



Linked Benefit Insurance Owned by an ILIT

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Situation: Several years ago, insurers began combining two different forms of insurance coverage by offering life insurance policies with long-term care/chronic care riders. With this type of coverage, if during the insured's lifetime long-term coverage is required, the policy pays coverage to help offset costs and the death benefit is reduced. However, if the insured never requires long-term care coverage, or only uses a portion of the long-term care benefit, any remaining life insurance death benefit will be available for heirs upon the death of the insured.

Although this hybrid "linked-benefit" product efficiently combines two important forms of insurance, it also creates a challenge for estate planning purposes. Specifically, if a life insurance policy is owned by the insured, the policy's proceeds can be accessed by creditors and are subject to estate tax at death. To remove the proceeds from reach of creditors, often an irrevocable life insurance trust (ILIT) is created to be the owner and beneficiary of the policy. Although the recent increase in the amount exempted from federal estate tax shelters most everyone except the ultra-high net worth clients, there are still many states with lower state death taxes where individuals will still seek use of the irrevocable life insurance trust. For example, Minnesota, Washington, Oregon, and Massachusetts have relatively small state death tax exemption. So, it is not unusual for moderately well-to-do individuals in states with low "death tax" exemptions to establish ILITs to avoid state death tax.

The Irrevocable Life Insurance Trust (ILIT) is one of the most commonly used estate planning tools. When properly established and managed life insurance proceeds escape estate, gift, and generation-skipping tax, while still providing liquidity to an insured's estate. However, where an ILIT owns a linked-benefit product and the trustee makes distributions to the insured or reimbursements to facility for the benefit of the insured, the entire trust can be included in the insured's taxable estate. Thus, the question becomes: Is it possible for an ILIT to own a linked benefit product to ensure the policy proceeds are outside of the estate, but still make the funds available to provide for long-term care needs?

Financial advisors are increasingly being asked by moderately well-to-do individuals who live in states with modest estate tax exemptions about owning linked-benefit products in an ILIT.

This *Counselor's Corner* will attempt to provide some guidance regarding this question.

Solution: Section 2042 is the primary Internal Revenue Code provision to describe the conditions under which life insurance will be included in an insured's estate for estate tax purposes.¹ Consequently, keeping a linked-benefit product on a decedent's life out of his/her estate is only possible when it avoids the reach of this provision. Under Section 2042 life insurance proceeds are included in an insured/decedent's estate if (a) the proceeds are receivable by the insured's executor, or (b) to the extent received by other beneficiaries the insured possessed at his death any incidents of ownership either alone or in conjunction with any other person.

To understand whether a linked-benefit product will be included in an insured's estate when owned by a properly designed ILIT we must first understand Section 2042 and then examine the product to determine if there is anything within the contract terms that may cause estate inclusion. Both the receivable by the executor and incidents of ownership aspects of code Section 2042 are more intricate than first meets the eye.

Overview of Taxation of Life Insurance Under Section 2042

Section 2042(1) provides that the value of the gross estate shall include the value of all property "to the extent of the amount receivable by the executor as insurance under policies on the life of the decedent." Thus, proceeds payable directly to the executor or administrator of the insured's estate will be includable in the gross estate.² According to the regulations the term "receivable by the executor" also includes payments that are for the benefit of the decedent's estate even when not paid to the estate. Therefore, proceeds payable to anyone that is subject to a legally binding obligation to pay taxes, debt, or other charges enforceable against the decedent's estate are includable to the extent of the obligation.³ Also, if a policy is pledged as collateral for a loan to the insured, then the proceeds are includable in the insured's estate to the extent of the debt.⁴ If the proceeds are payable to a beneficiary who is authorized, but not required, to use the proceeds to pay estate obligations, the discretion to use the proceeds for the benefit of the estate will not cause inclusion. However, the proceeds will be included to the extent they are used for estate obligations.⁵

The determination of the estate's interest in life insurance proceeds is a matter of state law. Consequently, life insurance proceeds that are not payable to the benefit of the estate, but which pass as though they were because of the application of state law, will be included in the gross under Section 2042(1).⁶ For example, if a policy indicates the estate of the insured as the beneficiary, but under applicable law the proceeds are community property so that one-half of the proceeds belong to the spouse, only half of the proceeds are included under Section 2042(1).

Like the received by the executor provision, the incidents of ownership provision as set forth in Section 2042(2) may appear to be straightforward but is deceptively complex. Section 2042(2) provides that the value of the gross estate includes the value of "the amount receivable by all other beneficiaries (other than the estate) as insurance 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."

There is no comprehensive definition of the term "incidents of ownership." The Regulations provide that the phrase "incidents of ownership" is not limited in application to ownership of the insurance contract in the technical sense. Rather, it also includes right of the insured to the economic benefit of the contract.⁷ According to the regulations, the phrase also specifically includes "the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy."⁸ Furthermore, over the years the courts and commissioner have expanded the taxing scope of the phrase "incident of ownership." For example, courts have considered such policy provisions as the right to elect a settlement option that affects the timing of payments to the beneficiary⁹ and the right to receive distributions in case of disability¹⁰ as incidents of ownership. For example, in a case that examined a disability feature that bares similarities to the long-term care riders on many of today's linked benefit products the right to receive disability benefits under a life insurance contract was held to be an incident of ownership, at least if the disability benefits reduce the amount of death benefit.¹¹

The courts and commissioner have gone to great lengths to include life insurance proceeds in an insured's estate where the insured derives an economic benefit even in the absence of technical ownership. For example, in *Pritchard v United States*,¹² an insured was held to have an incident of ownership where his wife was the original owner of the policy that was assigned to a lender to secure a loan to the insured because the court found that there was an oral agreement for the wife to make the collateral assignment. This case illustrates that there is always a risk of the Service arguing that there is an agreement between the owner and an insured giving the insured the rights in the

policy. It should be noted that in this case even if the Service had not found an incident of ownership, the proceeds would have been includable in the insured's estate under Section 2042(1) to the extent paid to the lender.

It's clear from this general overview of Section 2042 that the taxing scope is broad. There is significant tax risk of having the proceeds included in an insured's estate where the insured receives an economic benefit. So, the question becomes do the typical provisions in a life insurance policy with a long-term care rider include terms that could cause a trust owned policy to be included in an insured's estate.

Long Term Care Life Insurance Provisions

Long term care riders on life insurance policies are generally paid in one of two ways: through a reimbursement plan or an indemnity plan.

In a product with a "reimbursement" style benefit rider, payments are limited to the lesser of the monthly policy benefit purchased or the actual amount expended. Bills and receipts incurred by the insured must be submitted each month to the insurance company. Then the insurance company determines which expenses qualify for reimbursement. Generally, benefits must be paid to the insured or directly to the facility/service provider providing care on behalf of the insured.

It's generally believed that a reimbursement style of long-term care rider will cause the policy to be included in an insured's estate because the benefits are typically paid either to the insured or to a facility providing care on behalf of the insured as a reimbursement of the insured's expenses. This should cause the proceeds to be included in the insured's estate under 2042(1) as a charge enforceable against the estate. In addition, like the right to receive disability distributions, the insured's right to receive distributions in the event of a long-term care event could be considered an incident of ownership.

In contrast, with an "indemnity" form of rider the benefit is paid in cash based on the lesser of the annual HIPAA amount or a predetermined percentage of the policy face without regard to expenses of the insured. The benefit is made directly to the owner of the policy; which is the trustee. The benefit with an indemnity rider is triggered by the status of the insured, but does not necessarily benefit the insured.

It's generally believed that with proper planning the indemnity form of rider has the potential of being excluded from the estate of the insured. With an indemnity style rider the life insurance policy is essentially funding the ILIT with cash via payment of an accelerated death benefit. The insured might then indirectly benefit. However, it's important to note that there must not be a pre-arranged understanding that the benefits will be used to benefit the insured.



Following are some of ways to structure an ILIT owned linked-benefit indemnity style product:

Structure #1: At the triggering of the long-term care event benefits are paid to the trust where they are retained. With this structure instead of using the ILIT owned policy to indirectly pay for long-term care expenses, assets included in the insured's estate pay the long-term care expenses. In effect the assets retained by the trust replenish the estate assets used to pay for long-term care expenses. This strategy provides the least tax risk of estate inclusion.

Structure #2: Where the trust is structured as a "defective grantor" trust and the trustee is given the power to make loans one possible method to distributing trust assets for long-term care expenses is by loaning the funds. With this approach the insured will need to provide collateral as security and consideration should be given to paying interest.

Structure #3: The third structure is dependent on the ILIT containing language permitting distributions to adult children while the insured is alive. With this structure at the triggering of the rider, the trustee applies for the benefits which are paid to the trust. Next, under the trust terms the trustee has the

option to distribute funds to the children. The children can then pay the expenses to the provider/facility or retain the funds for their own use. If the children decide to pay some or all of the insured's expenses, the payment must be to the medical provider to avoid gift tax. There is a greater tax risk that this structure will cause the trust to be included in the estate of the insured. To avoid estate inclusion, the children:

- cannot be legally obligated to pay for the expenses, and
- there can be no prearranged agreement between the parent and children to pay those expenses.

In Summary

Regardless of the type of long-term care rider used careful consideration should be given to the appropriateness of including such a policy in an irrevocable trust. There is a tax risk that the rider will cause a trust owned policy to be included in the insured's estate. The safe course of action may be to purchase two policies with one owned in an ILIT to provide estate tax liquidity and the other retained by the insured to address long-term care needs, if incurred, and if not, provision for a surviving spouse or charity.

¹Proceeds not included under section 2042 may be included under some other section. For purposes of this article our focus is on inclusion under Section 2042.

²Treasury Reg. §20.2042-1(c)(1).

³Id.

⁴Id.

⁵Estate of Wade v. Commissioner, 47 B.T.A. 21 (1942).

⁶First Kentucky Trust Company v. United States, 737 F.2d 557 (6th Cir. 1984).

⁷Treasury Reg. §20.2042-1(c)(2).

⁸Id.

⁹Lumpkin v. Commissioner 474 F.2d 1092 (5th Cir. 1973) held that the right to elect settlement options in a group plan was an incident of ownership, but in Connelly v. United States, 551 F.2d 545 (3rd Cir. 1977) considering the same group plan the court held that the right to elect settlement option was not an incident of ownership. The Service has indicated it will follow Lumpkin.

¹⁰Old Point National Bank v. Commissioner, 39 B.T.A. 343 (1939).

¹¹Id.

¹²Pritchard v United States, 397 F. 2d 60 (5th Cir. 1968). However, in Goodwyn v. Commissioner the insured was held to have no incidents of ownership where the policy was owned by someone other than the insured and the owner as an accommodation to the insured, collaterally assigned the policy to secure a loan to the insured.

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