Dead Or Alive? How To Rescue Your Divorced Client's Life Insurance Policy From An ILIT

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A divorced client who goes to an attorney for estate planning may hope that the process runs smoother than her divorce. Unfortunately, one particular issue could not only derail the estate-planning process, but also impact the client's ability to meet certain obligations in her divorce agreement. This issue manifests itself when the client has a life insurance obligation in her divorce agreement that secures an alimony obligation. For example, while negotiating the divorce, the client believes that a life insurance policy she purchased before the divorce will satisfy this obligation to her former spouse. After the divorce is finalized, however, the client realizes that she's not the owner of the life insurance policy; rather, an irrevocable life insurance trust (ILIT) that she established during her marriage owns it.

After consulting an estate-planning attorney who reviews the ILIT, the client remembers that the ILIT owns the policy and learns that, as a result of the divorce, her former spouse is deemed deceased for the purposes of the ILIT. That means that on her death, the death benefit from the policy won't be paid over to the former spouse for whom she's obligated to provide under the divorce agreement, but instead will belong to the other beneficiaries of the ILIT, leaving the insurance obligation in the divorce agreement unfunded. Perhaps complicating the matter even more is that, for one reason or another, there may be an insurability issue significantly restricting the client's ability to obtain a new policy. The practitioner is then left with an unhappy client who simply wants to satisfy her life insurance obligation with her existing policy without expending further time or resources.

This complication could have been avoided if the client understood that when an ILIT owns a life insurance policy, the client no longer owns or controls the policy. In the case of a divorce, if the client hopes to rely on an existing policy in an ILIT to fund an obligation, it's important that her options are

evaluated before the divorce is finalized. If the divorce has been finalized, however, a practitioner can still discuss certain techniques and options with his client.

Purchase New Policy?

As a preliminary matter, it's essential for a practitioner to ascertain three pieces of information before evaluating the techniques discussed below: (1) the client's disposable income; (2) the client's insurability; and (3) the type of life insurance policy that the ILIT owns. If the client is insurable and has disposable income, it may be more cost effective for her to purchase a new life insurance policy to fund the obligation in the divorce agreement, rather than implement these techniques. If a new policy is purchased to fund the obligation to the former spouse, the ILIT could continue to own the existing policy for the benefit of its beneficiaries other than the former spouse. If the client then determines that the policy the ILIT owns is no longer desirable, she could stop making contributions to the ILIT to fund the premiums on the policy, thus allowing that policy to lapse. Alternatively, to the extent that there's sufficient cash value in the policy, the trustee, after discussion with the client, may consider converting the policy to a fully paid-up policy or explore other insurance products and investments of the policy value.

In addition to ascertaining the client's insurability and disposable income, it's also important for a practitioner to understand the type of life insurance policy that the ILIT owns. This information plays a significant role in the analysis of the techniques discussed below because different types of policies will have different values for the purposes of each technique. Because any transaction between the client and ILIT will have to be an arms'-length transaction at fair market value (FMV), the value of the policy will determine the amount of cash that the client must generate to fund the transaction. For example, if the ILIT owns a permanent policy with a high value for federal gift tax purposes, then the substitution of assets of equivalent value into the ILIT in exchange for the policy may present problems to a cash-poor client.

Substituting Assets

If purchasing a new policy isn't an option for a particular client, then the first technique for a practitioner to evaluate is whether the grantor (that is, the client) of the ILIT retained a power to reacquire the trust corpus by substituting assets of equivalent value into the ILIT pursuant to Internal Revenue Code Section 675(4)(C). A practitioner must analyze the trust agreement to determine whether the client retained this power and the scope of the power. Practitioners may find that older ILITs don't provide this power. Until Revenue Ruling 2011-28 was issued, many practitioners were wary of including such a power in a trust designed to own a life insurance policy because of the concern that retaining such a power would cause the death benefit to be included in the client's estate under IRC Section 2042(2). In Rev. Rul. 2011-28, however, the IRS alleviated this concern, providing that:

> . . . retention of the power, exercisable in a non-fiduciary capacity, to acquire an insurance policy held in trust by substituting other assets of equivalent value will not, by itself, cause the value of the insurance policy to be includible in the grantor's gross estate under section 2042.[1]

As a result, practitioners may find that ILITs established more recently are more likely to include a power of substitution.[2]

To comply with Rev. Rul. 2011-28 and IRC Section 675(4)(C), the trustee of the ILIT (which no longer should be the former spouse if the ILIT was prudently drafted) will have a fiduciary obligation, either under local law or the trust agreement, to ensure that any property that the client offers to substitute into the trust is equivalent in value to the value of the policy. This fiduciary obligation requires the trustee to value the life insurance policy in the ILIT. While the many rules and regulations for valuing life insurance policies are outside the scope of this article, the regulations provide that the appropriate method to determine the FMV of a life insurance policy for gift tax purposes is the "willing buyer-willing seller" method. For policies that have been in force for some time and have continuing premiums, FMV can be approximated by using the interpolated terminal reserve plus unearned premiums (unless this method doesn't result in a value reasonably close to the full value of the policy).[3]

Once the value of the policy is determined, cash or other assets of equivalent value to the life insurance policy can be substituted into the ILIT in exchange for the policy. The client, now having ownership of the policy, can simply change the beneficiary of the policy to her former spouse or establish a new ILIT that complies with her obligation in the divorce agreement and transfer the policy to that ILIT. Depending on the terms of the ILIT now holding cash or other assets, it could make a distribution of corpus to its discretionary beneficiaries and the trust could terminate, or the trust could continue with other investments.

Buy the Policy

If the existing ILIT doesn't have a substitution power, a practitioner should consider whether the client could buy the policy from the ILIT's trustee. The trustee, considering his fiduciary obligation to the beneficiaries, would determine whether the client's offer to buy the policy is in the best interests of the beneficiaries. However, in evaluating the offer from the client (particularly an offer to buy a term policy), the trustee must consider the fact that the trust has relied in the past on premium funding through gifts from the client, and if the client so chooses, she could end that stream of funding. If the trustee determines that an offer is fair, after considering the valuation of any policy being sold, then a sale could occur. The sale should be memorialized in a purchase agreement, and an absolute assignment of the policy should be executed in favor of the client. The client would then own the policy, and the ILIT would hold the cash for the benefit of the beneficiaries.

The client could also consider establishing a grantor trust to purchase the policy from the ILIT. A grantor trust may be preferable when the client's life insurance obligation to her former spouse is subject to a reduction based on a formula in the divorce agreement.[4] Despite the reduction in her obligation, however, the client may want to continue to maintain the full value of the policy for the benefit of her other heirs. In this situation, establishing a grantor trust with terms that comply with the reduction formula in the divorce agreement will allow the client to accomplish this objective in a manner she deems appropriate. For this transaction to succeed, it's essential that the buyer is a grantor trust to comply with the transfer-for-value rules found in IRC Section 101(a)(2)(B); otherwise, the client risks the death benefit of the policy being subject to income taxes.[5]

If the purchase price is more than the client is willing to pay, the price may be paid through the use of a promissory note. However, the treatment of the sale and receipt of either the client or the grantor trust for tax purposes must be fully analyzed before a note is offered. If the client is purchasing the policy from the ILIT with a note, then the note will have to provide for an interest rate of at least the applicable federal rate (AFR) based on the month in which the note is executed and the term of the note. It could be structured with a balloon payment of principal at the end of the term and interest accruing and payable annually. The client should understand that she or her estate will be obligated to repay the note. For income tax purposes, however, this transaction wouldn't be considered a sale.[6]

Instead of the client entering into a promissory note with the ILIT, a new ILIT, established in accordance with her obligation in the divorce agreement, could offer to buy the policy from the existing one. In this transaction, an interest rate consistent with the AFR will also need to be applied, meaning that the new ILIT will owe interest to the existing one. Because the new ILIT is unlikely to hold cash, the client would have to contribute cash to the new trust to pay the interest due or allow the interest to accrue. At the client's death, the new ILIT would have the cash to pay off the note to the ILIT that initially owned the policy.

Distribute to Discretionary Beneficiary

If there's not a power of substitution in the ILIT and the client is unable to purchase the policy from it, a third option is for the trustee of the ILIT to distribute the policy to a discretionary beneficiary of the trust, likely a client's child who's the age of majority. The trustee would not only require the power in the trust agreement to make this type of discretionary distribution to a beneficiary during the life of the client, but also would have to agree to make such a distribution to the discretionary beneficiary. If the agreement provides this power and the trustee agrees to make the distribution, the policy could be distributed to the discretionary beneficiary, who would then have to agree to transfer the policy back to the client. This transfer is a gift subject to the federal gift tax, meaning that a value of the policy would have to be obtained in the manner discussed above to file a federal gift tax return. With all of the external factors involved in this transaction—the willingness of the trustee and the cooperation of the beneficiary—this option should be carefully scrutinized before it's implemented.

Endnotes

1. For a full discussion of Revenue Ruling 2011-28, *see* Richard L. Harris, "Substituting a Life Insurance Policy in an Irrevocable Trust," Trusts & Estates (April 2012) at p. 54.

2. With the issuance of Rev. Rul. 2011-28, practitioners who draft irrevocable life insurance trusts (ILITs) should strongly consider including a substitution power to provide options to their clients in the event of not only a divorce, but also a client's concern over other provisions of the ILIT.

3. See Treasury Regulations Section 25.2512-6.

4. A grantor trust may also be structured as an ILIT solely to remove the death benefit from the estate of the client; however, the federal estate tax benefit of such a trust is debatable because the client's life insurance obligation to her former spouse is, arguably, a deductible obligation of her estate.

5. See Rev. Rul. 2007-13 (holding that a sale of a life insurance policy between two grantor trusts falls within the exception set forth in Internal Revenue Code Section 101(a)(2)(B)).

6. See Rev. Rul. 85-13.