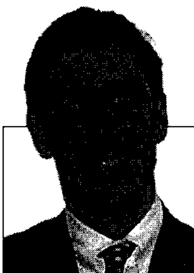
Estate & Succession Planning Corner

By Louis S. Harrison and John M. Janiga

When Is a Trustee Not a Trustee? When the Trust Owns Insurance



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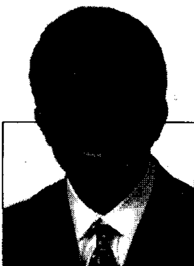

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Insurance, Excludability and Incidents of Ownership

Insurance is often touted to be one of those rare assets free of estate tax. Not exactly. It is not free of estate tax to any greater extent than cash or marketable securities. But insurance transferred to a third party, much like cash and marketable securities transferred to a third party, is free of estate tax. And insurance, because it has no value (in the case of a term policy) or minimal value (in the case of a whole life policy) at inception of a policy, is a seemingly easier asset to gift than cash or marketable securities because the transfer of insurance has minimal gift tax concerns.

For transferred insurance to be free of estate tax, the insured must not retain any strings over the policy in terms of economic rights. These economic rights are treated by the Internal Revenue Code (the "Code") as equivalent to ownership rights and are referred to as "incidents of ownership." Incidents of ownership refers to "the economic benefits of the policy," including the right to surrender or cancel the policy, the right to assign or revoke an assignment or the right to pledge or the right to obtain a loan against the policy.[1]

Economic Rights Are Not the End of the Story

What if insurance is owned by a trust or partnership in which the insured controls the trust or partnership, but has no economic rights? With no economic rights, one would tend to think there are no incidents of ownership. But the answer is actually more complex.

This month's column looks at the result in the trust context. In the future, we will examine the answer in the context of a partnership holding insurance.

The Treasury Regulation: A Bit Controversial

There is a regulation on point:

> "A decedent is considered to have an 'incident of ownership' in an insurance policy on his life held in trust if, under the terms of the policy, the decedent ... has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust."[2]

The question then is whether being the trustee of a trust containing an insurance policy on the trustee's life, with the trustee having no beneficial interest in the trust, results in estate tax inclusion under Code Sec. 2042, Arguably there is no power to "change the beneficial enjoyment" as trustee by merely surrendering or changing the policy, so that part of the regulation is arguably avoided.[3]

But there will be a power to change "the time or manner of enjoyment." For example, the trustee could surrender the policy, take a loan against the policy, take out part of the cash value or buy a new policy; and any one of these could change the time or manner of enjoyment.

Hence, under the literal language, our question is answered in the affirmative. Being the trustee of an insurance trust holding a policy on the insured's life invokes the regulation and inclusion.

The IRS Clarifies the Area After First Being a Tough Guy

Early on, the IRS took a rather literal view toward the (c)(4) regulation. In Technical Advice Memorandum 7411260100A[4], the insured was acting as trustee of a residuary trust created by his wife. The trust was allocated ownership of an insurance policy on the insured. Under the residuary trust, the husband/insured held no beneficial interest. Citing the (c)(4) regulation, the IRS ruled that the decedent in his capacity as trustee had the power to change the beneficial owner because he could sell the policy (probably a wrong read of this language) and could alter the time and manner of enjoyment of the proceeds because he could choose how the insurance policy was paid out (right result, bizarre reasoning).

In that TAM, the IRS recognized that there had been cases holding that the Treasury regulation was inconsistent with congressional intent, and those cases chose to ignore the literal reading of the regulation (*H.R. Fruehauf Est.*[5] and *H.R. Skifter Est.*[6], discussed below). Nevertheless, it cited two cases, *J.H. Lumpkin, Jr. Est.*[7] and *C.M. Rose*[8], as authority for the validity of the regulation. (This despite the fact that *Lumpkin* does not discuss the regulation.)

> [The IRS] ruled that if the decedent/insured received the insurance policy in a trust that the decedent did not create, then acting as trustee would *not* result in estate tax inclusion.

The IRS backed away from this position in 1982, with GCM 39317.[9] It ruled that if the decedent/insured received the insurance policy in a trust that the decedent did not create, then acting as trustee would *not* result in estate tax inclusion. (This is more in line with *H.R. Skifter Est.*.) The GCM involved a residuary trust that was allocated a policy on the life of the trustee. Citing *H.R. Skifter Est.*, the GCM indicates that there must be a "transfer" by the insured to the trust. This would mean both a direct transfer or (we assume) a purchase by the trustee of an insurance policy on the insured's life. The reasoning of the GCM picks up on that of the court's (citing legislative history that indicates that Code Sec. 2042(2) was supposed to be parallel in concept to Code Secs. 2036, 2037 and 2038, and that there must be a transfer by the insured to the trust). As the IRS reasoned: "[I]t is difficult to conceive of a decedent using devolved powers over a life insurance policy, held in a fiduciary capacity, without beneficial interest therein, as a substitute for a testamentary disposition." This position was made official in Rev. Rul. 84-179.[10]

Case Law Has Been Kinder and More Consistent

Case law has been evolving to a standard more reflective of the *H.R. Skifter Est.* case, discussed

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below. In an early case, *H.R. Fruehauf Est.*, the Sixth Circuit refused to apply what had, as of that date, been a *per se* rule by the Tax Court, citing the Treasury regulation that an insured retaining trusteeship over a trust containing the policy resulted in estate tax inclusion. The court established a reasoning that was later adopted by the IRS in GCM 39317: No inclusion when "a decedent holds the requisite powers over policies on his life solely because he is the transferee, in a fiduciary capacity, of those powers, with no beneficial interest therein."[11]

Thereafter, in *H.R. Skifter Est.*, the court held that in order for the insured as trustee to have an includable incident of ownership, the insured would have to transfer the policy to the trust. The (c)(4) regulation "must be read to apply to 'reservations of powers by the transferor as trustee' and not to powers" merely inherited as trustee. This seems, now in retrospect, like a bizarre engraftment onto the regulation.

Later, and somewhat surprisingly, the Fifth Circuit took a contrary approach. In *C.M. Rose*, the Fifth Circuit ignored the transfer requirement and held that merely retaining trusteeship over a trust in which the trustee was the insured was sufficient to invoke the statute. The 1982 GCM probably overrides the reasoning of this ruling. As an aside, the court's reasoning is hard to follow or agree with, and is written with such great pomposity that the judge writing the opinion, now deceased, must still be chilled with embarrassment. The following quotes are from the opinion:

- He ponders whether Code Sec. 2036 is really "consanguineous" with Code Sec. 2042?[12]
- The judge further questions whether Congress really had a "common design to tax testamentary harvests."
- He emphasizes that "as the case law cross-pollinations—or pari materia interpretations—establish" that the insured as trustee is still the insured ... though "garlanded by leaves of trusteeship."
- He does not care that the "insurance sheaves found in the decedent's hands are selected stalks from once-larger bundles."[13]

Like a bad song (say, Kansas, "Dust in the Wind"), the language in this opinion has not aged well. Or, alluding to the literary prose in that opinion, "the grapes of that written opinion have been left on the literary vine too long to result in a tasteful harvest."

Be Careful, Avoid the Issue and Understand the Option

The insured could be the trustee. In that instance, the practitioner could argue along the *H.R. Skifter Est.* line of cases. But one has to wonder if, given two options—running into a wall head first, as one option, versus walking gently around the wall, as a second—why not opt for the one not likely to result in a concussion? That is, don't name the insured as trustee. Don't name the insured as a co-trustee.

Or, if faced with the insured as trustee, consider a global carve-out that the trustee has no right to exercise any rights over any insurance policy on the trustee's life. Arguably, this global carve-out should be a standard provision put in the trust boilerplate to prevent accidental injury. For example, if the spouse is the trustee of a credit shelter trust, the spouse may inadvertently purchase insurance in that trust, or be advised to do so. Avoid any risk by having the trust boilerplate language provide that the spouse cannot act as to that insurance, and instead, a successor trustee steps in to so act as to the insurance if it is in fact purchased by that trust.

Endnotes

1. *See* Reg. §20.2042-1(c)(2).
2. Reg. §20.2042-1(c)(4) (the "(c)(4)" regulation).
3. However, the IRS has ruled that the power to surrender the policy is the power to change the beneficial enjoyment. TAM 7411260100 (1974).
4. TAM 7411260100A (Nov. 26, 1974).
5. *H.R. Fruehauf Est.*, CA-6, 70-1 USTC ¶12,688, 427 F2d 80, *aff'g* 50 TC 913, Dec. 29,146.
6. *H.R. Skifter Est.*, CA-2, 72-2 USTC ¶12,893, 468 F2d 699, *aff'g* 56 TC 1190, Dec. 30,956.
7. *J.H. Lumpkin, Jr. Est.* CA-5, 73-1 USTC ¶12,909, 474 F2d 1092, *rev'g and rem'g* 56 TC 814, Dec. 30,877.
8. *C.M. Rose*, CA-5, 75-1 USTC ¶13,063, 511 F2d 259, *aff'g* DC-LA, 74-1 USTC ¶12,965.
9. GCM 39317 (Dec. 21, 1984).
10. Rev. Rul. 84-179, 1984-2 CB 195.
11. *See H. Bloch, Jr.*, 78 TC 850, Dec. 39,048 (1982) (Tax Court reconsidered its position and adopted a softer position, requiring an actual "transfer" for inclusion under Code Sec. 2042).
12. As a kid, one of the authors used to raise consanguines, but most of them died shortly after brought home the pet store.
13. Clearly the Judge must have had a high school English teacher that either criticized or encouraged him for writing in similes, as if planting the seeds of literary comparisons spawned fruits of genius.