Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1900

Date: 05-Dec-11
From: Steve Leimberg's Estate Planning Newsletter
Subject: FLASH - Rev. Rul. 2011-28 - IRS Blesses Substitution of Assets in ILIT.

EXECUTIVE SUMMARY:

When asked

"whether a grantor's retention of the power, exercisable in a non-fiduciary capacity, to acquire a life insurance policy held by a trust by substituting other assets of equivalent value will cause the value of the insurance policy to be includible in the grantor's gross estate under Code Section 2042,"

the IRS said "NO." (assuming certain guidelines are met).

This now means that the comfort that can be found in Rev. Rul. 2008-22 (discussed below) allowing a Grantor to substitute assets of equal value for trust assets has been enlarged to include the swap of cash or other property for a life insurance policy.

FACTS:

D, a United States citizen, established and funded an irrevocable trust for his descendants with cash.

The trust then purchased a life insurance policy on *D*'s life.

T is the trustee of Trust, and the terms of Trust prohibit *D* from serving as trustee of Trust.

D makes gifts every year to Trust.

Premiums on the insurance policy insuring D's life are paid by the trust.

The proceeds of the policy are payable to the Trust upon *D*'s death.

D cannot revoke, alter, amend, or terminate the trust.

However, the governing instrument of Trust provides *D* with the power, exercisable at any time, to acquire any property held in Trust by substituting other property of equivalent value.

The trust instrument provides that the power is exercisable by *D* in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity.

To exercise the power of substitution, *D* must certify in writing that the substituted property and the Trust property for which it is substituted are of equivalent value.

Additionally, under local law, *T* has a fiduciary obligation to ensure that the property that *D* seeks to substitute is equivalent in value to the property distributed to *D*. Moreover, if a trust has two or more beneficiaries, local law requires the trustee to act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.

Finally, under local law and without restriction in the trust instrument, *T* has the discretionary power to acquire, invest, reinvest, exchange, sell, convey, control, divide, partition, and manage the trust property in accordance with the standards provided by law.

D has no incidents of ownership in the insurance policy unless D's right of substitution is considered an incident of ownership.

D dies without having exercised the power to substitute with respect to the life insurance policy.

COMMENT:

Far Reaching Scope of Code Section 2042:

Code Section 2042(2) requires inclusion in the value of the gross estate of life insurance proceeds under policies on the life of the decedent by beneficiaries (other than the executor), with respect to which the decedent possessed at decedent's date of death any of the incidents of ownership in the policies, exercisable either alone or in conjunction with any other person.

Corresponding Estate Tax Regulations [i] state that the meaning of the term "incidents of ownership" is not confined to ownership of the policy in the technical legal sense. Generally speaking, the term “incident of ownership” refers to the right of the insured or the insured's estate to the economic benefits of the policy. Thus, the term includes without limitation the power to (1) change the beneficiary, (2) to surrender or cancel the policy, (3) to assign the policy, (4) to revoke an assignment, (5) to pledge the policy for a loan, or (6) to obtain from the insurer a loan against the surrender value of the policy.

A decedent is considered to have an incident of ownership in a policy held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust. [ii]

Moreover, assuming the decedent created the trust, such a power may result in the inclusion in the decedent's gross estate under Code Sections 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.

Rev. Rul. 84-179

In Rev. Rul. 84-179, [iii] the decedent purchased an insurance policy on his life and transferred all incidents of ownership to his spouse.

His spouse designated their adult child as the policy beneficiary.

Subsequently, the spouse died and her will established a residuary trust for the benefit of the child.

The decedent was designated the trustee of this trust. The insurance policy on the decedent's life, which was part of the residuary estate, passed to the testamentary trust. As trustee, the decedent had broad discretionary powers in the management of the trust property and the power to distribute or accumulate income.

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 annual dividends.

The will did not preclude the decedent from exercising these powers, although the decedent could not do so for his own benefit. The decedent paid the premiums on the policy out of other trust property and was still serving as trustee when he died.

Citing the legislative history of § 2042(2), Ruling 84-179 states that Congress intended Code Section 2042 to parallel the statutory scheme governing those powers that would cause other types of property to be included in a decedent's estate under §§ 2036 and 2038. Code Section 2036 applies to the transfer of property where rights or powers are retained incident to the transfer, and Code Section 2038 pertains to situations where property is transferred and power over the property subsequently returns to the transferor-decedent.

Under the facts in Rev. Rul. 84-179, the decedent transferred the policy to his wife and subsequently, in an unrelated transaction, reacquired incidents of ownership over the policy in a fiduciary capacity. The ruling holds that the decedent will *not* be considered to possess incidents of ownership in the policy for purposes of Code Section 2042(2), provided the decedent

- could not exercise the powers for the decedent's personal benefit,
- did not transfer the policy or any of the consideration for purchasing or maintaining the policy to the trust from personal assets, and

the devolution of the powers to the decedent was not part of a prearranged plan involving the participation of decedent.

The ruling further states, however, that the decedent *will* be deemed to have incidents of ownership over an insurance policy on the decedent's life where decedent's powers are held in a fiduciary capacity and the decedent has transferred the policy or any of the consideration for purchasing and maintaining the policy to the trust.

Also, where the decedent's powers could have been exercised for decedent's benefit, they will constitute incidents of ownership in the policy, *without* regard to how those powers were acquired and without consideration of whether the decedent transferred property to the trust. Thus, in such a situation, if the decedent reacquires powers over insurance policies in an individual capacity, the powers will constitute incidents of ownership even though the decedent is a transferee.[iv]

Jordahl:

In *Estate of Jordahl*,[v] the decedent created an *inter vivos* trust. The *corpus* of the trust included insurance policies on the decedent's life and other income producing assets. Under the terms of the trust, the decedent reserved the power to substitute other securities or property for those held in trust, provided the substituted property was equal in value to the property replaced. After the decedent's death, the Service argued that the trust assets were includible in the decedent's gross estate under Code Section 2038 because the decedent's power to substitute assets of equal value could be exercised to alter the beneficial interests in the trust. The Service also argued that the proceeds from the insurance policies should also be included under § 2042(2) because the power to substitute the insurance policies allowed the decedent to reacquire full ownership of the policies in the trust.

The Tax Court determined that, because the decedent was bound by fiduciary standards and was therefore accountable in equity to the succeeding income beneficiary and remaindermen, the decedent could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries.

Accordingly, the Court held that the substitution power was not a power to alter, amend, or revoke the trust within the meaning of § 2038. The court further concluded that the decedent's power to substitute an insurance policy was merely a power to exchange at arm's length. The Court held that such a power was in effect a right to purchase the policy and that such a right could not be considered an incident of ownership.

Rev. Rul. 2008-22:

In Rev. Rul. 2008-22,[vi] (See LISI Estate Planning Newsletter # 1278 and **Jeff Pennell**'s article in LISI Estate Planning Newsletter # 1279) the grantor created an irrevocable *inter vivos* trust for the benefit of the grantor's descendants. The grantor retained the power, exercisable in a nonfiduciary capacity, to acquire any property held in the trust by substituting other property of equivalent value. The ruling concludes that the grantor's retained power to substitute assets of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under Code Section 2036 or 2038 - provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value. The ruling further provides that the substitution power cannot be exercised in a manner that would cause the shifting of benefits among the trust beneficiaries.

Rev. Rul. 2011-28

Here, as in the situation presented in Rev. Rul. 2008-22:

- the trust instrument expressly *prohibits D* from serving as trustee.
- It also states that *D*'s power to substitute assets of equivalent value is held in a nonfiduciary capacity.

However, trust terms require that the assets that *D* may transfer into Trust must be equivalent in value to the insurance policies that *D* will receive. In addition, *T* has a fiduciary obligation to ensure that the assets substituted are of equivalent value.

In other words:

- *D* cannot exercise the power to substitute assets in a manner that will reduce the value of the trust corpus or increase *D*'s net worth.
- In view of *T*'s ability to reinvest the assets and *T*'s duty of impartiality to the trust beneficiaries, there will be no shifting of benefits between or among the beneficiaries that could otherwise result from a substitution of property by *D*.

The Service held that, under these circumstances, *D*'s retained power to substitute assets of equivalent value for a life insurance policy held by Trust is not, by itself, an incident of ownership under § 2042(2).

A grantor's retention of the power, exercisable in a nonfiduciary capacity, to acquire an insurance policy held in trust by substituting other assets of equivalent value will not, by itself, cause the value of the insurance policy to be includible in the grantor's gross estate under § 2042.

This favorable result assumes:

1. the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and

2. the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

Good News:

This Revenue Ruling seems to eliminate the fear that **Howard Zaritsky** and I had expressed in an update to **Tax Planning With Life Insurance.** There, we pointed out that the IRS has a history of contending that a right to buy a life insurance policy is itself an incident of ownership under Code Section 2042. For instance, assume the insured's employment contract gave the insured the right to buy the policy from his employer at any time for an amount equal to its cash surrender value. The IRS would argue that the right to buy the policy amounts to a power to veto the policy's cancellation and therefore is an incident of ownership possessed by the insured). Although the Service lost on this argument in *Estate of Smith* ***[vii]***, and acquiesced in *Estate of Smith*, it did so only in the result; it continues to disagree with the Tax Court's method of determining what constitutes an incident of ownership.

It now appears that prudent and careful estate planners can safely rely on a power that gives the grantor the right to exercise a substitution power with respect to a life insurance policy on the grantor's life – assuming the trust contains the safeguard provisions required by Rev. Rul. 2011-28.

Warning:

It must be made very clear in the trust document that the trustee has a fiduciary oblgation to ensure that the Grantor complies in full with the terms of the power.

Having said that, however, the question then becomes, "What IS the value of a life insurance policy?"

The answer to that seemingly simple question is neither simple nor always clear. (See LISI Income Tax Newsletter # 9 by **Howard Zaritsky** and the commentary by **Keith Buck** and myself in LISI Estate Planning Newsletter # 1638 entitled "Life Insurance Valuation: What Advisors Need to Know." As we point out in that article, determining (and defending) the fair market value of an existing life insurance policy is no easy matter. There are a number of factors that impact the value, such as:

- The reason the policy is being valued – different valuation rules may apply.
- The product type – some products types, such as those with secondary guarantees, will likely have higher values that other types of products.
- The valuation methodology used by the insurance company.

PLANNING TIPS:

Here are some practical tips regarding policy valuation that may help you to better serve your clients:

1. When you request the value of a policy from an insurance company, be specific about what value you're looking for (e.g., is it the value for gift, income or some other purpose).
2. Start out by informally requesting the value from the insurance company. For example, instead of asking the carrier to send you a Form 712, have some idea what the ITR value on the 712 will be *before* they send it to you. This might make it easier for you to argue for and obtain an alternative value before the insurance company has formally issued the Form 712.
3. Ask the insurance company how they calculated the value that they have informally provided you. Knowing their methodology can put you in a better position to determine if the value you've been provided is reasonable.
4. Negotiate the value with the insurance company, if possible. Most insurance companies probably won't be willing to change the number they put on the Form 712, but some companies may be willing to do so due to the ambiguities involved. It certainly doesn't hurt to ask. You may have more success going through an insurer's Advanced Marketing or Actuarial department as opposed to Client Services (a.k.a., Policyholder Services), as the former are more likely to be familiar with the issues involved and the latter are likely just following what is laid out in their company's policies and procedures manual.
5. If all else fails, be prepared to consider another approach, such as obtaining an independent appraisal.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Steve Leimberg

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CITES:

Rev. Rul. 2011-28; 2011-49 IRB 830.

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[i] Reg. Section 20.2042-1(c)(2).

[ii] Reg. Section 20.2042-1(c)(4).

[iii] Rev. Rul. 84-179, 1984-2 C.B. 195.

[iv] *See Estate of Fruehauf v. Commissioner*, 427 F.2d 80 (6th Cir. 1970); *Estate of Skifter v. Commissioner*, 468 F. 2d 699 (2d Cir. 1972).

[v] *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975), *acq. in result*, 1977-2 C.B. 1

[vi] Rev. Rul. 2008-22, 2008-16 I.R.B. 796.

[vii] *Estate of Smith v. Comm'r*, 73 T.C. 307 (1979), *acq'd in result*, 1981-1 CB 2.

0 Comments Posted re. *FLASH - Rev. Rul. 2011-28 - IRS Blesses Substitution of Assets in ILIT*

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