Options When the Policy is Ready but the Trust Is Not

Counselor's Corner

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Situation: The recent outbreak of the Coronavirus has caused many people to think about their own mortality, causing a surge in estate planning and the purchase of life insurance. As a result, we are receiving a renewed interest in one of the most common estate planning techniques – that of the irrevocable life insurance trust (ILIT). Some of the most frequently asked questions are,

> ***What options does an insurance professional have when s/he finds that a client is ready to apply for a policy, but the ILIT that will own the policy doesn't exist? What if the policy is ready to be issued but the trust is not ready? The client(s) want the insurance issued and bound, but still desire to keep it out of the estate.***

Solution: There are a variety of potential options, but each has its own issues and problems.

Trial "Application" Approach

The most common approach is designed with the intent of not getting into the situation where there is no trust at the time the policy is issued. The most common approach is to begin the underwriting process using what is often referred to as a "trial application." The trial application is not an application for insurance but a medical inquiry that helps to initiate the medical underwriting process. Once the policy rating classification is determined and accepted by the client, the attorney proceeds to draft the ILIT. After the ILIT is drafted and the trustee(s) established, but BEFORE the premium is paid, a formal application for each proposed insured is signed by the trustee of the ILIT, as owner and beneficiary. Next a gift of the premium payment is made to the trust. The payment of premium can be structured as simple as a direct gift or as complex as a split-dollar or premium finance arrangement. The insurance company then issues the policy. After the Crummey withdraw time period ends the trustee remits a check written on the trust bank account for the first premium payment.

There is a tax issue with this approach: Did the insured ever hold any incidents of ownership in the policy that could cause inclusion of the insurance proceeds in the estate should death occur within three years? Many legal advisors believe the policy will not be subject to the three-year inclusion rule, because the formal application is not taken and no premiums are paid until the trust is established. Therefore, no contract for insurance exists – just an offer for an insurance contract. In TAM 9323002, the IRS used a similar analysis and came to the conclusion that the insured did not have any incidents of ownership where, under the terms of the policy and state law, the policies did not become effective until the first full premium was paid and the policies were issued and delivered.

Oral Trust Approach

Another solution is the use of an "oral trust." With the oral trust approach the application is completed with the owner listing the trustee of the "not-yet-completed" ILIT. Just prior to signing the application, the initial trustee and the insured discuss the terms of the trust with the attorney and complete a memorandum of understanding that an irrevocable oral trust has been established at that time and will be reduced to writing at a later date.

In addition to the fact that many insurance carriers will not accept applications using this approach, there are significant tax and legal risks associated with this approach. Some states do not recognize oral trusts, and some are unclear on the issue. Potential challenges over intended beneficiaries, dispositive provisions, etc. are a

risk if the insured should die before the trust is reduced to writing. Finally, the IRS may argue that an oral trust is not truly irrevocable with the adverse result of estate inclusion.

Assumption of the Risk Approach

An alternative approach where the insured(s) is/are healthy is to take a calculated risk and have the policy issued directly to the insured(s), then have the insured(s) gift the policy to the trust after it has been created. The obvious drawback is the possibility of inclusion under the three-year pullback rule. The effect of inclusion could be eliminated through the use of an additional term policy owned by a family member that would cover the estate tax cost of policy inclusion if the insured should die within three years after policy transfer.

Sale to the Trust Approach

An alternative to having the insured gift the policy to trust is to have the insured sell the policy to the trust. Under this approach the insured(s) purchases the policy and once the trust is established the policy is transfered through a sale to the trust. The insured could “seed” the trust with cash to enable it to purchase the policy. The three-year pullback rule will not apply if the transfer is structured as a bona fide sale for adequate and full consideration.

Like the other approaches, there is a tax risk associated with this approach. First, to avoid estate inclusion the transfer must be for “full and adequate consideration.” While the IRS has issued regulations and rulings on the valuation of life insurance, there still remains a great deal of uncertainty as to what measure of value to use in many situations, including transfers subject to the three-year inclusion rule. The variety of elements that make up an insurance product, the differences in the health of the insured and other circumstances mean the same type of life insurance policy may have different values.

Another problem could arise if the IRS views the gifts to the new ILIT followed by the purchase by the new ILIT as one interdependent plan – a step transaction. This could lead to the argument that this transaction was simply a disguised gift of the policy by the insured to the new ILIT, invoking the three-year inclusion rule. Some advisors feel this risk is minimized by allowing a period of time to elapse between the sale to the insured and the sale to the trust. Finally, to avoid income taxation of the death benefit, proceeds of the sale must qualify for one of the exceptions to the transfer-for-value rule.

Initial Ownership by a Third-Party Approach

Another solution is to find a trusted individual other than the insured to temporarily own the policy until the ILIT is completed and the policy can be transferred. Generally, the person chosen is the spouse or an adult child.

When a spouse is used as the temporary owner, the unlimited marital deduction for U.S. citizen spouse effectively shelters any cash gifts made to the spouse to pay premiums. If a child is the temporary owner of the policy, the parent could apply for the policy and pay the first premium with a cash gift to the child – using the annual exclusion and/or the exclusion amount. After the donor/insured has signed the trust, the spouse or child gifts the policy to the trust. This second transfer will be subject to gift tax. Estate tax issues also arise when a spouse or child gifts a policy to the ILIT and is a named beneficiary of the trust. Such a situation could lead to a portion of the trust being included in his/her estate under the “retained strings” provisions of IRC §§2036-2038. Don’t ignore the fact that, while a spouse or child holds the policy, is it available to his/her creditors.

Product Approach

When using survivorship products, many insurers have added product riders that gross up the death benefit to pay the estate tax if both insureds die within 4 years of the issuance of the policy. Such a product rider gives an insured the ability to initially own the coverage. However, the policy should still be transferred within the first year to avoid unnecessary estate tax even when this rider is available because the maximum payment period for this rider is 4 years from policy issuance.

Creative Planning Technique for Survivorship Products

Often the product being purchased to provide estate liquidity is a second-to-die/survivorship policy. As indicated above, these products often come with a 4-year gross up to pay estate taxes. Where it’s contemplated that ownership by an insured is likely to be longer than

one year, then you might want to consider a planning technique called the "Survivorship Standby Trust." Basically, the technique is used where insureds' don't want to necessarily give up ownership of a survivorship contract. The need to control the policy may stem from uncertainty over financial or tax law, or it could just be the desire to control and have access to policy cash value. This approach involves the following two parts:

1. **Ownership structure**
   The policy is initially owned and premiums paid from the separate funds of one of the insureds – the one because of age or health who is expected to die first. The primary beneficiary and the contingent owner is the "standby trust."

2. **Standby trust**
   The standby trust can be the testamentary B/by-pass trust established as part of estate plan in a will or living trust, or it can be an ILIT. This trust is structured so that it will not be included in the estate of either spouse. A key point is that trust does not own the policy from the inception, rather it is waiting in the wings on standby to own the policy at some future date.

With this ownership structure as long as the policy owner/insured is the first to die, the policy value (not the death benefit since the policy has not matured) is included in his/her estate, but sheltered by the estate tax exemption amount. The policy ownership passes to the standby trust under the terms of the policy ownership provision. At the death of the surviving spouse, since he/she did not own the policy and no ownership interest is provided under the terms of the standby trust the policy passes to heirs outside of the estate.

There are some practical risks with this ownership structure. The greatest risk occurs when the non-owning insured dies first. if this happens a decision will need to be made on policy ownership since continued ownership by the only living insured will result in estate inclusion of the death proceeds at that insured's death. Another potential concern is the source of premium payments once the policy is owned by the trust.

In Summary

While there are several ways to address the "trust isn't ready" problem, perhaps it is important to stress the need for managing the process so that the ultimate goal of the ILIT – escaping estate inclusion of the policy – is achieved without subjecting the client to policy transfers, unclear legal situations, and potential IRS challenge.

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