage assets (when the trust is funded), cause income tax returns to be prepared and filed and otherwise to act prudently and responsibly. Where the trust contains only group term life insurance assigned by the insured, or an ordinary life insurance policy without other funds, the duties of the trustee will be minimal during the lifetime of the insured. Frequently, an individual such as the spouse of the insured, an attorney or some other person closely related can easily perform the duties required.

Upon the insured's death, however, the trustee's duties multiply and become complicated. The trustee must notify the the insurance company of the insured's death and possibly even pursue claims against such company if there is any question as to whether the insurance was in effect or was effectively conveyed to the trust. This could occur, for instance, if the insured dies before policies have been reissued in the name of the trustee. The trustee may be required to claim the policy proceeds as against the surviving spouse or other persons previously named as beneficiaries. If such events come to pass, the beneficiaries will be grateful for a competent trustee. The trust instrument should specifically indemnify the trustee against any expenses which he may incur. More importantly, the insured should select a suitable trustee at the outset who will be able to effectuate the settlor's intentions.

After policy proceeds have been collected, the activities of the trustee will expand greatly in investment, administration, recordkeeping and other functions. If an individual is named as trustee, he should clearly be given authority to engage outside investment counsel, accountants and others to assist in discharging his duties, especially if the amount of insurance proceeds is expected to be large. Should there be remaindermen, separate trusts, or other provisions of the trust which further complicate the trustee's functions, the insured should ascertain that his trustee is competent to handle these matters. Finally, the trust should include provisions for successor trustees, particularly if an individual is selected.

One planning device which recognizes the distinction between trustee functions before and after the insured's death involves providing for an individual to be trustee during the life of the insured and for a bank to become successor trustee when the insured dies. Another approach is to provide that the surviving spouse of the insured will have the right to designate a successor trustee, generally a corporate banking institution, at any time after the death of the decedent. If such a provision to designate a successor trustee is included, care should be taken not to permit the insured to be able to name himself as trustee during his lifetime. In *Mathey v. United States*,⁸¹ the decedent reserved the right to substitute a successor or alternate trustee and the court held that this was a retained right in the settlor within the meaning of section 2038, because she could have named herself as successor trustee.

81. 491 F.2d 481 (3d Cir. 1974). See also Rev. Rul. 73-21, 1973-1 C.B. 405 to the same effect.

B. THE INSURED AS CO-TRUSTEE

In the present tax climate, the insured should not be named trustee or co-trustee or retain any rights to be so appointed. In Revenue Ruling 76-261, issued by the Internal Revenue Service in September, 1976, the Service formalized the position it had taken in three cases involving the decedent as trustee or co-trustee of an insurance trust.⁸² The following factual situation is hypothesized in the Revenue Ruling:

In 1957 the decedent, H, purchased an insurance policy on decedent's life. Decedent's spouse, W, was named beneficiary. In 1962 H transferred complete ownership of the policy to W and added the names of their children as beneficiaries. In 1971 W died. In W's will, H was named executor of W's estate and trustee of a residuary trust established for the benefit of their children. The insurance policy on H's life was included in W's residuary estate.

H, as trustee, was granted absolute and unfettered discretion to distribute the current income from the trust to the beneficiaries or accumulate the income and add it to corpus. In addition, H, as trustee, was empowered in the management and investment of the trust property to do any and all things that a natural person, free from disability of every kind, might legally do with or in respect of such person's own property. Under the terms of the policy, the owner could elect to have the proceeds made payable according to various plans, use the loan value to pay the premiums, borrow on the policy, assign or pledge the policy, and elect to receive the annual dividends.

In 1975, H died and a successor trustee was named.⁸³

The ruling holds that upon H's death his gross estate included the proceeds of insurance on his life because he possessed an incident of ownership in the insurance policy at the time of death, even though held only in a fiduciary capacity. The conclusion and the hypothesized facts of the ruling are almost identical to the fact situation and conclusion in the Fifth Circuit decision in *Terriberry v. United States*.⁸⁴ *Terriberry* and *Rose v. United States*⁸⁵ both followed the *Lumpkin* case, which had

82. Rev. Rul. 76-261, 1976-28 I.R.B. 10. The three cases involving the decedent in a fiduciary capacity where the Commissioner's position was approved were *Terriberry v. United States*, 517 F.2d 286 (5th Cir. 1975), *cert. denied*, 424 U.S. 977 (1976); *Rose v. United States*, 511 F.2d 259 (5th Cir. 1975); *Skifter v. Commissioner*, 468 F.2d 699 (2d Cir. 1972).

83. Rev. Rul. 76-261, 1976-28 I.R.B. 10.

84. 517 F.2d 286 (5th Cir. 1975) *cert. denied*, 96 S. Ct. 1484 (1976).

85. 511 F.2d 259 (5th Cir. 1975).

held that Congress, by using the term "incidents of ownership," was attempting to tax the value of life insurance proceeds over which the insured at death still possessed a substantial degree of control. "Substantial control" was held to exist when the decedent had the right to elect optional modes of settlement under a group term life insurance policy.⁸⁶ Because those rights would have been "substantial" under sections 2036 and 2038 of the Code, they were considered to be substantial by the court in *Terriberry* and *Rose* for purposes of section 2042(2), despite the fact that decedents actually could not benefit themselves or their estates. Accordingly, *Terriberry* and *Rose* held that possession of an incident of ownership, even as a fiduciary, was sufficient, even if no benefit could be obtained by the decedent or his estate. The Court of Appeals for the Second Circuit in *Skifter v. Commissioner*,⁸⁷ held that holding incidents of ownership in a fiduciary capacity is not sufficient to cause inclusion in the gross estate. The Sixth Circuit's decision in *Fruehauf v. Commissioner*,⁸⁸ contains dictum to the same effect. In view of the Service's announced position, an estate planner is inviting litigation if he allows the insured to be a fiduciary with respect to insurance on his own life.

V. TRUST PROVISIONS

The terms and provisions of an irrevocable life insurance trust can be as flexible as the needs of the client and the imagination of the estate planner will permit. However, the draftsman should be alert to certain pitfalls which could ruin the tax benefits afforded by the irrevocable trust. Certain provisions which could be included in an irrevocable trust already have been discussed. Other provisions which are essential and unique to such a trust will be considered in this section.

A. PROVIDING FOR ESTATE LIQUIDITY UNDER A LIFE INSURANCE TRUST

Proceeds of insurance held by an irrevocable life insurance trust are payable to the trustee. If the trustee is required to use them for payment of estate taxes, expenses or debts of the estate, the proceeds will be considered "receivable by the executor" and includable in the decedent's gross estate under section 2042(1) of the Code.⁸⁹ If less than all

86. *Id.* at 262-63.

87. 468 F.2d 699 (2d Cir. 1972).

88. 427 F.2d 80 (6th Cir. 1970).

89. Treas. Reg. § 20.2042-1(b)(1) (1974).

the proceeds are required to be so used, it is unclear whether all the proceeds will be includable in the gross estate as "receivable by the executor."⁹⁰ Thus, even if the estate is free from debt or has other sources of cash from which to meet its obligations, the trust should not obligate the trustee to pay any of the decedent's obligations. Insurance, however, frequently is a major source of cash for an estate. Will holding the policies in an irrevocable life insurance trust make them unavailable to the executor so that the estate will have to sell assets or otherwise raise cash in order to meet its obligations? Not necessarily.

One approach is to authorize the trustee, in his sole discretion, to purchase assets from the estate or to loan money to the estate. In *Old Colony Trust Co. v. Commissioner*,⁹¹ it was held that insurance proceeds available to a trustee, in his discretion to pay debts of the insured, were not includable because there was no binding obligation to pay such debts. No reported case has held that a trustee's actual use of life insurance to purchase assets of the estate in order to generate liquidity will cause the proceeds to be treated as "receivable by the executor." In a closely related area, Judge Goffe of the Tax Court recently held that death benefits payable to a trust from a qualified employee benefit plan and used to purchase stock from the decedent's estate in order to provide the estate with cash to pay certain liabilities, were excludable from the decedent's estate under section 2039(c) of the Code.⁹² The benefits were not considered "receivable by or for the decedent's estate" (the test of section 2039(c) as well as for section 2042, according to Treasury Regulations 20.2039-2(b) and 20.2042-1(b)) because the trustees were not under a binding legal obligation to pay liabilities of the estate.⁹³

B. GENERAL POWERS OF THE TRUSTEE

As a general matter, the trustee's investment and administration powers under an irrevocable life insurance trust should be very broad. Curtailing the trustee's authority by reserving power to the settlor-insured can result in the insurance proceeds being includable in the insured's estate upon his death. For instance, the settlor-insured's veto power over the trustee's right to change beneficiaries under an insurance policy held in trust may be an incident of ownership.⁹⁴

90. See 111-3d TAX MNGM'T, *Life Ins.* at A-3 (BNA).

91. 39 B.T.A. 871 (1939).

92. Estate of Joseph E. Salsbury, 34 T.C.M. (CCH) 1441 (1975).

93. 34 T.C.M. (CCH) at 1419, 1420.

94. See notes 95-97 *infra* and accompanying text.

C. AVOIDING RETAINED RIGHTS AND REVERSIONARY INTERESTS

Retained Rights

The general principles of sections 2036, 2037 and 2038 apply to life insurance trusts in that a settlor-decedent who has retained interests includable under the terms of those sections will have the trust assets includable in his gross estate. With a life insurance trust, the Treasury Department has another argument for inclusion in the gross estate under section 2042.

The Regulations provide:

A decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or a time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust. Moreover, assuming the decedent created the trust, such a power may result in the inclusion in the decedent's gross estate under Section 2036 or 2038 of other property transferred by the decedent to the trust if, for example, the decedent has the power to surrender the insurance policy and if the income otherwise used to pay premiums on the policy would become currently payable to a beneficiary of the trust in the event that the policy were surrendered.⁹⁵

One retained right that should be avoided is the trustee's obligation to distribute trust income or principal for the maintenance and support of dependent beneficiaries during the grantor's lifetime. If such is provided (it would ordinarily arise in a funded trust situation), the grantor-insured would have the insurance proceeds includable in his gross estate under section 2036(a). Section 2036(a) provides that trust assets are includable in the estate of the grantor if he has retained for his life: "(1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

The Regulations at section 20.2036-1(b) (2) provide that the use, possession, right to the income or other enjoyment of the transferred property is retained to the extent that the income is to be applied toward the discharge of a legal obligation of a decedent. According to the Regulations, this would include the obligation of supporting a depen-

95. Treas. Reg. § 20.2042-1(c)(4) (1974).

dent during the decedent's lifetime. Although the Regulations relate only to mandatory distributions by the trustee, according to the *Old Colony Trust v. United States*,⁹⁶ section 2036(a) (2) would be applicable to a discretionary power to support if the grantor is the trustee or co-trustee, unless the trustee's discretion is governed by ascertainable standards. Should the draftsman desire to provide ascertainable standards, any reference to "support" or "comfort and welfare" should be avoided. Section 2036(a)(2) could also be avoided by using an independent trustee and not allowing the grantor to be a co-trustee or retain any right as to determinations of discretionary distributions to his dependents.

Reversionary Interests

Section 2042(2) of the Code specifically provides that certain reversionary interests will be treated as "incidents of ownership" if the value of any such interest exceeds five percent of the value of the insurance policy immediately before the death of the decedent. The statute also provides that the term "reversionary interest" includes a possibility that the policy or its proceeds may return to the decedent or his estate or may be subject to a power of disposition by him. Accordingly, the estate planner should take care to avoid giving the settlor-insured the power of disposition over an insurance policy transferred to an irrevocable trust.

A reversionary interest can arise where the terms of the trust provide that insurance proceeds are payable to the estate of the decedent if other beneficiaries predecease him. The decedent's reversionary interest, however, must be worth more than five percent of the value of the insurance policy immediately before the insured's death. In determining whether such value exists in the decedent, the Regulations provide that any incidents of ownership held by others immediately before the decedent's death, which would affect the value of the reversionary interest, must specifically be taken into consideration:

For example, the decedent would not be considered to have a reversionary interest in the policy of a value in excess of 5 percent if the power to obtain the cash surrender value existed in some other person immediately before the decedent's death and was exercisable by such other person alone and in all events.⁹⁷

96. 423 F.2d 601 (1st Cir. 1970).

97. Treas. Reg. § 20.2042-1(c)(3) (1974).

One way to insure that the reversionary interest never causes the inclusion of the proceeds in the decedent's gross estate would be to specifically provide that certain named persons have the right to surrender the policy for its cash surrender value. Such a provision, for instance, should be a standard power of the trustee. In addition, the estate planner should be sure that the life insurance trust provides for a sufficient number of intervening beneficiaries before the policy proceeds revert to the estate of the decedent.

D. OTHER POWERS AND DUTIES OF THE TRUSTEE

In addition to the provisions of the trust instrument heretofore discussed, it is suggested that an irrevocable life insurance trust contain provisions which cover the following:

1. Recognition of the trustee as the absolute owner of all life insurance policies transferred to the trust. Such a provision would authorize life insurance companies to deal with the trustee and would disclaim any ownership or retained interest in the grantor-insured. The grantor should specifically relinquish all powers and rights in the policies and should agree to execute all other instruments necessary to effectuate the relinquishment.

2. Authorization of the payment of premiums on policies of insurance either from income, corpus or the proceeds of loans. If income of the trust may be applied to the payment of premiums on the insured's life insurance, such income will be taxable to the grantor-insured. To avoid such effect, the draftsman may wish to specifically provide that no income of the trust may be applied to the payment of premiums of insurance on the life of the grantor. If it is contemplated that the grantor or some other person will make periodic transfers of funds to pay premiums, the draftsman may wish to relieve the trustee of any responsibility for premium payments. If income of the trust is to be used to pay the premiums, provision should be made for obtaining additional amounts if the income is insufficient. This may be handled by allowing the trustee to borrow from the insurance policies, or other sources, or to obtain funds from the grantor.

E. RESIDUARY TRUST FOR SURVIVING SPOUSE

In keeping with the estate plan generally outlined in the introduction of this article, the estate planner may wish to provide that the proceeds of life insurance policies on the insured's life will be held in a

trust which not only escapes (hopefully) the estate tax on the insured but also the tax on the estate of his surviving spouse. If this arrangement is elected, the wife may be given a life estate in the trust and a limited power of appointment over the trust assets. It should be noted that if income payments to the surviving spouse are made in this fashion, the spouse will lose the exemption provided under IRC section 101(d) with respect to the first \$1,000 of income each year payable from an insurer under a life insurance contract. The loss of this tax benefit should be weighed against the possibility of better investment return under a trust and the advantage of additional flexibility with respect to other beneficiary provisions.

F. MISCELLANEOUS PROVISIONS

If the estate planner desires to avoid transferring any benefits at all to the surviving spouse, the insurance trust could provide for income and principal to be payable to his children or other beneficiaries. It is desirable to include a clause in any irrevocable trust to the effect that if the insured is not married on the date of his death, all proceeds will be held for the benefit of other beneficiaries. Such a provision could avoid disastrous consequences in the event of divorce. Accordingly, instead of naming the insured's spouse specifically as being the one to receive benefits so long as she is living, the trust should provide that the beneficiary will receive benefits only if she is living and has not been divorced from the insured.

In designing the provisions of the insurance trust which is to provide for beneficiaries other than the spouse, care should be taken to avoid arrangements which would incur the tax on generation-skipping transfers imposed by new sections 2601 through 2622 of the Code, added by the Tax Reform Act of 1976.⁹⁸

VI. CONCLUSIONS

The potential benefits of irrevocable life insurance trusts in removing substantial value from a decedent's gross estate for estate tax purposes, thereby saving estate taxes for a small gift tax cost, are still available after the Tax Reform Act of 1976. In addition, the use of insurance trusts could take on added importance in light of new carryover basis rules and elections that are based on values of assets other than life

98. Tax Reform Act of 1976 § 2006.

insurance in the estate. The effect of the new law on transfers within three years of death could be beneficial to the taxpayer, although the matter is not at all clear in light of the committee explanation of new IRC section 2035(b)(2). But an extension of the theory adopted in the *Bel* case⁹⁹ could eliminate taxpayer benefits apparently available under the new law for decedents dying within three years after a transfer. However, if the insured survives by three years, the "transfer" to his trust can cause significant tax benefits. Care must be taken, particularly at the time an irrevocable trust is established, to anticipate the many pitfalls that await the careless planner if the significant benefits potentially available are to be realized.

99. 452 F.2d 683 (5th Cir. 1971).