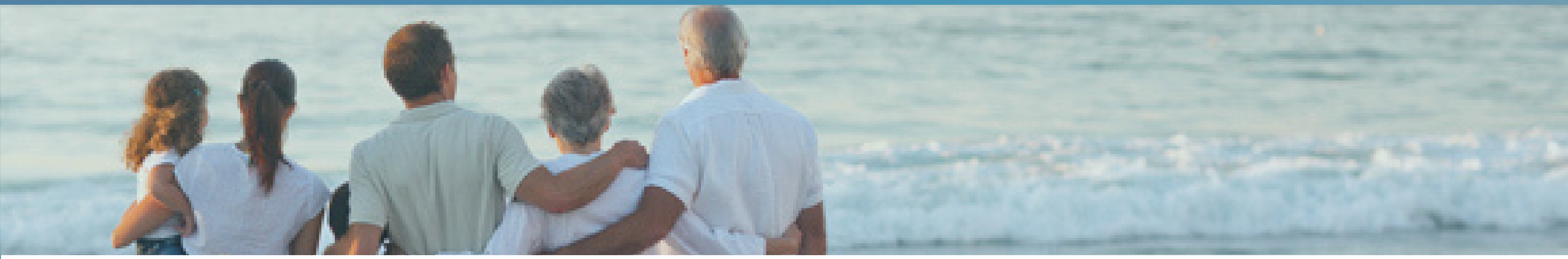
Standby Survivorship Trust: An Alternative to an ILIT for Insureds Desiring Control

by Terri Getman, JD, CLU, ChFC, RICP, AEP (Distinguished)



Situation: The uncertainty of the estate tax laws has created a dilemma for many taxpayers, estate planners, and insurance professionals. Should moderately high net worth couples take action today to shelter a significant amount from estate tax (under the $13.61 million exemption) by making a large gift; or should they hold off making a large gift and hope that the value of their estate stays under what is likely to be a much smaller exemption in the future?

One of the most obvious examples of this dilemma is found with the traditional irrevocable life insurance trust ("ILIT"), which has played a critical role in estate planning for many years. If an ILIT is established, access is significantly limited. On the other hand, if a decision is made to wait to establish an ILIT, the proposed insured's health could deteriorate, thus significantly increasing the cost of insurance coverage. Even worse, the individual may become uninsurable and insurance may be unavailable especially in this COVID environment.

The Standby Trust (also referred to as the Wait-and-See Trust) was developed as an alternative to the ILIT because it permits the insureds (i) to purchase survivorship life insurance today based upon current underwriting conditions and (ii) to retain a great deal of flexibility. This Counselor's Corner provides information about this arrangement.

Solution: In general terms, the Standby Trust arrangement utilizes an ownership and beneficiary structure on a survivorship policy on the lives of a married couple. The insured with the shorter life expectancy is named the initial owner of the life insurance policy ("the insured owner") and premium payer. At the time the insurance is purchased, a trust (i.e., the Standby Trust) is also established as either an existing stand-alone (revocable or irrevocable) trust or as a testamentary trust and is named the contingent owner and primary beneficiary.[1] If the estate tax continues to not apply to the client's situation, the Standby Trust may not be utilized. On the other hand, if the estate tax does apply, then the life insurance policy can be transferred to the Standby Trust in an attempt to minimize future estate tax consequences.

Under this arrangement, trust ownership of the policy is normally deferred until after the death of the first insured, thus giving the insureds the time needed to make any irrevocable decisions concerning the ultimate policy ownership. Consequently, during the lifetime of both insureds, this arrangement provides the insured owner of the policy with (i) a great deal of flexibility, (ii) easy access to cash values for retirement and other uses, and (iii) the potential to exclude the net death benefit from the estate of both insureds. It is important to note, however, that there is a price associated with all of the flexibility. In a Standby Trust arrangement, since the insured owner initially owns the policy, the entire cash value will be included in his/her taxable estate if he/she is the first to die. The application of the so-called "three-year rule" of IRC Section 2035 is also a possibility.

Using a Survivorship Life Insurance Policy

This arrangement utilizes a survivorship policy rather than a single life policy. Although any type of survivorship policy can be used to fund the Standby Trust, the arrangement works most efficiently with a flexible premium universal, indexed, or variable survivorship policy because the flexible premium feature may be needed to minimize gift and income tax consequences associated with the policy after the death of the first insured. The cost of insurance charges in a survivorship policy are generally less than those in an individual policy.

The Three Stages of the Arrangement

While Both Insureds Are Living. In general terms, the spouse with the shorter life expectancy applies for the survivorship life insurance policy with ownership in his or her own name (or in the name of a revocable trust with the insured owner as the trustee), and waits to see what takes place with the estate tax laws. In the interim, the insured owner has ready access to the cash values in the form of loans and/or withdrawals.

As discussed more fully below, while both insureds are alive, the policy ownership is structured so that the spouse with the shorter life expectancy either (i) owns the policy individually and names a stand-alone unfunded Irrevocable Standby Trust as the successor owner of the policy, (ii) names a Revocable Standby Trust as the initial owner, or (iii) owns the policy individually and the will of the insured owner contains a testamentary trust that receives the policy upon the death of the insured owner. The policy owner has control and access to the policy cash value and can use it as he/she deems appropriate.

During this time period, it is important that the insured owner be the source of the premium payments. In community property states, the premiums should be paid from the separate property of the owner spouse.

If the estate tax exemption amount shelters your client's estate from taxes, individual ownership of the policy is no longer a concern from an estate tax perspective. In such a case, the insured owner may retain the policy in his/her own name, add the other insured spouse as a co-owner, or add the other insured spouse as a successor owner.

Alternatively, if the client is subject to estate tax, the insured owner can take steps necessary to potentially shelter the death proceeds from estate taxation. There are two ways this can be accomplished. First, the insured owner could transfer the policy during his/her lifetime to an irrevocable life insurance trust, in which case the value of the policy on the date of transfer is considered a gift. Any unused exclusion amount may be used to offset all or a portion of the gift. (Also, see the discussion titled "Three-Year Rule of IRC Section 2035.") Alternatively, the policy ownership could be transferred to the Standby Trust at the insured owner's death, in which case the policy cash values will be includable in his/her estate and offset by any unused federal estate tax exclusion amount.

Upon the Death of the Insured Owner. In the event the insured owner dies before transferring the policy to the Standby Trust and while the estate tax is still in place, the insured owner's incidents-of-ownership in the life insurance policy will cause the entire cash value to be included in his/her taxable estate. This is unlike a policy owned by an ILIT where both the death benefit and cash value are kept outside of an insured's estate. Because a survivorship policy is used in the Standby Trust arrangement, the death benefit is not paid until the second death. Therefore, if the insured owner is the first to die, the death benefit is not included in the decedent's taxable estate. (See the discussion titled "Three-Year Rule of IRC Section 2035.")

Unless previously transferred to the Standby Trust during the life of the insured owner, the policy is "transferred" directly to the Standby Trust either through operation of the successor ownership provision in the life insurance policy or via the insured owner's will. (If a revocable Standby Trust was originally named the owner of the policy, the Standby Trust becomes irrevocable upon the death of the trustee/insured owner.) At this point, the Standby Trust arrangement becomes a traditional ILIT. Upon the death of the surviving spouse, no portion of the death proceeds should be included in his/her taxable estate.

During this timeframe, care must be taken to make sure the non-owner insured does not acquire any incidents of ownership over the life insurance policy under IRC Section 2042 or retain powers under IRC Sections 2036-2038, which could cause the death benefit to be included in his/her estate. (See discussions below on the subjects of IRC Sections 2042 and 2036.) This caution is especially applicable if additional premiums are required to keep the policy in force or if the surviving spouse is a beneficiary of the Standby Trust.

Upon the Death of the Surviving Spouse. As is the case with a traditional ILIT, the death benefit is paid to the Standby Trust and may be used to generate liquidity for the estate by either purchasing assets from the estate or by making loans to the estate. Assets received in the Standby Trust from the estate can then distributed to the Trust beneficiaries. If the trust is structured properly, none of the death benefit is included in the estate of the surviving spouse even if he/she dies within three years of the insured-owner spouse. (Also, see the discussion titled "Three-Year Rule of IRC Section 2035" with respect to the insured owner spouse.)

Different Ownership Structures

One of the most important aspects of the Standby Trust arrangement is to ensure that the life insurance policy does not pass to the surviving spouse upon the death of the insured owner but instead passes directly to the Standby Trust. This is accomplished in a number of different ways:

1. When one of the insureds establishes a Revocable Standby Trust and names the trust as the initial owner of the policy, the trust becomes irrevocable upon the death of the insured who established the trust, and the successor trustee acquires the policy without the need of changing ownership on the policy or passing through the will.

2. When the insured owner is named as the initial owner of the policy, the policy is transferred at the first death directly to a Testamentary Standby Trust (often the family trust) under the owner's will by naming the testamentary standby trust as the successor owner in the life insurance contract.

3. When one of the insureds is named as the initial owner of the policy and that insured establishes a stand-alone, unfunded Irrevocable Standby Trust and names the trust as the successor or contingent owner and the policy transfers directly to the trust upon the death of the insured owner.

When using either of the last two forms of ownership discussed above, it is important that the application for the survivorship policy specifically designate the trust as the contingent owner of the life insurance policy to ensure that the policy passes to the Standby Trust at the death of the insured.

When Death Occurs in the "Wrong" Order

If the non-owner spouse is the first to die, the insured owner must determine whether to continue to hold the policy or to after considering the current status of the estate tax laws and the need for ready access to policy values through loans and withdrawals.

If avoidance of estate tax is an important factor, the insured owner can transfer the policy to an irrevocable trust. Assuming the insured lives three years after the transfer, no portion of the proceeds should be included in his/her estate. (Also, see the discussion entitled "Three-Year Rule of IRC Section 2035.") Alternatively, if the policy owner spouse retains the policy, the entire death proceeds will be included in his/her estate. This may be acceptable if control of, and access to, policy cash values are the primary concerns.

Simultaneous Deaths

If the spouses die simultaneously, the entire death benefit is likely to be included in the estate of the spouse who owns the policy. Some advisors are of the opinion, however, that only the policy's cash value is included in the insured owner's estate if his or her will contains a provision that he or she is presumed to have died first. Under these circumstances, there will not have been a transfer of the policy that would cause inclusion under IRC Section 2035. The policy would, therefore, pass to the trust without inclusion of the death benefit in the estate of either spouse. This latter position is not without tax risk, and the parties should seek advice from their tax or legal advisors.

Premium Payment Issues

As previously indicated, the source of the premium payment can raise serious issues. The issues will depend upon whether the insured owner is a resident of a common law or community property state.

Common Law States. The source of premium payments in a common law state will not normally create an estate tax issue for the insured non-owner spouse. As long as the insured non-owner spouse is not an owner of the policy and otherwise possesses no incidents of ownership, it is of no consequence that premiums are paid out of the jointly owned assets of the couple.

There is an estate tax concern when an insured owner has transferred a policy to a Standby Trust during life and continues to make gifts to the trust. If jointly owned assets are utilized to pay the premiums in this circumstance, and the surviving spouse is a trust beneficiary, then the surviving spouse will have an IRC Section 2036 problem because the premiums are deemed to have been paid from funds of both spouses. The problem is resolved by simply utilizing separate property to pay the premiums. This can be accomplished by transferring jointly owned property to a separate, individually owned account of the insured owner and then using those proceeds to make the gift and pay the premiums.

There may be similar issues if, at the death of the insured owner, premiums are required to keep the trust-owned policy in force. If the surviving spouse contributes premiums and is a beneficiary of the trust, the surviving spouse will have an IRC Section 2036 retained interest, causing a portion of the proceeds to be included in his/her estate. This problem can be avoided by having another party pay the ongoing premiums or by structuring the policy premium so that no additional premiums are needed to maintain the policy. Of course, whether additional premiums may be required depends on a number of factors, such as the policy type, guarantees against lapse, etc.

Community Property States. The source of premiums is more of a concern in a community property state. It is essential that premiums be paid from the separate property of the insured owner during his or her lifetime. If premiums are paid from community property, the premium is deemed to come 50% from one spouse and 50% from the other spouse under Treasury Regulation Section 20.2042-1(c)(5). Therefore, 50% of the death benefit will be included in the estate of the surviving spouse under Section 2042. Consequently, to avoid creating unnecessary estate tax consequences, the insured owner should always utilize separate property for the premiums.

Estate Tax Issues

IRC Section 2042. This Section causes the proceeds of a life insurance policy to be included in the estate of the insured (i) to the extent the proceeds are payable to or for the benefit of the estate of the insured or (ii) to the extent the insured possesses an "incident of ownership" in a policy on his/her life regardless of the beneficiary designation. The rules for the inclusion of proceeds in the estate of the insured are the same for a Standby Trust as they are for a traditional ILIT. This inclusion can be avoided by drafting the trust documents to ensure that the trustee is not subject to any obligation to pay taxes, debts or charges. In the context of the Standby Trust, the more complex IRC Section 2042 concerns relate to the insureds' retention of an incident of ownership and, as discussed more fully below, occur at both the death of the insured owner and the non-owner insured.

Estate Tax Inclusion Under IRS Section 2042 in the Estate of the Non-Owner Insured. If the non-owner spouse dies first, nothing is included in his/her estate because he/she never had any incidents of ownership in the policy. However, the Standby Trust concept contemplates that the insured owner will be the first to die in most situations. In the situation where the non-owner spouse predeceases the insured donor, there are complex IRC Section 2042 issues.

First, as is the case with a traditional ILIT, the incident-of-ownership rule can cause estate inclusion where the insured has

www.dbs-lifemark.com

a right to exercise policy ownership rights in either an individual or fiduciary capacity. For this reason, the non-owner insured surviving spouse should not be a trustee or co-trustee of any trust holding an interest in the survivorship policy. (When a policy passes under the terms of the insured owner's will, the surviving spouse should not be the executor of the estate.) In addition, Treasury Regulation Section 20.2042-1(c) provides that an incident-of-ownership exists if the insured has the power to change the beneficial ownership in the policy or proceeds. Many trusts give the surviving spouse a limited power-of-appointment to direct the ultimate distribution of trust assets, typically among children. Clearly, in the Standby Trust concept, this power will cause inclusion of the proceeds in the insured surviving spouse's estate.

Second, as in the case with a traditional ILIT, less obvious incidents-of-ownership can occur where the non-owner insured is one of the trust beneficiaries of the Standby Trust. For example, an ILIT will typically give a beneficiary spouse the right to all the income or the right to trust income and principal according to ascertainable standards (health, education, maintenance and support). In recent cases the IRS has not attributed an incident-of-ownership when a spouse is entitled to trust distributions,[3] although it has alluded to a potential gift tax trap if the trustee diverts trust income or principal to pay life insurance premiums.[4] Consequently, the surviving spouse should not have an absolute right to distributions of income or principal from the trust.

To avoid the IRC Section 2042 issues, the document should give the trustee absolute discretion to distribute income or principal. Since one of the reasons for using the trust arrangement is to provide that the amounts accumulated in the survivorship policy will be available for the benefit of the non-owner insured surviving spouse, it is important to select a trustee who is attentive to the needs of the spouse.

Estate Inclusion Under IRC Section 2033 at Death of Insured Owner. If the insured owner dies first, his/her estate will include the policy's cash value under IRC Section 2033. Since the policy passes to a trust that does not qualify for the unlimited marital deduction, the cash value is subject to estate tax, but is sheltered by any unused federal estate tax unified credit/ applicable exclusion amount. (Note: As more fully explained below, if the policy is transferred during the life of the insured owner and both spouses die within three years, there is a tax risk that the proceeds will be included in the decedent's estate under IRC Section 2035.)

Three-Year Rule of IRC Section 2035. IRC Section 2035 provides that if an insured owner transfers a life insurance policy (even an irrevocable transfer) and dies within three years of the transfer, the entire death benefit is pulled back into the taxable estate. When using the Standby Trust arrangement, the three-year-rule can apply in several instances.

First, if the insured non-owner spouse is the first to die, the insured owner generally would need to transfer the policy and survive for three years after the transfer to avoid the three-year rule. Likewise, if it becomes clear that the estate tax is not going to be repealed while both insureds are still living, the insured owner would need to transfer the policy to an irrevocable Standby Trust and one of the insureds would need to survive for three years in order to avoid the three-year rule.

Another situation where the three-year rule may apply is where the owner insured and non-owner insured die simultaneously. Some assert it is possible that only the cash value will be included in the estate of the insured owner if his/her will contains a provision that he/she is presumed to die first under these circumstances. This position is not without tax risk and the parties should seek advice from their tax or legal advisor.

IRC Section 2036. IRC Section 2036 provides that an individual's estate will include the value of property to the extent a decedent has made a transfer under which he/she has retained possession, enjoyment of, or the right to the income from the property. Generally, Section 2036 pulls assets back into the taxable estate "to the extent" the prior owner retains a lifetime interest in the asset. It is not an all or nothing test. A portion of the assets may be pulled back into the estate. The potential application of IRC Section 2036 is one of the primary estate tax concerns for the non-owner insured surviving spouse following the death of the insured owner and subsequent transfer of the policy to the Standby Trust.

In the Standby Trust context, there are IRC Section 2036 issues following the death of the insured owner if premiums are still required to keep the life insurance policy in force and the surviving spouse is also a beneficiary of the Standby Trust. If any portion of the premiums are paid by the surviving spouse, and the surviving spouse is also a beneficiary of the Standby Trust, a proportionate share of the death benefit will be included in the taxable estate of the surviving spouse.

How to Avoid IRC Section 2036. There are several options available for steering clear of IRC Section 2036 in these circumstances.

First, do not name the surviving spouse as a beneficiary of the Standby Trust. The surviving spouse would thus be able to make significant premium contributions to the trust in the form of gifts, presumably for the benefit of the children who are named as trust beneficiaries. This is perhaps the most conservative approach because it ensures that the proceeds are not included in the taxable estate at death. However, under this option the trustee will not be able to distribute assets to the surviving spouse.

Second, name the surviving spouse as a trust beneficiary, but have all of the premiums paid by third parties, such as the children. It is important to note, however, that this will create an IRC Section 2036 issue for the contributing children. Since the trust was established for the benefit of the children, meaning that some day each child will receive their proportionate share of the trust anyway, there is little incremental risk associated with this option.

Third, name the surviving spouse as a trust beneficiary and provide the trustee with absolute discretion to make income and/or principal distributions to him/her. In other words, place a barrier between the surviving spouse and the assets of the trust. Of all the options available for circumventing Section 2036, this option contains the most risk. Since the surviving spouse cannot possess the right to force a distribution without pulling the assets into his/her taxable estate, the surviving spouse must place a great deal of faith in the trustee. The IRS may also try to bring trust assets into the taxable estate if it feels there was an implied promise on the part of the trustee to make distributions to the surviving spouse or to the extent to which state law permits creditors of the surviving spouse to reach trust assets.

Fourth, the insured owner can purchase a survivorship policy that includes a death benefit guarantee and that can be acquired on a limited-pay basis. During the lifetime of the insured owner, he/she could make payments sufficient to guarantee the death benefit so that the surviving spouse will not have to make further premium payments. The risk of this option is that the insured owner may die prior to the last premium payment. If this is a concern, the insured owner can purchase a term policy inside a stand-alone, unfunded, irrevocable Standby Trust, with a death benefit amount sufficient to pay the remaining premiums. Please note that limited-pay scenarios may cause the policy to become a modified endowment contract with additional potential tax consequences.

Gift Tax Issues

The Standby Trust concept does not trigger gift taxes while the insured owner pays the premiums if the policy is individually owned or indirectly owned by a revocable trust. In these instances, the premiums and the policy remain the property of the insured owner. However, if the policy is transferred to an irrevocable trust during the lifetime of the insured owner or if future premiums are required once the policy has been transferred, as discussed below, gift taxes may be triggered.

Actual Transfer of the Life Insurance Policy. Gift taxes may also be imposed when the policy is transferred to an Irrevocable Standby Trust during the lifetime of the insured owner (either because the estate tax is not repealed or because the spouses die in a different order than anticipated). The transfer of the policy is a gift subject to gift tax but may be offset by any unused exclusion amount.

Future Premiums Required. If future premiums are required after the transfer to the Standby Trust but before the death of the insured owner, then the gift tax consequences of funding the premiums are the same as with the traditional ILIT, (i.e., the insured former-owner's gifts to the trust that are used to pay premiums are taxable future interest gifts unless the trust beneficiaries are granted Crummey withdrawal rights to all, or a portion, of the premium gifts.) As is the case with a traditional ILIT, when trust beneficiaries do not exercise their Crummey withdrawal rights, these rights lapse, creating the so-called 5 X 5 concerns under IRC Section 2514 with respect to the trust beneficiaries. The 5 X 5 issue is typically addressed with "Hanging Powers," which are beyond the scope of this guide but are the same as with a traditional ILIT. (See Prudential Financial's Frequently Asked Questions "Crummey Withdrawal Powers and the 5 X 5 Limit" 0165518 for a more detailed discussion).

Any gifts to the trust subsequent to the death of the insured owner also generate gift tax issues for the donor unless the trust beneficiaries receive Crummey withdrawal rights noted in the previous paragraph.

Income Tax Issues

There is nothing unique about the income tax issues associated with using a life insurance policy in connection with a Standby Trust. The income tax rules that apply to life insurance continue to apply.

Income Taxation of Loans and Withdrawals. One of the primary reasons for using the Standby Trust arrangement is the desire to have access and control over the policy cash values. Unless the policy is a modified endowment contract, loans or withdrawals accessed during life are generally not taxable up to basis.

(If the policy lapses with an outstanding loan that exceeds the owner's basis in the policy, then the loan is taxable to the extent it exceeds basis.) Consequently, it is possible to supplement the insured's income by accessing the policy values on an income tax-free basis. Of course, any withdrawals or loans may reduce cash values and death benefits, may affect any guarantees against lapse, and may have tax consequences.

It should be noted that the ability to access the policy values on a tax-favored basis does not apply if the policy is a modified endowment contract (MEC). If a policy is a MEC, loans and withdrawals are taxable to the extent of any gain inside the policy. A 10% penalty could also apply to the taxable portion of the loan/withdrawal if the owner has not yet reached 59½.

www.dbs-lifemark.com

Further, as is always the case with a life insurance policy that is "cash rich" under the recapture ceiling rules of IRC Section 7702(f)(7), all or a portion of a withdrawal could be taxable even if the policy is not a modified endowment contract and even where the policy still has cost basis to offset the withdrawal.

Transfer-for-Value Rule and Discharge of Indebtedness. Normally, beneficiaries receive life insurance death proceeds exempt from income taxation under IRC Section 101(a). However, this can be lost if there has been a transfer-for-value. Under the transfer-for-value rules of IRC Section 101(a)(2)(A), the death proceeds are subject to income taxes if the transfer does not fall within one of its exceptions.

Aside from one narrow situation, the transfer-for-value rules ordinarily do not apply to the Standby Trust arrangement. This exemption could occur if the policy that is transferred to the Standby Trust is subject to an outstanding loan that exceeds the owner's basis in the policy. In that situation, the death benefit is generally subject to income tax. This adverse tax consequence can be avoided by paying off the loan or by paying it down so that it does not exceed the owner's basis in the policy.

There is a corollary income tax issue for the owner if, as a result of the transfer, his/her interest in the survivorship policy terminates at a time that the policy loan exceeds his/her basis. Because the transfer of the policy ownership discharges the owner's obligation to repay the policy loan, the amount of the loan is considered to be the amount received by the transferor. If this amount exceeds the owner's basis in the survivorship policy, that excess is taxable to the owner or owner's estate as ordinary income. Note that the policy loan itself is not discharged by the insurance company. The adverse tax consequences can be avoided by limiting the loans and withdrawals to premiums paid. As long as total loans and withdrawals do not exceed premiums paid, the forgiveness of indebtedness will not generate taxable income.

Income Taxation on Earnings. If gifts are made to the trust to cover future premiums and those assets generate taxable income inside the trust before they are used to pay premiums, then, as is the case with a traditional ILIT, the Standby Trust will have taxable income. If the income is distributed to the beneficiaries of the Standby Trust, it will be taxed to the beneficiaries (not the trust).

Conclusion. Properly structured, the Standby Survivorship Trust concept has many benefits. It can provide the insureds the flexibility they desire during this time of estate tax uncertainty. The Standby Trust concept is worth considering as an alternative to a traditional irrevocable life insurance trust for the moderately wealthy or young couple.

---

[1] *Since this technique does not require ownership of the survivorship policy by the Standby Trust from the inception, it is not necessary to have the Standby Trust in existence at the time of policy application. However, it is prudent to have the trust established as soon as possible.*

[2] *Rev. Rul. 84-179, 1984-2 C.B. 195. held that when an insured holds a policy on his/her own life in a fiduciary capacity, he/she is deemed to hold "incidents of ownership" if the fiduciary powers can be used for his or her own benefit. Since it is normally contemplated that the surviving spouse will be a beneficiary of the Standby Trust, this rule acts as a circular inclusion trap since the surviving spouse is the beneficiary of his/her own actions as a fiduciary.*

[3] *PLRs 9748029, 9434028,9451053 and 9748020.*

[4] *In PLRs 9434028 and 9602010, the IRS concluded that where trust income is used to purchase non-income producing assets, such as life insurance, instead of distributing it to the income beneficiary, the income beneficiary may be deemed to have made a gift to the other trust beneficiaries.*