

# Advanced Planning Bulletin

## August 2006

### Pension Protection Act of 2006

On August 3, 2006, the Senate passed the Pension Protection Act. The legislation, which is expected to be signed into law by the President on August 17, contains significant pension reforms including permanent extensions of many of EGTRRA's retirement savings provisions. Among its other provisions, the law creates new requirements for employer owned life insurance and incentives for long term care insurance and charitable gifts. This article identifies the Act's key provisions (for more details, see the [Explanation by the Joint Committee on Taxation](#)). A complete analysis will be available soon.

#### I. Pension Reform

- Makes permanent the increased pension and individual retirement account (IRA) contribution limits, the Savers' Credit and other pension rules under EGTRRA.
- Permits direct deposit of tax refunds into IRAs (effective for tax years beginning after December 31, 2006).
- Provides safe harbor treatment for defined contribution pension plans with automatic enrollment (effective for plan years beginning after December 31, 2007).
- Allows non-spouse beneficiaries to transfer benefits to an inherited IRA (effective for distributions after December 31, 2006).
- Changes minimum funding standards for single-employer and multi-employer defined benefit pension plans (effective for plan years beginning after December 31, 2007).
- Permits direct rollovers from retirement plans to Roth IRAs (effective for distributions made after December 31, 2007).
- Relaxes rules for fiduciaries that provide investment advice, sell securities pursuant to the advice, or receive fees (effective after December 31, 2006).
- Establishes added reporting and disclosure rules for qualified plans (effective for plan years beginning after December 31, 2007).

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---To comply with Circular 230

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- Allows for the creation of a combined defined benefit-401 (k) plan for employers with no more than 500 employees (effective for plans years beginning after December 31, 2009).
- II. Employer owned life insurance requirements
- Subjects death benefit of employer-owned life insurance (COLI) to income tax unless certain requirements are met.
  - Requires employers to notify employees that COLI will be purchased and obtain their consent before the policy issue date.
  - Establishes certain eligibility requirements (e.g., employee compensation levels) in addition to the notice/consent requirements.
  - Requires employers to file annual COLI information returns with the I.R.S.
  - Applies to policies issued after the date of enactment unless the policy is issued pursuant to a 1035 exchange of a grandfathered policy. However, a material increase in the death benefit or other material change after the date of enactment may cause a policy to be treated as newly issued.
- III. Charitable Incentives
- Allows IRA owners, after age 70½, to make a distribution up to \$100,000 per year to a qualified charity without including the amount in income. Effective in 2006 and 2007 only.
  - Requires charitable organizations participating in the purchase of certain pools of life insurance contracts (sometimes referred to as “ChOLI” arrangements) to disclose their participation.
  - Increases several of the excise taxes related to public charities and private foundations.
  - Denies deductions for donations of clothing and household items unless the items are in “good used condition or better.”
  - Requires donors to keep records of all donations made by cash or check in order to claim a deduction.
  - Creates new rules for contributions of fractional interests in tangible personal property.
  - Establishes numerous additional reporting requirements.
  - Subjects donor advised funds and supporting organizations to additional regulation and excise taxes.
- IV. Long Term Care Insurance
- Allows income tax free withdrawals from an annuity and life insurance contract’s cash values for coverage under long term care insurance that is a part of or a rider on the annuity or life insurance.
  - Expands tax-free exchanges of life insurance, annuity and endowment contracts for long term care contracts.
  - Applies to tax years beginning after December 31, 2009.

**Another Ruling Supports (Irrevocable) Trust-Owned Annuities,  
But Questions Remain:  
[Private Letter Ruling 2006-26-034 \(March 22, 2006\)](#)**

**Facts:** Parent creates and funds an irrevocable trust. It is not a grantor trust with respect to Parent. The trust beneficiaries are Parent's four children; each will receive one-fourth of the trust assets at Parent's death. Trust buys a deferred annuity and names itself as owner and beneficiary. One of the children is the annuitant.

The trust later § 1035 exchanges the annuity for another deferred annuity from a different insurer. The trust remains the owner and beneficiary on this contract, and the same child remains the sole annuitant. Five years later, Parent dies. The trustee intends to surrender the annuity and distribute the proceeds to the four children, but wants to wait until the contract's surrender charge is zero. This is characterized as "a short period of time," but it is clearly more than a year after Parent's death.

**Issue:** Does the trust violate the non-natural person rule of § 72(u) for either the first or second annuity, or does it instead meet the exception of holding the annuity as an agent for a natural person?

**Ruling:** The trust meets the "agent exception" to the non-natural person rule for both annuities.

**Reasoning:** The reasoning here is now quite familiar. Section 72(u) provides that an annuity held by a non-natural person (e.g., a trust) loses its normal tax-deferred status, so that the non-natural owner is taxed each year on the contract's growth. The exception to this rule is for contracts held by a non-natural person "as an agent" for a natural person, in which case tax deferral is maintained.

Like previous favorable private letter rulings involving irrevocable trusts,<sup>1</sup> this one focuses on a portion of legislative history that defines an agent as a person who holds the annuity as a mere "nominal owner" when an underlying natural person is the "beneficial owner."<sup>2</sup> The I.R.S. sees this approach as fitting the facts here – the trust is the nominal owner of the annuity, while the four children who are trust beneficiaries are the beneficial owner of the annuity. So the agent exception is met, and deferral is allowed.

**Analysis:** This Ruling does not really cut a new path, but it smoothes out the pavement a little so that the planning road is less bumpy.

As for not cutting a new path, practitioners wondering whether and when annuities should be owned by a trust still suffer from a dearth of precedential guidance explaining what it means to

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<sup>1</sup> See, e.g., Priv. Ltr. Ruls. 2006-26-034 (March 22, 2006); 2004-49-011, -013, -014, -015, -017 (December 3, 2004); Priv. Ltr. Rul. 1999-33-033 (May 25, 1999); Priv. Ltr. Rul. 1999-05-015 (February 8, 1999); Priv. Ltr. Rul. 97-52-035 (September 25, 1997); Priv. Ltr. Rul. 92-04-014 (October 24, 1991); and Priv. Ltr. Rul. 92-04-010 (October 10, 1991).

<sup>2</sup> H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. Vol. II 401-402 (1986), 1986-3 (Vol. 4) C.B. 401-402.

be an agent for a natural person. The “authority” still comes only through private letter rulings, rather than case law or treasury regulations, and the reasoning is still the same.

But the planning road may have been made smoother by the fact that here we have *four* primary trust beneficiaries but *only one* annuity (with, of course, one annuitant). The Ruling considered each of the children to be an underlying “natural person.” This helps alleviate fears of many advisors who felt safe only when there was a separate annuity for each separate trust beneficiary (and some felt comfortable only if there was a separate *trust*, each owning an annuity where a lone trust beneficiary was the annuitant). But under this Ruling, all is fine even if there is one annuity contract in a trust with multiple beneficiaries.

Despite this Ruling’s pleasant features, some caveats and issues remain:

1. *Which trust beneficiary will die first?* With a trust-owned annuity, the mandatory distribution-after-death rules are triggered by death of the *annuitant*.<sup>3</sup> Here the annuitant was not the dead grantor but a still-alive trust beneficiary so, although the Ruling did not speak to the issue, there should not have been any forced § 72(s) distributions. If the beneficiaries had been willing to wait to get their hands on the money, it seems this contract could have enjoyed deferral for many more years. This possibility might prompt a trustee to pick the youngest (or at least healthiest) trust beneficiary as annuitant.

But a trustee still might be wise to buy several contracts with several annuitants. First, no one knows who will die first, so having several annuitants “spreads the risk.” What’s more, if the contracts are to be ultimately kicked out to the trust beneficiaries in-kind, each child likely will want to be annuitant on his own contract. Unfortunately, merely *changing* the annuitant while it’s in the trust triggers § 72(s), and trying to change the annuitant after the contract is in the child’s hands usually is barred by the insurer. Having separate annuities with separate annuitants at inception can avoid such nuisances later.

2. *Grantor Trusts – Non-Natural Person Rule.* None of the private letter rulings addressing irrevocable trusts in the estate planning context involve grantor trusts. Perhaps naturally, then, these rulings looked to the trust *beneficiaries* as the underlying natural person and the trust’s mere “nominal” ownership. In the current Ruling, the I.R.S. relies on the taxpayer’s representation that it is not a grantor trust.

The non-natural person rulings that *have* dealt with grantor trusts involved employment situations where the employees contributed after-tax amounts to trusts providing “deferred compensation.”<sup>4</sup> In these rulings, the employee was the trust grantor *and* beneficiary,<sup>5</sup> but it is not always clear which role is more important in determining the

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<sup>3</sup> § 72(s)(6).

<sup>4</sup> Of course, some of us might smirk at characterizing a *post-tax* arrangement as a form of deferred compensation, because although it might defer the enjoyment of compensation, it certainly does not defer the pain of tax.

<sup>5</sup> The employee’s dual role of grantor and beneficiary is in fact what gave rise to defective trust status under § 677(a). Priv. Ltr. Rul. 93-16-018 (January 22, 1993); Priv. Ltr. Rul. 93-22-011 (March 5, 1993); and Priv. Ltr. Rul. 98-10-015 (December 4, 1997).

underlying natural person. One ruling plainly relied on the individual's status as the grantor.<sup>6</sup> Another discussed the nominal *v.* beneficial owner analysis that usually supports looking to the trust beneficiary.<sup>7</sup> The third based its finding on traditional "law of agency," leaving the grantor trust aspect as a side issue.<sup>8</sup> Yet another employment ruling said nothing about grantor trust status whatsoever, but (like the current Ruling) focused on the employee as the "beneficial owner."<sup>9</sup>

So it is still uncertain how to treat an annuity under § 72(u) if it is held by an irrevocable grantor trust. Some say it should be treated as not held by the trust *at all*, but instead held *directly* by the grantor himself. This is somewhat consistent with the general rule that the individual grantor and the trust are identical for income tax purposes.<sup>10</sup> But it's not necessarily consistent with the above-mentioned rulings that have dealt with grantor trusts and the non-natural person rule specifically.

3. *Grantor Trusts – Distribution-After-Death Rule.* To make matters worse, annuities held in grantor trusts create a vexing problem when determining whose death triggers § 72(s). If the annuity is seen as held by the individual grantor, then the grantor's death trips the wire. But if it is seen as held by the trust, then we'd look to the annuitant's death. As the current Ruling shows, these are not always the same people, and taking a different approach can cause a dramatically different outcome.

Even if we wanted to treat only those annuities in non-grantor trusts as truly trust-held for the "death of annuitant" rule, it would present a nearly impossible task for the insurance company (which must obey § 72(s) in order for the contract to be considered an annuity under the Code). An insurer generally has no way of knowing which trusts qualify as grantor trusts and which do not, particularly because that status can change over time and the insurer typically doesn't see the trust to begin with. As a practical matter, it appears best to treat all annuities that are owned by a trust as trust-held, at least for purposes of the "death of annuitant" provision. But this issue is hardly settled.

4. *Revocable Trusts.* It is still usually a lousy idea to have an annuity owned by a *revocable* trust. Doing so introduces all the difficulties alluded to above, without the added benefit of removing the contract from the taxable estate. Even without the revocable trust, the annuity can escape probate at death and can be managed during life by a trusted party through a power of attorney. For more information on this topic, see our planning idea article, [Nonqualified Annuities and Trusts – Owner and Beneficiary Tips](#), *Advanced Planning Bulletin*, February 2005.

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<sup>6</sup> Priv. Ltr. Rul. 93-22-011 (March 5, 1993).

<sup>7</sup> Priv. Ltr. Rul. 93-16-018 (January 22, 1993).

<sup>8</sup> Priv. Ltr. Rul. 98-10-015 (March 6, 1998).

<sup>9</sup> Priv. Ltr. Rul. 2000-18-046 (May 8, 2000).

<sup>10</sup> See Rev. Rul. 85-13, 1985-1 C.B. 184.

## UNCONVENTIONAL USES OF LIFE INSURANCE TRUSTS

### I. Introduction.

- A. This outline describes five uses of irrevocable life insurance trusts that are based on real cases. Each debunks the view of these trusts as a one-trick pony for financing your client's death taxes, and collectively they suggest that the most effective planning solutions may be unconventional ones.
- B. While life insurance isn't a required element in any of the examples, its tax-favored treatment, in addition to the potential financial leverage it offers at death, can make life insurance an attractive option for funding the trust.
  - 1. The "inside buildup" of a life insurance policy is not taxed as it builds because the client's access to the funds is subject to substantial restrictions or limitations. See *Cohen v. Comm'r*, 39 T.C. 1055 (1963), *acq.* 1964-2 C.B. 4.
  - 2. In addition, the policy's death benefit is income tax-free under § 101 unless an interest in it is transferred for valuable consideration to certain persons or entities.

### II. The Irrevocable Life Insurance Trust as a QDOT Supplement or Proxy.

- A. The foreign-born population in the United States was approximately 32.5 million in 2002, of which 20.5 million were not citizens. U.S. Census Bureau, *Current Population Survey* (May 16, 2003). For those non-citizens who require estate plans, many advisors assume that U.S. transfer tax rules don't apply or that the client's problems can be solved using familiar strategies, such as the marital deduction, credit shelter trusts, family business entities, and charitable gifts. These are dangerous assumptions.
  - 1. Non-residents aren't subject to estate tax except on property located in the U.S.; however, residents are subject to estate tax under § 2001(a) regardless of whether they're U.S. citizens. The gross estate of a non-citizen living in this country includes all property owned by him, wherever situated in the world. In certain respects, the gross estate computation is worse than usual; for example, property owned by spouses that is titled as joint tenancy with rights of survivorship is all included in the deceased's estate under § 2052 if the survivor isn't a citizen, unless she paid for her interest.
  - 2. Moreover, § 2056(d) denies an estate tax marital deduction for transfers to a non-citizen spouse, grounded in the concern that she could bypass the estate tax normally collected at the second death by returning to her country of origin. This means a \$4 million combined estate must be equalized between the spouses before the first death in order to avoid federal estate taxes.
  - 3. It may be impossible to equalize larger estates because lifetime gifts to non-citizen spouses in excess of \$120,000 (for 2006) are subject to gift tax.
- B. There are several possible solutions to the marital deduction problem, but let's begin with the obvious – have each spouse become a U.S. citizen.

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1. Any transfer to a U.S. citizen that meets the marital deduction rules qualifies for full gift and estate tax deductions. However, the naturalization process is lengthy, and one or both spouses could die before it ends.
  2. Practically speaking, it may be adequate to naturalize only the poorer of the two spouses since the wealthier spouse may not be receiving a large bequest. This approach can be helpful in marriages where both spouses are non-citizens if the couple anticipates returning to native soil and wants to retain a citizenship there.
- C. As an alternative, a Qualified Domestic Trust (QDOT) can be created and funded at the first death to defer estate tax until the second death. This amounts to a Pyrrhic victory because of what follows.
1. The trustee must be a U.S. citizen or domestic corporation, and must have authority to withhold estate tax on any distributions of trust principal to the survivor. These requirements don't apply to marital deduction trusts established for U.S. citizens.
  2. The QDOT must satisfy the QDOT qualification rules *in addition to* the usual marital deduction rules that apply to marital trusts established for U.S. citizens. Typically, this means a QTIP election is required in order to get the marital deduction while avoiding principal distributions that generate estate tax withholding.
  3. The QDOT deferral doesn't mimic exactly a "pure" marital deduction because any estate tax deferred via the QDOT is taxed at the second death starting at the marginal estate tax bracket of the *first person to die*.
    - a. In practical terms, this means that one spouse's \$4 million estate (in 2006) that fully funds a credit shelter trust, with remaining amounts going to a QDOT, triggers a federal estate tax of \$920,000 assuming that the trust assets haven't appreciated [see Appendix for calculations].
    - b. Had the surviving spouse been a citizen, no tax would be owed under the same facts.
    - c. In addition, the QDOT is subject to estate tax in the survivor's estate, unless the assets were previously distributed to (and spent by) her. Her estate receives a credit for previously-taxed property that washes out the inclusion here, unless rates have risen or the exemption lowered since the first death occurred.
- D. This leads us to a third solution. A non-citizen has available the \$12,000 annual exclusion and the \$1 million lifetime gift exemption like anyone else. Why not employ it by creating an irrevocable life insurance trust to provide income for the surviving spouse since the assets inside the trust are excluded from both estates and are exempt from the QDOT rules?
1. Under § 2041, the survivor can serve as trustee and make distributions of trust assets, free of the withholding a QDOT would require, to herself as a beneficiary according to standards relating to her health, education, maintenance and support.

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- a. If the survivor returns to her country of origin, she should resign as trustee in order to avoid “foreign trust” status. Under § 7701(a), a trust is a foreign trust unless both of the following conditions are satisfied: (i) a court or courts within the U.S. must be able to exercise primary supervision over administration of the trust; and (ii) *one or more U.S. persons have the authority to control all substantial decisions of the trust.*
  - b. Foreign trusts are subject to nasty tax consequences that are beyond the scope of this outline.
2. If the insurance trust is funded using only annual exclusion gifts, this leaves the \$2 million estate tax exemption intact for credit shelter funding at the first death, which can provide an additional source of funds for the survivor.
  3. Any excess wealth can fund the QDOT as a backup source for distributions.
    - a. The I.R.S. has provided a specimen QDOT form in Rev. Proc. 96-54, 1996-50 I.R.B. 9 (December 9, 1996) that can serve as a drafting skeleton.
    - b. Income should be distributed from the QDOT each year in order to avoid adding it to trust principal. The payment of estate taxes at the second death, whether attributable to the QDOT or to other assets owned by the survivor, may be paid with QDOT funds or financed through any funds remaining in the insurance trust at that time.
- E. If you don't have any non-citizen clients now, you eventually will. In addition to the issues mentioned, planning for them is complicated by the fact that many countries sign treaties with the U.S. that trump rules that otherwise apply, and by the facts-and-circumstances test for determining whether the client is a resident. However, the changing demographics of America warrant learning some of these rules and developing a network of experts for follow-up referrals.

### III. The Irrevocable Life Insurance Trust as a Private Foundation Alternative.

- A. Large charitable donations to private foundations offer wealthy clients income and transfer tax advantages in return for red tape.
1. Contributions to organizations that are tax-exempt under § 501(c)(3) generally are income tax-deductible under § 170, up to a certain percentage of the donor's adjusted gross income. This includes gifts to both public and private charities. A private charity or “foundation” can allow the client to control investments, decide when and to whom grants are made, and encourage future involvement by other family members in philanthropy.
  2. However, the control that a private foundation offers to its donor(s) must be weighed against a barrage of regulatory requirements that apply, starting with the filing of I.R.S. Form 1023, Application for Recognition of Exemption, and receipt of an exemption letter from the I.R.S.
    - a. A foundation's exemption from income tax may be useless, depending on what it holds. Sophisticated investors are likely to consider leveraged real estate, S corporation stock and securities bought on margin, but these and

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other investments can cause unrelated business or debt-financed income if owned by a tax-exempt entity.

- b. The amount of tax owed on this income depends on whether the foundation is established as a trust or a corporation.
3. In addition, a private foundation is subject to certain restrictions and taxes that do not apply to public charities:
- a. Section 4940 imposes a 2% tax on investment income.
  - b. Section 4941 imposes a 5% tax on self-dealing transactions between a private foundation and disqualified persons (generally, the donor, foundation managers and their families).
  - c. Section 4942 requires 5% of a foundation's net fair market value to be distributed to qualified charities each year.
  - d. Section 4943 imposes a 5% tax on "excess business holdings" (*e.g.*, more than 20 percent of a family business) of a private foundation.
  - e. Section 4944 imposes a 5% tax on jeopardy investments held by a private foundation. This requirement exists on top of state law fiduciary standards that apply to the management of foundation assets.
  - f. Section 4945 imposes a 5% tax on distributions to organizations that are not qualified charities.
4. But wait, there's more! Failure to correct can trigger additional taxes up to 200% of the amount involved, and if that's not bad enough, a private foundation must file I.R.S. Form 990-PF annually in order to justify its existence to the federal government; the form must be available for public inspection, and the foundation must publish notice of its availability. This tax return reports the foundation's income, expenses and charitable grants. It also provides information about the foundation's activities, as well as the names, addresses and compensation of its officers and directors (or trustees). Notwithstanding its name, privacy is *not* an advantage of a private foundation.
- B. The question is whether the red tape is always worth it. As a whole, the private foundation requirements amount to a financial menu no one would order from but for the accompanying tax "benefits." If a client is willing to forego (1) income and transfer tax deductions for gifts to an irrevocable trust that has charitable purposes, and (2) tax-exemption of the trust itself, *none* of the private foundation rules apply.
- C. In the right situation, this idea isn't as crazy as it sounds.
1. Clients who have no children, especially those with no transfer tax exposure, may wish to use the lifetime gift tax exemption to fund an irrevocable trust that benefits charity. See Priv. Ltr. Rul. 97-26-009 (June 27, 1997) where taxpayer funded a taxable trust at death with an amount below the then-existing \$600,000 exemption to support educational scholarships in teaching, bookkeeping and carpentry.

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- a. With today's estate tax exemption amount set at \$2 million per person, a larger pool of taxpayers could benefit from similar planning.
  - b. While this ruling involved a testamentary trust, the trust could be funded during the client's lifetime with transfers up to the \$1 million gift tax exemption, with additional funding up to the combined exemption to occur at the client's death.
2. An irrevocable trust could be established to avoid specific private foundation rules that some clients find objectionable, perhaps by allowing: (a) economic transactions with the client that would otherwise be "self-dealing," (b) the purchase of jeopardy (*e.g.*, hedge fund) investments, (c) contributions to political organizations, (d) retention of all principal and income in any year, (e) the option to distribute to beneficiaries that are not exempt under § 501(c)(3), and (f) investments in the client's business. See Priv. Ltr. Rul. 92-09-016 (December 2, 1991) where taxpayers owned 100% of the stock of a corporation that they transferred to a trust providing income to a 501(c)(3) charity and a remainder interest to their private foundation.
3. A non-qualified charitable trust like this can own a life insurance policy in addition to other assets it might acquire (which is generally true of a private foundation as well). The foregoing of the income tax exemption for the trust is painless with respect to the policy because the buildup of cash value inside the policy generates no immediate income tax, and the death benefit is tax-free. Any trust income after the insured's death can be deducted by the trust under § 651 (for simple trusts) or 661 (for complex trusts) if it is distributed to a beneficiary. Because the recipient-charity is exempt, it pays no income tax on the distributions it receives. Similarly, a discretionary distribution of appreciated trust principal by the trustee generates no taxable income to the trust.
4. This leaves the loss of income and transfer tax charitable deductions as the primary drawbacks of failing to qualify the trust as a private foundation.
  - a. Under § 170, the income tax deduction for gifts to private foundations generally is limited to an asset's cost basis unless it is "qualified appreciated stock" traded on an established securities market. For the asset-rich, income-poor millionaire next door, the income tax benefits for funding a foundation may be exaggerated because his primary assets (real estate and the family business) aren't fully deductible or because he lacks adequate income to absorb the income tax deduction.
  - b. Although the client receives no gift tax deduction, the lifetime funding of the trust is gift tax free if gifts don't exceed the annual exclusion (\$12,000 per *Crummey* beneficiary) or the \$1 million gift exemption.
5. The drafter must avoid § 4947, which allows income and transfer tax deductions for gifts to non-exempt charitable trusts (*i.e.*, those for which the I.R.S. hasn't granted an exemption letter) but nevertheless subjects the trust to the private foundation rules. See Priv. Ltr. Rul. 2002-35-035 (August 30, 2002) for a rare glimpse into the world of non-exempt trusts.

- D. There's a saying that the fastest way to make something popular is to make it seem forbidden. This certainly holds true with private foundations, as they continue to grow in number despite their adverse regulatory treatment, and despite the comparatively low income tax environment that we enjoy today. While some alternatives to private foundations such as donor advised funds (marketed as a "poor man's private foundation") purport to achieve the same ends, the cure is worse than the poison where the client wants to retain actual control. For this reason, non-qualified trusts funded with life insurance or other assets can present a viable option for achieving charitable objectives with fewer complications and more privacy than a tax-exempt trust.

**IV. The Irrevocable Life Insurance Trust as a Business Succession Financing Technique.**

- A. Closely held business interests enjoy little market demand, and may die on the vine absent a succession plan. Life insurance can serve an important purpose in a succession plan because it creates liquid funds for buying an owner's business interest at his death.
- B. The question is often where to put the insurance.
1. As a rule of thumb, the business should own it in an "entity purchase," while the other shareholders should own it in a "cross-purchase." Neither arrangement is apt to stir controversy when term insurance is used because it is generally cheap and disposable at young ages.
  2. However, in situations where the business is expected to last awhile (*e.g.*, a family owned company), or if the shareholders need policies for personal use later on, permanent life insurance may be preferred over term insurance. These other uses may include survivor income for family members, the payment of personal debts, or the financing of estate taxes. In addition, term insurance provides a static death benefit over time that won't fully fund a buyout if the business grows, while a permanent policy can be structured to have an increasing death benefit.
  3. Because the premium for a permanent insurance policy is higher at most ages than the premium for term insurance (assuming a like death benefit) and because the policy accumulates cash, each insured might insist that he or someone in his family own or control it. In that case, policy rights can be allocated to achieve the best of both worlds, with the insured's irrevocable life insurance trust controlling the cash value, and the business buyer (whether the business itself or the other business owners) controlling the mortality protection.
    - a. These arrangements generally are governed by the § 61 "split-dollar" rules. They provide, among other things, that the buyer pay a one-year term charge to the insured's trust as a rental charge for the mortality protection.
    - b. The value of \$1 million of one year's term protection on a 55 year old male is \$4,150 under I.R.S. Table 2001, or, an alternative insurance company split-dollar rate can be used, which for Northwestern Mutual insurance amounts to \$1,733.

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- c. These rates rise with age, and the charge to the buyer eventually will become prohibitive, requiring a termination of the split-dollar plan.
  - 4. The transfer of mortality protection to the business buyer is usually achieved by means of a policy endorsement recorded on the books of the insurance company, although nothing under the split-dollar regulations appears to require it. Any portion of the death benefit, or the entire amount, can be endorsed to the buyer.
    - a. Because the buyer has agreed to apply death proceeds to buy the insured's shares later on, he has given the trust consideration for the endorsed death benefit. This violates the transfer-for-value rule under § 101 unless the buyer and the insured are partners in a partnership or are members of a limited liability company (taxed as a partnership) with one another. If the business is the buyer, a transfer-for-value exception is also available because the insured is one of its owners.
    - b. The insured generally should not own the policy because any incident of ownership held by the insured causes the policy to be included in his estate under § 2042. Some would argue that the insured's estate gets a deduction for the endorsed death benefit, but having the insured's irrevocable trust own the policy avoids this issue altogether. Similarly, rights should not be endorsed to a corporation where the insured is a majority shareholder because part of the death benefit will be included in the insured's estate under Treas. Reg. § 2042-1(c)(6).
    - c. If the insured dies, the buyer collects the death benefit tax free and purchases the shares from the insured's estate. The estate has no income tax because the shares receive a stepped-up basis.
  - 5. If the insured lives and the buyout doesn't occur, or if circumstances otherwise change, the endorsement can be removed from the policy, in which case the mortality protection reverts to the trust. This is a transfer-for-value violation unless an exception can be met (*e.g.*, the trust is a grantor trust or a partner of the insured).
- C. Too often, the life insurance tax rules cause planners to title policies where they present the fewest immediate tax issues or problems, rather than considering later uses of the contracts by the parties. The availability of endorsements that alter the contract's boilerplate language can allocate economic rights to where they do the most good under changing scenarios. This takes initiative by the planner and sometimes conversations directly with an insurance company's beneficiary and title department in order to achieve the best outcome.

### **V. The Irrevocable Life Insurance Trust as an Asset Protection Entity.**

- A. The life insurance trust is a frequently overlooked asset protection technique, perhaps because it's viewed primarily as an estate planning tool. This perspective reflects muddled thinking – what is the Internal Revenue Service but a giant and omnipotent creditor to anyone who dies owing federal estate tax?
- B. While you and your clients may be drawn to complex and costly asset protection structures, a flexibly designed and properly funded irrevocable trust offers many of the

same benefits as its more elaborate counterparts, but with greater flexibility, less audit risk, and at a lower cost.

1. This technique should appeal to doctors, contractors, owners of high-risk businesses (*e.g.*, trucking companies, farms, rental real estate) or anyone else exposed to potential lawsuits.
  2. A wealthy client, even one with umbrella liability coverage, makes an easy target who potentially is a “slip and fall” away from financial Armageddon.
  3. The winner of the past two presidential elections campaigned on a tort reform platform, but little federal legislation has occurred to date. Perversely enough, the federal government during this same period has enacted legislation that *waters down* protections for debtors in bankruptcy, including restrictions on the value of state provided homestead exemptions.
- C. Properly designed, a lifetime irrevocable trust allows for protection of trust property from creditors of both the grantor and the trust beneficiaries.
1. The grantor’s creditors (absent a fraudulent transfer) cannot reach the trust principal or income because the grantor has no rights to either one.
  2. The beneficiaries’ creditors cannot reach the trust property because the trust if properly drafted will contain a “spendthrift clause” that suspends distributions that can be attached by creditors. With roughly half of all marriages ending in divorce (including those of your client and your client’s children), the importance of spendthrift provisions can’t be emphasized enough. Spendthrift provisions in some jurisdictions aren’t enforceable against alimony rights, but it is better to have the spendthrift clause than not to have it. The highest level of protection is achieved by limiting all trust distributions to the trustee’s discretion (*i.e.*, with no governing or ascertainable standard) because there the beneficiaries have no immediate right to any property under state law.
  3. A federal tax lien trumps a spendthrift provision, but is effective only against a taxpayer’s “property and rights to property” under § 6321. Under common law, a taxpayer generally isn’t deemed to hold a property interest in a discretionary trust.
  4. Notwithstanding the asset protection afforded by discretionary trusts, they require that the beneficiary not be trustee, in order to avoid estate inclusion for that individual. This might not suit the controlling client. If a family member (*e.g.*, the grantor’s wife) is named trustee, she can still enjoy the use of trust principal and income according to an ascertainably standard (*e.g.*, relating to her health, education, maintenance and support) if the document allows. In addition, she can transfer property to anyone besides herself, her estate, or creditors of either one – even back to the grantor – through a limited power of appointment. These rights effectively keep the property out of both spouses’ taxable estates under § 2041. However, even though many jurisdictions shelter from creditors any beneficial interest limited by an ascertainable standard, the safer course is to allocate distribution powers to an independent trustee.
- D. The trust can allow the grantor to substitute one type of property for another of equal value. This language has the dual advantage of allowing the client to move selected

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creditor-vulnerable assets in and out of the trust over time without income taxation, and pay income taxes personally on trust gains (making the trust a *de facto* tax exempt entity because the trust's taxes are shifted to the grantor). See Priv. Ltr. Rul. 2006-03-040 (January 20, 2006). The payment of income taxes by the client isn't a taxable gift to his grantor trust. Rev. Rul. 2004-64, 2004-27 I.R.B. 7 (July 6, 2004).

- E. What property can the irrevocable trust hold? Anything!
1. Life insurance can be owned on the life of anyone in whom the trust has an insurable interest. Careful trust design is particularly important here to ensure the life insurance proceeds are not unwittingly subjected to estate and GST taxes.
  2. Closely-held business interests can be owned by the trust, as can marketable securities or real estate. If the assets include S corporation stock make sure the trust is a qualified shareholder under § 1361, perhaps by making it a grantor trust, in order to avoid spoiling the S election.
- F. The trust beneficiaries can be whomever the grantor deigns. In most cases, the grantor's spouse and children are named; however, establishing a trust for grandchildren is common, especially in larger estates that can benefit from lifetime use of available GST exemptions through the use of life insurance and other appreciating property.
- G. A self-settled trust (one that can make distributions to the grantor) can provide asset protection beyond that offered by plain-vanilla life insurance trusts. To achieve maximum creditor hindrance, these trusts are often established in the Bahamas, Gibraltar, Cook Islands, and other offshore jurisdictions, but domestic variations are also available. The idea is to obtain the same level of asset protection as an offshore self-settled trust (have your cake) without moving your property offshore (and eat it too). A domestic trust is also easier and less costly to establish and maintain.
1. States that offer asset protection to self-settled trusts established under their laws include Alaska [Alaska Stat. § 34.40.110(b)(4) (2003)], Delaware [Del. Code Ann. Tit. 12 § 3573 (2003)], Nevada [Nev. Rev. Stat. § 166.170 (2001)], Rhode Island [R.I. Gen. Laws § 18-9.2-5(a) and (b) (2003)], and South Dakota [S.D. Senate Bill 93 (2005)]. Four other states, Missouri, Utah, Colorado, and Oklahoma, offer a lesser degree of protection.
  2. Generally, the debtor-friendly states allow a person to create and fund a trust, be a discretionary beneficiary, and shield the trust assets from creditor claims. The statutes typically require that (a) the trust be irrevocable, (b) some or all trust assets be held in the state whose laws govern, and (c) at least one trustee be a resident (a corporation or individual) of that state.
  3. There are several areas that could affect the use of domestic self-settled spendthrift trusts, though none have been ruled on by courts.
    - a. The Constitution's Full Faith and Credit Clause (Art. IV, § 1) may require the trustee to recognize a judgment from another state. In addition, the Constitution's Supremacy Clause (Art. VI, § 2) says that if federal and state law conflict, federal law (*e.g.*, bankruptcy law) wins. Nevertheless, it may be costly for a creditor to litigate either issue, and for that reason the Constitutional issues may be overblown by critics of this technique.

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- b. The taxation of these trusts may pose bigger problems. If the assets aren't available to the grantor's creditors, the transfer to the trust is a completed gift. Rev. Rul. 76-103, 1976-1 C.B. 293. However, the I.R.S. ruled that a transfer to an Alaska trust was complete but refused to rule on whether the trust was excluded from the taxpayer's estate. See Priv. Ltr. Rul. 98-37-007 (September 11, 1998). Court opinions on the estate inclusion of self-settled trusts have produced mixed outcomes. See *Estate of Linderman v. Comm'r*, 52 T.C. 305 (1969), *Wells v. Comm'r*, T.C. Memo 1981-574 (1981), and *Outwin v. Comm'r*, 76 T.C. 153 (1981).
  - c. It would appear that a trustee's mere discretion to make payments to the grantor doesn't, on its face, cause inclusion (see Rev. Rul. 2004-64, above, where the I.R.S. ruled that a trustee can be authorized to reimburse the grantor for income taxes without inclusion under § 2036).
  - d. Owing estate tax on the trust assets isn't fatal if the main objective is creditor protection, but it could dampen the trust's appeal or convince the client to leave out provisions allowing distributions to him.
4. Under new § 548(e) of the Bankruptcy Code, assets transferred to a self-settled trust within ten years of a bankruptcy filing are not exempt if the grantor transferred the assets with the intent to hinder, delay or defraud a creditor. See the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) § 1402. This suggests that self-settled trusts should be considered primarily for non-bankruptcy asset protection planning.
- H. A simpler approach might be to pick up your bags and move.
- 1. Many states such as Florida offer generous state creditor protections that caused O.J. Simpson and other debtors to do exactly that.
    - a. These exemptions, however, can disappear at the drop of the hat. Witness Wisconsin's exemption for life insurance cash values, which dropped from "unlimited" to \$4,000 overnight, but then increased to \$150,000 several years later.
    - b. Moreover, these exemptions aren't always straightforward, particularly with respect to life insurance policies. For example, New York's statute contains exemption provisions that address separately life insurance rights held by an owner on his life versus on the life of another person. It also contains special provisions for policies held on a spouse, distinguishes between exemptions for death benefits and cash value, and includes special provisions for creditors of the insured and of the beneficiaries. [N.Y. Ins. Law § 3212; N.Y. Debtor & Creditor Law §283].
    - c. Federal law nullifies certain state law exemptions in bankruptcy proceedings (*e.g.* homestead exemptions exceeding \$125,000 where the debtor moved within 40 months before filing).
  - 2. Anyone who decides where to live based solely on statutory creditor protections should move to Atlantis, Brigadoon, or Xanadu – as should you, if you take him as a client without investigating the cause of these creditor woes.

**VI. The Irrevocable Life Insurance Trust as an Education Dynasty Vehicle.**

- A. Trust-owned life insurance can efficiently meet the needs, including the educational costs, of future generations. Sadly, much of the knee-jerk “education planning” done today is tax-driven with little consideration of the client’s long term investment or non-tax objectives.
- B. Suppose married clients wish to fund private school tuition for their ten grandchildren (and later descendants) for grades one through graduate school.
1. Section 529 allows upfront annual exclusion funding of \$1.2 million and tax-deferral of investment gains through qualified accounts under these circumstances, but with strings attached. Among them, the penalties for non-education distributions, penalties for primary school distributions, five year gift tax “recapture” rules, rigid plan qualification rules (*e.g.*, no investment self-direction, investing on margin, or excessive plan contributions) and uncertain tax treatment of qualified distributions after the EGTRRA sunset date make the § 529 option considerably less attractive for large scale, long-term education planning.
  2. They can prepay tuition directly to the institution, gift tax free under § 2503(e), but will forego the earnings on the transferred amount. Worse yet, if the grandchildren do not attend the institution holding the prepayments, the gift principal must be forfeited. See Tech. Adv. Mem. 99-41-013 (October 18, 1999) and Priv. Ltr. Rul. 2006-02-002 (January 17, 2006).
  3. In lieu of these alternatives, a life insurance trust can be created to fund the education of the grandchildren and later generations. In states that have abolished the rule against perpetuities (almost half of them have done so), the trust can continue up to the earlier of forever or the statutory maximum (*e.g.*, 1,000 years in Alaska or Utah).
    - a. The trust can own second-to-die insurance on clients’ lives, naming all (or any one) of their children as trustee. Regardless of who serves, the trust can allow the trustees to make distributions for the grandchildren’s educational needs, with this caveat: if the parent is named as trustee, the trust should forbid any distributions that can offset the parent’s support obligation in order to avoid estate inclusion in the parent’s estate under § 2041. College expenses aren’t normally considered a part of a parent’s support obligation, but at least one court implied they might be in the divorce context. See *Newburg v. Arrigo*, 88 N.J. 529, 544-45 (1982).
    - b. The trust can be designed to not only avoid inclusion in the clients’ estates, but also the beneficiaries’ estates because it is anticipated that the property not used for education will stay in trust for the educational needs of future generations.
      1. Section 529 exempts from the beneficiary’s estate amounts that are retained by the plan at the beneficiary’s death. However, Prop. Treas. Reg. § 1.529 states that a beneficiary’s interest is included in his estate, without reference to whether the interest is distributed

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- to him. This ambiguity may preclude the use of § 529 plans to skip more than one generation.
2. In addition, the plan itself may limit the number of generations that can be skipped.
- c. For that reason, any *Crummey* withdrawal rights for a grandchild should be limited to the greater of \$5,000 or 5% of the trust assets. For further analysis of this issue, see Joseph Maier, *The Irrevocable Trust* (January 2003).
1. Assuming a \$5 million second-to-die policy with a \$90,000 premium, each grandchild can be given a \$5,000 withdrawal right, qualifying \$50,000 of the gift for the annual exclusion.
  2. Some of the remaining \$40,000 can qualify for the annual exclusion if \$5,000 (per beneficiary) withdrawal rights are given to contingent trust beneficiaries. *Estate of Cristofani*, 97 T.C. 74 (1991); *Estate of Kohlsaas*, 73 T.C.M. 2732 (1997).
- d. To avoid generation-skipping transfer tax, clients should allocate their GST exemption to the annual gifts. Under § 2632, the allocation can occur after the trust is funded and achieve additional GST value leverage by applying the GST exemption before the policy's value exceeds the cumulative premium gifts to the trust. However, if clients die before allocating, GST tax will apply to the death benefit and earnings when the trust makes distributions. In order to achieve a late or deferred allocation, it's necessary to avoid certain "automatic" allocation rules under § 2632 that are intended to *help* taxpayers who inadvertently miss an allocation, but in our case do the opposite.
4. Several possibilities exist within this design for meeting the grandchildren's educational needs.
- a. If the clients both die before the grandchildren reach college age, the trustee(s) can use the \$5,000,000 death benefit to pay tuition, room, board, or other educational expenses. If the clients (one or both) haven't died, other options exist:
    1. the trustee can use the cash values to pay those expenses;
    2. clients can pay those expenses in gift tax efficient ways (leaving the insurance proceeds for other beneficiaries) under § 2503 (e);
    3. clients can lend funds to the trust to meet these expenses and their estate could be reimbursed later by the trustee; or
    4. given that the grandchildren only have \$5000 withdrawal rights, clients can make additional \$19,000 (in 2006) per grandchild in annual exclusion gifts.
  - b. Any trust funds not spent on education can be invested to benefit later generations. In addition to (or in lieu of) insuring clients, one possible

asset is insurance on the life of the next generation, the clients' four children, perhaps after the original policy pays the \$5 million death claim. The trust can use its own money to pay premiums; no one has to use annual exclusions or worry about withdrawal rights.

- c. We needn't worry about estate inclusion if the trustee (one of the children) is the insured because the child did not create the trust nor does any child benefit from it. *Skifter v. Comm'r*, 468 F.2d 699 (2d Cir. 1972); *Hunter v. U.S.*, 624 F.2d 833 (8th Cir. 1980); *Bloch v. Comm'r*, 78 T.C. 850 (1982).
  1. The I.R.S. has ruled that the insured /trustee does not possess incidents of ownership under § 2042 if the insured
    - (i) holds those incidents of ownership solely in a fiduciary capacity,
    - (ii) has not retained those powers (in other words, the insured didn't create the trust that names him as trustee) and
    - (iii) the trustee cannot exercise the incidents of ownership for his benefit. Rev. Rul 84-179, 1984-2 C.B. 195.
  2. If it is anticipated that someday the original trust beneficiaries (*i.e.* the grandchildren) will be trustees and the trust will hold insurance on their lives, the trust should remove them as beneficiaries before that time (for example, upon attaining a certain age). That is, in addition to the insured, a grandchild can be trustee or beneficiary, but not both simultaneously, under these circumstances. These concerns can be avoided altogether by naming an independent trustee to manage the trust.
- C. For the right client who is financially secure, and who places a strong priority on education for future generations, this technique can build a "family bank" to achieve that objective.

## VII. Conclusion.

Planner bias can reduce life insurance planning to an assembly line activity that leaves the client poorly served. What makes each example above unique isn't the complexity of the trust itself but how it relates to the client's objectives and to other planning being done. May they inspire you to approach your practice the same way.

APPENDIX

This example compares the tax owed at the second death to demonstrate the unequal treatment of a QDOT compared to other marital deduction transactions. Don has an estate of \$4 million and is married to Katy. The first column shows the estate tax result if both Don and Katy are U.S. citizens. The second column shows the result if Katy isn't a citizen. Both columns assume Don uses a fully funded credit shelter trust at his death, with the remainder passing in a marital deduction trust for Katy. The applicable exemption amount is \$2 million for 2006 (\$780,800 credit).

<i>Don's Gross Estate</i>	\$ 4,000,000	<i>Don's Gross Estate</i>	\$ 4,000,000
<u><i>Marital Deduction</i></u>	<u>\$ (2,000,000)</u>	<u><i>QDOT</i></u>	<u>\$ (2,000,000)</u>
<i>Taxable Estate</i>	\$ 2,000,000	<i>Taxable Estate</i>	\$ 2,000,000
<i>Gross Tax</i>	\$ 780,800	<i>Gross Tax</i>	\$ 780,800
<u><i>Don's Credit</i></u>	<u>\$ (780,800)</u>	<u><i>Don's Credit</i></u>	<u>\$ (780,800)</u>
<b><i>Don's Net Tax Due</i></b>	<b>\$ 0</b>	<b><i>Don's Net Tax Due</i></b>	<b>\$ 0</b>
<i>Katy's Gross Estate</i>	\$ 2,000,000	<i>Don's Taxable Est.</i>	\$ 2,000,000
<u><i>Marital Deduction</i></u>	<u>\$ 0</u>	<u><i>QDOT Corpus</i></u>	<u>\$ 2,000,000*</u>
<i>Taxable Estate</i>	\$ 2,000,000	<i>Total</i>	\$ 4,000,000
<i>Gross Tax</i>	\$ 780,800	<i>Gross Tax</i>	\$ 1,700,800
<u><i>Katy's Credit</i></u>	<u>\$ (780,800)</u>	<u><i>Don's Credit</i></u>	<u>\$ (780,800)</u>
 		<b><i>Don's Deferred</i></b>	
<b><i>Katy's Net Tax</i></b>	<b>\$ 0</b>	<b><i>Estate Tax</i></b>	<b>\$ 920,000</b>
		<i>Katy's Gross Estate</i>	\$ 0
		<u><i>QDOT Corpus</i></u>	<u>\$ 2,000,000**</u>
		<i>Total</i>	\$ 2,000,000
		<i>Gross Tax</i>	\$ 780,800
		<i>Katy's Credit</i>	\$ (0)
		<i>Katy's Estate Tax</i>	\$ 780,800
		<u><i>Credit Prev Pd Tax</i></u>	<u>\$ (780,000)</u>
		<b><i>Katy's Net Tax</i></b>	<b>\$ 0</b>

\*Example assumes no appreciation in the QDOT after Don's death. If the QDOT investments grow between deaths, a larger tax is owed.

\*\*The QDOT enters into both Don's and Katy's estate tax calculations, but in Katy's case is offset by the § 2013 credit for previously-taxed property.

**Penalty on Early IRA Distribution**  
**[Gee v. Commissioner, 127 T.C. No. 1 \(July 24, 2006\)](#)**

Husband's IRA names wife as beneficiary. Husband dies, and 51 year-old wife rolls the IRA into her own already-established IRA. Four years later, wife takes a distribution from her IRA. She includes the distribution on her income tax return but not any 10% penalty. Wife argues that the 10% penalty does not apply because the distribution was "made to a beneficiary on or after the death of the employee". § 72(t)(2)(A)(ii). The court finds that, once wife rolled husband's IRA to her own IRA, she is treated as the owner for all purposes. Wife must pay the 10% penalty, as well as an accuracy-related penalty for substantial understatement.

There are certainly advantages for a surviving spouse to roll over an IRA and treat it as her own. For example, she can use her own life expectancy for distributions and she can delay distributions until her required beginning date. The court got this one right: the surviving spouse can't have it both ways – she can't get the advantages of rolling over the IRA and retain the beneficiary exception to the 10% penalty.

**Insurable Interest**  
**[Utah Insurance Department, Bulletin 2006-13 \(July 10, 2006\)](#)**

Utah is the latest state to strike down "StOLI" type transactions under its insurable interest laws. For an explanation of "Stranger Owned Life Insurance" transactions, see [A New York StOLI State of Mind: The Beginning of the End?](#), *Advanced Planning Bulletin*, March 2006.

**Health Savings Accounts (HSAs)**  
**[Treasury Decision 9277 \(July 31, 2006\)](#)**

Employers are not required to contribute to the HSAs of its employees. However, if an employer chooses to make contributions to any employee's HSA, it must make comparable contributions to the HSAs of all comparable employees. The Service has issued guidance on the comparability rules. For information on HSAs, see [When an Apple a Day Does Not Keep The Doctor Away - Should You Use an HSA To Pay?](#), *Advanced Planning Brief No. 57*, April 2004.

**Excise Taxes and Tax-Exempt Entities**  
**[Notice 2006-65, 2006-31 I.R.B. 102 \(July 11, 2006\)](#)**

The Tax Increase Prevention and Reconciliation Act of 2005 includes provisions creating new disclosure rules and excise taxes applicable to tax-exempt entities (including certain qualified plans) that are parties to potentially abusive tax shelter transactions. The Service has issued this Notice clarifying these rules.