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Credit Shelter Trusts as Potential Purchasers of Life Insurance

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Abstract: *Life insurance has always been regarded as a highly effective vehicle for leveraging of transfer tax exemptions. The irrevocable* inter vivos *life insurance trust is an important planning device that uses this leveraging concept. While life insurance is commonly used as a funding vehicle to leverage transfer tax exemptions in the context of* inter vivos *irrevocable trusts, in the context of its testamentary cousin — the credit shelter trust — life insurance is often overlooked, even though the factual circumstances may be such that similar leveraging with life insurance would be highly advantageous.*

For many years the credit shelter trust has been a standard element in estate planning for married persons. These trusts, which are usually created upon death and funded to the extent of the decedent's applicable exemption amount ($600,000 in 1997; $625,000 in 1998), represent a vast untapped potential market for life insurance. Life insurance on the life of the surviving spouse can be a highly suitable asset for credit shelter trusts, although there are technical obstacles to such an investment, particularly when the surviving spouse is the trustee of the credit shelter trust or when the surviving spouse holds certain other powers over trust property. This article discusses the advantages of life insurance as an asset of a credit shelter trust and the circumstances in which such an investment would be indicated. The potential technical obstacles to such an investment are identified, and solutions are suggested which would clear the way for acquisition of the insurance.

The Role of the Credit Shelter Trust in Estate Planning

Current estate and gift tax law permits unlimited transfers of property between spouses without transfer tax. Thus, when a married person dies, all of his or her property may be transferred to the surviving spouse with no estate tax liability, regardless of the size of the estate. When the surviving spouse later dies, the then-current value of all of this property still held by the surviving spouse is taxable in his or her estate.

Leaving all assets to the surviving spouse can be unnecessarily expensive. Since every individual is entitled to transfer up to $625,000 of property free of estate or gift tax,[1] a married couple can effectively shelter $1,250,000 from transfer tax. However, half of this shelter will be lost if the first spouse to die leaves all of his or her property outright to the surviving spouse.[2] On the other hand, if this first $625,000 of assets is transferred not to the surviving spouse outright, but to a trust for the primary benefit of the surviving spouse, and if the spouse's rights with respect to the trust property are appropriately limited, the property will not be includable in the estate of the surviving spouse, and the married couple will have been able to utilize the full $1,250,000 of available exemption.

This preservation of the applicable exemption amount of the first spouse to die is a fundamental objective in estate planning for married couples, and the transfer of this applicable exemption amount ($625,000 in 1998) to a trust for the primary benefit of the surviving spouse is the commonly used method of achieving this objective. These trusts are referred to in estate planning as "credit shelter" trusts or "bypass" trusts.[3]

Life Insurance as a Credit Shelter Trust Asset

Under an estate plan utilizing a credit shelter trust, the surviving spouse is often named as the income beneficiary of the trust for his or her lifetime, and upon his or her death, the trust is distributed or held for the benefit of the couple's children and/or grandchildren. If the income from the assets that the surviving spouse ends up owning outright (i.e., the assets received *outright* from the deceased spouse plus all of the assets originally owned by the

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surviving spouse in his or her own right) is adequate for the surviving spouse's standard of living, it is highly advantageous to focus the investment of the credit shelter trust assets on growth of principal rather than current income. Because these assets in the credit shelter trust will not be included in the estate of the surviving spouse, increases in value during his or her lifetime can pass to the children undiminished by estate tax. This technique of "leveraging" a transfer tax exemption to shelter future growth of assets transferred in trust is a fundamental concept of estate planning.

Life insurance has always been regarded as a highly effective vehicle for the leveraging of transfer tax exemptions. The irrevocable *inter vivos* life insurance trust has long been recognized as a useful planning device that uses this leveraging concept. Yet, little attention has been given by planners to the utilization of life insurance in a testamentary credit shelter trust. The use of trust assets for the purchase of an insurance policy on the life of the surviving spouse can be a means of assuring significant leverage (i.e., tax-free growth of the trust corpus as of the date of the surviving spouse's death) without regard to the ultimate longevity of the surviving spouse, a factor that would have a material and unpredictable effect on the extent of the growth of a credit shelter trust funded with a traditional securities portfolio.

The balance of this article discusses technical issues that can arise when a credit shelter trust owns — or the trustee contemplates purchasing — insurance on the life of the surviving spouse.

Authority of Trustee to Purchase Life Insurance

A preliminary question is whether the purchase of a life insurance policy would be a legally proper investment by a credit shelter trust. In general, state law governs the types of investments into which a trustee may place trust assets. These rules are generally broad, intended primarily to limit excessive exposure to risk, and do not limit powers otherwise specifically granted in the trust instrument. A well-drafted trust instrument will delineate the investment powers of the trustee. If the purchase of insurance by the credit shelter trust is contemplated at the planning stage, the trust instrument might contain a clause specifically granting authority to acquire a life insurance policy. Even if life insurance is not specifically mentioned, the trustee is often given virtually unlimited discretionary authority, either by the trust instrument itself or under state law. Most states have abandoned so-called "legal list" statutes, which delineated specific types of permissible trust investments, in favor of a broad standard of prudent judgment on the part of the trustee exercised in the context of the known objectives of the trust.[4] Thus, in most instances, the purchase of an insurance policy would be permissible, as a matter of trustee discretion.

Avoiding Inclusion of the Insurance Proceeds in the Surviving Spouse's Estate

Assuming that the trustee has the authority to acquire a life insurance policy on the life of the surviving spouse, does the fact that the surviving spouse is the insured party raise the possibility that the insurance proceeds would be includible in the gross estate of the surviving spouse when he or she dies? Whether the proceeds of life insurance are includable in the gross estate of the insured party depends upon whether, at the time of death (or within the three-year period prior to death) the insured held any "incidents of ownership" with respect to the policy.[5] The Treasury Regulations provide a lengthy interpretation of the meaning of "incidents of ownership."[6] The term is not limited to ownership in the technical legal sense. "Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy," including certain powers over the policy.[7]

When credit shelter trusts are utilized in estate planning for married couples, the parties typically desire that the surviving spouse be given significant lifetime benefit from, and control over, the trust but short of such benefit or control as would cause the trust assets to be included in the surviving spouse's gross estate. Thus, in many cases, the surviving spouse will be given a lifetime income interest and a limited (special) power of appointment over trust assets. The surviving spouse is also sometimes designated as the trustee. Each of these benefit/control elements in the surviving spouse requires analysis as to whether they would cause the surviving spouse to be deemed to hold incidents of ownership if the trust should acquire an insurance policy on his or her life.

Incidents of Ownership If the Insured Holds a Limited Power of Appointment

Treasury Regulations provide that "[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 (either alone or in conjunction with another person or persons) 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."[8] Thus, it seems quite clear that if the surviving spouse holds a limited power of appointment over the credit shelter trust and the trust acquires an

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insurance policy on his or her life, the insurance proceeds will be included in the insured's gross estate.

This result can be avoided if anticipated in the trust planning and drafting stage. For example, the power of appointment can be drafted to specifically exclude any insurance policy on the life of the power holder.[9] In the alternative, the trust can provide that the entire power of appointment is to be voided if the trust acquires an insurance policy on the life of the power holder.[10] In both of these real life examples, the planners contemplated a potential advantage of life insurance as a trust asset and drafted provisions that would permit the flexibility to acquire such insurance without the risk of the death benefit being included in the insured's gross estate by reason of "incidents of ownership."

Incidents of Ownership if the Insured Is Trustee of the Trust

As part of a typical scenario of granting as much control as possible to the surviving spouse, he or she is sometimes designated as trustee of the credit shelter trust. This will not, per se, cause the trust to be included in the surviving spouse's gross estate (as long as the trustee's authority to invade corpus for his or her own benefit is specifically limited); however, if the trust owns an insurance policy on the life of the surviving spouse/trustee, the previously discussed rules of Code Section 2042 come into play. Because the insured party is the trustee of the trust that owns the policy, he or she is likely to be deemed to hold incidents of ownership in the policy, causing the death benefit to be included in his or her gross estate, unless the authority of the trustee with respect to the policy is sufficiently limited.

In 1984 the Internal Revenue Service (IRS) ruled that when an insured holds a policy on his or her own life in a fiduciary capacity (i.e., as trustee of the trust that owns the policy), he or she is deemed to hold "incidents of ownership" if the fiduciary powers could have been exercised for his or her own benefit or if he or she had originally transferred the policy to the trust or provided the funds for maintaining the policy.[11] In the normal credit shelter trust situation, the policy would not have been transferred to the trust by the trustee/insured nor would he or she be providing funds for maintaining the policy. The policy will have either been transferred by the trust grantor (the first spouse to die) or initially purchased by the trust after the grantor's death, and would be maintained with other assets acquired by the trust from the grantor.

That analysis leaves, as the only significant factor under the 1984 ruling, the extent to which the insured/trustee is able to exercise his or her authority over the policy for his or her own benefit. Unless some restrictions over the trustee's normal authority as owner of an insurance policy are created in the trust instrument, the trustee would indeed be able to exercise that authority for his or her own benefit. For example, a trustee with unfettered authority could at some point decide to surrender the policy and invest the proceeds in income-producing securities. If the trustee is also the income beneficiary of the trust, as would be the case for a typical credit shelter trust, this would certainly result in the trustee's benefiting from the exercise of his or her fiduciary authority.[12]

This problem can be dealt with through trust provisions specifically limiting the authority of the trustee over a life insurance policy held by the credit shelter trust. The IRS has ruled that a trust containing a provision that prohibits any individual trustee whose life is insured by a policy owned by the trust from exercising any power conferred on the owner of such policy did not convey incidents of ownership over the policies to the trustee/insured.[13] The insurance policy was also excluded from the special power of appointment that the trustee held over trust property.

Incidents of Ownership If the Insured is a Beneficiary of the Trust

What if the proposed insured is not the trustee of the trust, but merely a trust income beneficiary? A mere beneficial interest (e.g., a lifetime income interest without a power of appointment) does not appear to involve the type of control contemplated in the Treasury Regulations defining "incidents of ownership." This appears to be borne out, without direct discussion of the point, in recent IRS letter rulings.[14] In addressing the issue of the insured as trustee and/or holder of a special power of appointment, the IRS has held that the insured did not possess incidents of ownership without discussing the fact that the insured was also an income beneficiary of the trust. In a 1996 ruling, the fact that the insureds were income beneficiaries of the trust was clearly stated, and after concluding that the special powers of appointment were not operative if the trust owned insurance policies on their lives, the IRS held that the insureds would not be considered to hold incidents of ownership in the trust-owned policies.[15] Accordingly, a mere income interest in a trust would not give rise to an incident of ownership in an insurance policy owned by the trust.

Potential Revision of Existing Trust Structure to Allow for Purchase of Insurance Without Incidents of Ownership

As already discussed, "incidents of ownership" in the insured can be avoided with appropriate trust provisions if the possibility of insurance being acquired by the credit shelter trust is recognized at the planning

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stage. What can be done, however, when such planning has not been done, but the trustee eventually determines that an insurance policy on the life of the surviving spouse is a desirable trust investment? If the surviving spouse is the trustee or holds a limited power of appointment over trust assets, either of these conditions will be deemed incidents of ownership unless the trust arrangement can be revised to eliminate them. Some potential approaches are discussed as follows.

Resignation as Trustee

As long as the insured is the trustee and there are no trust provisions limiting his or her authority over the policy, the policy proceeds will be includible in his or her gross estate. One solution would be for the proposed insured to resign as trustee and have the successor trustee acquire the insurance policy for the trust.[16] Such a solution was the subject of a favorable IRS letter ruling in 1994.[17] Of course, the feasibility of such a course of action would depend upon the facts of the given situation (e.g., the degree of importance of the loss of control over trust assets, and the degree of confidence that the designated successor trustee will act as desired with respect to the surviving spouse's interests).

Delegation of Trustee's Authority Over the Insurance Policy

Assuming that the surviving spouse would not want to resign the trusteeship altogether, it might be possible to remain as principal trustee, but be insulated from any power over the insurance policy. In a 1995 letter ruling, the trust at issue provided for certain co-trustees.[18] The trustees petitioned the local probate court for modification of the trust to allow for a special subtrust that could acquire life insurance, and the trustees of which would be only those trustees of the original trust who were not beneficiaries. The ruling held that under such an arrangement, the insurance proceeds would not be includible in the gross estate of the insured co-trustee.[19]

In another 1995 letter ruling, a series of trusts were proposed to acquire insurance on the lives of their respective primary beneficiaries.[20] The beneficiaries were not trustees, but each could be appointed as successor trustee of his or her respective trust if the original trustee resigned or otherwise failed to serve. However, they were specifically prohibited from becoming trustees if their respective trusts held insurance policies on their respective lives. A beneficiary could become successor trustee only in the event that his or her trust was partitioned into two separate trusts, one of which would hold the insurance policy and the other of which would hold all other assets; the beneficiary could then become successor trustee with respect only to the portion that did not hold the insurance policy. While it appears from the ruling that such potential partitioning may have been provided for in the original trust instruments, the ruling at least suggests the possibility of such a trust partitioning as a solution to the incidents of ownership problem, even without such specific authorization.

In general, the insulation of a trustee from direct authority over an insurance policy owned by the trust on his or her life, unless set forth in the original trust instrument[21] or accomplished through outright resignation as trustee, would require modification of the trust terms. Such modification would be governed by state law applicable to trusts and would in most instances require a petition for local court approval.

Elimination of Power of Appointment Over Trust-Owned Policy

If the trust instrument grants the surviving spouse a limited power of appointment over the credit shelter trust, this power would have to be eliminated or modified in order to clear the way for the trust to acquire an insurance policy on the life of the spouse without the death benefit being includible in the spouse's gross estate under the incidents of ownership test. Depending upon the terms of the power of appointment and the applicable state law, the power might be eliminated through a formal "release" executed by the power holder.[22]

With respect to a limited power of appointment, there is no gift tax issue connected with release of the power. Unlike the case of a general power of appointment, a release of a limited power is not considered a transfer of the underlying property.[23] Thus, should the surviving spouse determine that the acquisition of life insurance by the credit shelter trust is sufficiently attractive to justify giving up (or restricting) his or her limited power of appointment, there would be no tax obstacle to doing so. However, reference must be made to applicable state law to determine whether there are any restrictions and/or procedural requirements with respect to releases of powers of appointment.

A detailed survey of the applicable law of the various states on this subject is beyond the scope of this article. However, the generally prevailing law permits releases of powers of appointment by action of the power holder without need for a court petition.[24] Certain formal procedures may be required by state statute, and thus, if a release of a power of appointment is planned in connection with the acquisition of an insurance policy by a credit shelter trust, legal assistance must be sought with respect to these nontax requirements. For example, California Probate Code Section 661 provides, "unless the creating instrument otherwise provides, a general or special power of appointment that is a discretionary power, whether testa-

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mentary or otherwise, may be released, either with or without consideration, by a written instrument signed by the donee and delivered as provided in [this section]." The section goes on to discuss permissible partial releases, the requirements for delivery of the written instrument of release, and recording of the instrument when real property is involved.

With regard to partial releases, the California statute provides that "a releasable power may be released with respect to the whole or any part of the appointive property." By specifically authorizing such a partial release, a statute such as this obviates the need to release a limited power in its entirety in order to solve the "incidents of ownership" problem. Thus, a release may be drafted in such a manner that the power is released only as to any insurance policy on the life of the power holder.[25] Whether a partial release is technically possible under a state statute that does not contain such a specific provision is subject to legal interpretation of the language of the general release provision and judicial precedent, if any.

Assuming that a total or partial release can be affected under applicable state law, a question arises as to the timing of the execution and delivery of such a release. If the release is executed after the trust has actually acquired the insurance policy, Code Section 2035 will come into play; if the insured dies within three years after the effective date of the release, the insurance proceeds will be includible in his or her gross estate — as a result of having disposed of an incident of ownership within the three-year period preceding death. On the other hand, if this risk is to be avoided by executing the release prior to the trust's acquiring the policy, there is a potential technical issue in the case of a partial release applicable only to the insurance policy: Can such a partial release be affected with respect to specific appointive property that was not even part of the appointive property pool at the time the release was executed and delivered? Could the IRS argue that such a purported release was not legally effective? Again, such an issue would have to be determined through interpretation of applicable state law.

Conclusion

An insurance policy on the life of the surviving spouse/beneficiary may be an especially attractive investment vehicle for a credit shelter trust. While life insurance is commonly used as a funding vehicle to materially leverage the gift tax annual exclusion and the applicable exemption amount ($625,000 in 1998) in the context of *inter vivos* irrevocable life insurance trusts, in the context of its testamentary cousin — the credit shelter trust — life insurance is often overlooked, even though the factual circumstances may be such that similar leveraging with life insurance would be highly advantageous.

Care must be taken to avoid the insured's possessing incidents of ownership in the policy, which would cause the death benefit to be included in the insured's gross estate. Incidents of ownership may be present if the insured is either a trustee of the credit shelter trust or holds a power of appointment over trust property. If the possibility that life insurance might be acquired by the credit shelter trust is contemplated in the estate planning stage, the factors potentially giving rise to incidents of ownership can, in most instances, be avoided with careful drafting. In the case of an existing credit shelter trust desiring to acquire such insurance, steps can be taken to eliminate potential incidents of ownership through modification of the insured's position or powers as trustee and/or full or partial release of his or her limited power of appointment. **J**

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(1) The Tax Reform Act of 1997 provides for an increase in the exemption amount to be phased in stages: $625,000 in 1998; $650,000 in 1999; $675,000 in 2000 and 2001; $700,000 in 2002 and 2003; $850,000 in 2004; $950,000 in 2005; and $1,000,000 in 2006 and thereafter.

(2) In 1998 the first spouse to die would be entitled to a $625,000 exemption, which would effectively shelter the first $625,000 of assets in his or her estate, regardless of whether they are transferred to the surviving spouse or any other party. (Because the $625,000 exemption is first applied against any otherwise taxable gifts that may have been made during lifetime, the balance remaining available upon decedent's death may be less than the full $625,000.) If these assets are transferred to the surviving spouse, the $625,000 exemption would not be needed, and there will be no estate tax, but these assets plus any subsequent increase in their value would be taxable as part of the estate of the surviving spouse upon his or her subsequent death. The surviving spouse would be entitled to his or her own $625,000 exemption, but the first spouse's $625,000 exemption will have been permanently lost.

(3) The "bypass" designation refers to the concept that these trust assets bypass inclusion in the gross estate of the second spouse to die. The term "credit shelter" refers to the fact that the trust is designed to be funded to the extent of the shelter provided by the unified transfer tax credit available to the decedent.

(4) *See generally*, Restatement (Third) of Trusts P.I.R. §227 (1990).

(5) IRC §§2042; 2035.

(6) *See* Treas. Reg. §20.2042-1(c).

(7) *Id.* at -1(c)(2).

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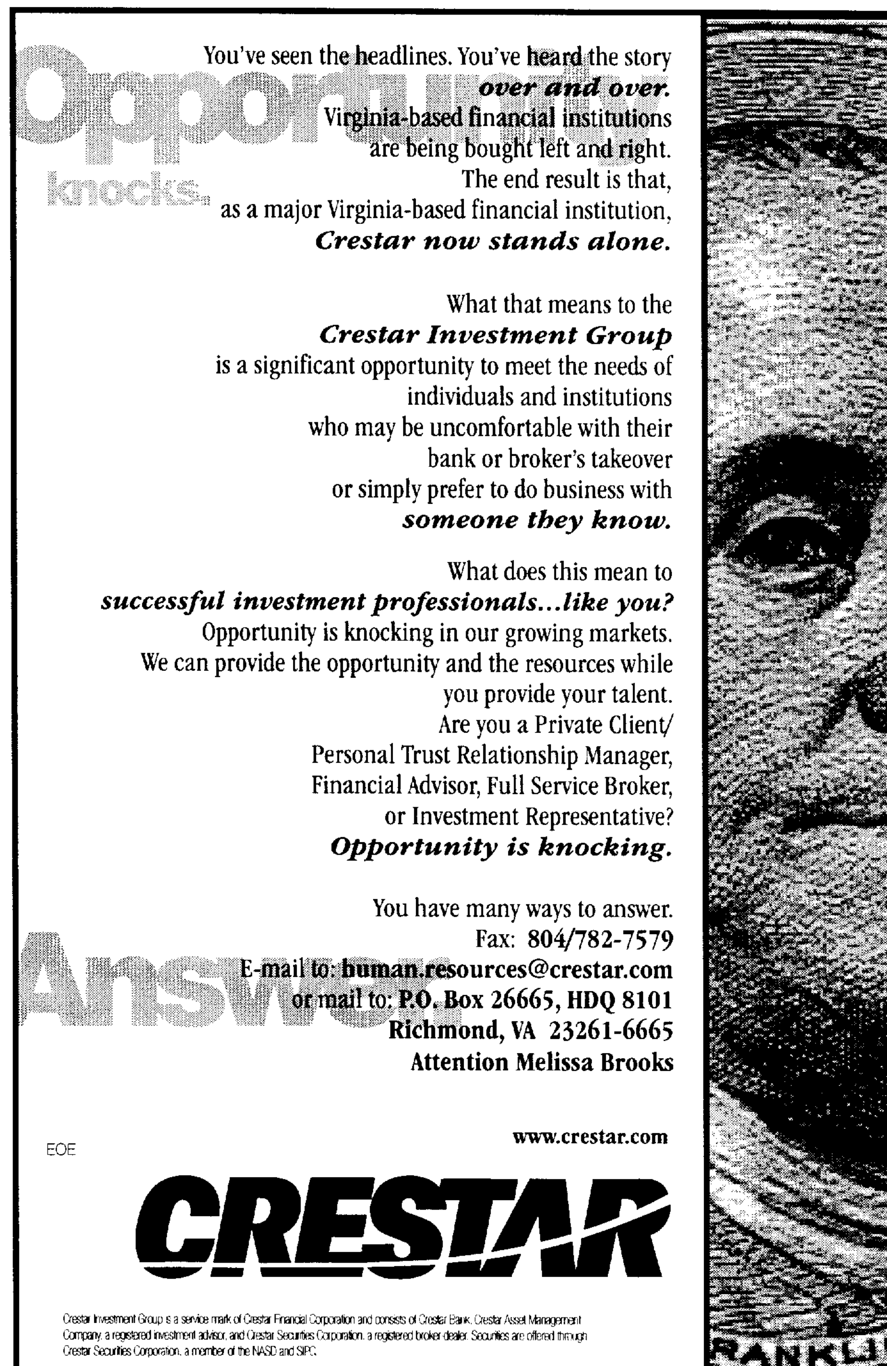
(8) *Id.* at –1(c)(4).
(9) *See* Priv. Ltr. Rul. 91-11-028 (Mar. 15, 1991).
(10) *See* Priv. Ltr. Rul. 96-02-010 (Jan. 12, 1996).
(11) Rev. Rul. 84-179, 1984-2 C.B. 195.
(12) *See* Estate of Freuhauf v. Comm'r, 427 F.2d 80 (6th Cir. 1970).
(13) Priv. Ltr. Rul. 91-11-028 (Mar. 15, 1991).
(14) *See, e.g.* Priv. Ltr. Rul. 94-34-028 (Aug. 26, 1994); Priv. Ltr. Rul. 91-11-028 (Mar. 15, 1991).
(15) Priv. Ltr. Rul. 96-02-010 (Jan. 12, 1996).
(16) If the policy is acquired by the trust prior to the resignation of the insured as trustee, there would remain a risk of inclusion of the death benefit in the estate of the insured if he or she were to die within the first three years after resignation as trustee. *See* IRC §2035.
(17) Priv. Ltr. Rul. 94-34-028 (Aug. 26, 1994).
(18) Priv. Ltr. Rul. 95-42-007 (Oct. 20, 1995).
(19) *Id.* It should be noted that the favorable holdings in this letter ruling and in Priv. Ltr. Rul. 95-38-035 erroneously overlooked the additional fact that the insured held a limited power of appointment over the trust, which would amount to an incident of ownership, despite the elimination of authority over the policy in the capacity as trustee. Both of these rulings were subsequently withdrawn without published explanation. Upon inquiry, the IRS branch responsible for these rulings confirmed that they were in fact withdrawn because of this oversight. The revoked rulings nonetheless provide useful examples of potential trust modifications to insulate a trustee-insured from authority over the trust-owned insurance policy.
(20) Priv. Ltr. Rul. 95-38-035 (Sept. 22, 1995).
(21) A common provision in so-called beneficiary controlled trusts is the granting of power to the beneficially interested trustee to appoint an independent trustee to hold or exercise any "tax-sensitive" powers, i.e., powers, such as control over an insurance policy, which might trigger adverse tax consequences if possessed by a non-independent trustee.
(22) A power of appointment, like other property bequeathed in a will, may be rejected through a "disclaimer," which, when formally completed within a statutorily designated period following the decedent's death, typically nine months, will result in the power never actually vesting in the designated power holder. The discussion in the main text, however, relates only to subsequent releases of limited powers of appointment not originally disclaimed.
(23) *See* Treas. Reg. §25.2514-3(e), Ex. (3).
(24) *See* 62 Am. Jur. 2d, *Powers of Appointment* §§64-75 (1990); Restatement (Second) of Property §14.2 (1984). The Restatement of Property sets forth a detailed listing of the various state statutes dealing with releases, categorized by general summary of the scope and/or limitation of the ability to affect a release.
(25) *See* Priv. Ltr. Rul. 91-11-028, *supra* notes 9, 13 and 14 and accompanying text, in which the power of appointment had been originally drafted to specifically exclude such an insurance policy.



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