COLLAPSING LIFE INSURANCE TRUSTS WHEN THEY ARE NO LONGER NEEDED

The client who is enamored initially with saving estate taxes on the proceeds of a life insurance policy by placing it in an irrevocable trust may find himself or herself disenchanted several years later. This occurs for a variety of reasons. When it occurs, clients look for a way out of this irrevocable arrangement. So does "irrevocable" mean unchangeable forever? The answer is "no."

Reasons for Termination of an Irrevocable Life Insurance Trust

An insured has to part with all control over a policy on her life if estate taxes on the proceeds are to be saved on the insured's death. For that reason, someone other than the insured frequently applies for and purchases the policy on the insured's life. When an irrevocable life insurance trust is established, it is the trustee of that trust (someone other than the insured) who generally applies for and purchases the policy. If the insured buys the policy and later transfers it to the trustee, if the insured dies within three years of the transfer, then the proceeds will be subject to estate taxes in the insured's estate.

Notwithstanding this need to part with control for tax purposes, it is usually the insured who instigates the termination of an irrevocable life insurance trust. Here are some common reasons why an insured may wish to terminate his irrevocable life insurance trust:

- The policy has become too expensive to maintain and after it lapses (assuming a life settlement is not an alternative), few assets will be left in the trust.

- The insured is no longer happy with the terms of the trust. Perhaps the insured was happily married when the trust was established, but he and his wife are now divorced and his former wife is the only beneficiary of the trust until her death. Maybe that child the insured thought was taking a while to grow up has proven herself to be financially irresponsible beyond a shadow of a doubt and distributing assets outright to her at certain ages (in keeping with the trust terms) is no longer a good idea.

- The federal estate tax exemption has increased significantly since the insurance trust was established and/or the insured's net worth has decreased so that estate taxes are no longer an issue. As a result, the client wishes to regain control of the insurance policy. In today's political climate clients should think twice about terminating an insurance trust for this reason because it is difficult to predict whether estate tax exemptions and rates will go up or down in the future and whether increases or decreases will be intermittent or permanent.

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Tension Between Insured's Wishes and Trustee's Duties

There may be a tension between the insured's desire to terminate a trust and the trustee's duties under California law. For example, a well-drafted insurance trust will prevent the policy from ever returning to the insured in order to keep the proceeds exempt from estate taxes in the insured's estate. If the insured wants to regain control of the policy because estate taxes are no longer an issue, the trustee has *no* power to return the policy to the insured and has an affirmative duty to be loyal to the trust beneficiaries. If the trustee gives the policy to the insured, she breaches the trust and exposes herself to a lawsuit by the trust's beneficiaries! In this situation, an alternative would be for the trustee to *sell* the policy back to the insured for its market value.

In most situations, the trustee will not be asked to return the assets of the insurance trust to the insured. Instead, he will be asked to transfer the assets to a new irrevocable trust or to distribute the assets outright to the beneficiaries of the existing irrevocable trust when it terminates. If the trust assets will be distributed outright to the beneficiaries, the trustee must be careful to calculate properly the present value of the interests of the income beneficiaries and the remaindermen, unless the trust directs how its assets are to be distributed on termination.

A transfer of assets to another irrevocable trust can take place in one of two ways: (a) the policy can be sold to the trustees of the new insurance trust for its market value, or (b) <u>if</u> the trustee has the power to do so, the policy can be added to another trust having the same beneficiaries with similar terms. The latter approach is helpful if the basic terms of the trust are still satisfactory but a change of trustees is desirable and there is no mechanism for changing trustees in the old trust.

Using the Terms of the Insurance Trust to Terminate It

A well-drafted insurance trust has flexibility built into it and may contain a provision enabling the trustee or a "special" (independent) trustee to terminate it. In the absence of such a provision, it can be very expensive and time-consuming for clients to go to court to effect a termination. Furthermore, there is no guarantee that a judge will agree that the insurance trust should be terminated.

The following types of clauses can be used to terminate an insurance trust:

- A power in the trustee to terminate a trust of relatively small value or that has become overly burdensome or expensive to administer, with a direction as to how the assets will be distributed on termination.

- If the value of the trust assets is small (<u>e.g.</u>, because the trust contains only enough money to pay insurance premiums as they fall due) and the beneficiaries still have Crummey withdrawal rights, it may be possible to pass all assets of the trust out to the beneficiaries through the exercise of

their withdrawal rights. If so, the trustee and beneficiaries must follow carefully the procedures set forth in the trust for the proper exercise of these withdrawal rights.

- Someone may have the power to appoint or distribute trust assets in favor of or to a certain class of persons during the insured's lifetime. For example, an independent trustee may have the power to distribute or appoint trust assets in favor of the insured's descendants for any reason.

- Along similar lines, if the trust calls for outright distributions to beneficiaries at certain ages, the trustee may have the power to accelerate those distributions.

Not all trust powers are created equally. It will be incumbent upon the trustee and his lawyer to determine whether the scope of a power is broad enough to permit the trustee to accomplish the insured's objectives without committing a breach of trust.

Court Approval, If Needed

If the trust instrument does not provide mechanisms to enable the trustee and/or beneficiaries to terminate the trust themselves, it may be necessary to petition the court to terminate the trust. For California trusts, to do so, there must be some authority under the Probate Code for seeking termination.

A. Termination by Grantor and All Beneficiaries.

Under California Probate Code Section 15404, if the grantor and all of the beneficiaries of a trust consent, they may compel the termination of the trust. This section allows the grantor and all of the beneficiaries to terminate a trust without court approval. Under Probate Code section 15410(b), on termination, the trust assets will be distributed in the manner agreed upon by the parties. However, practically speaking, court approval may be necessary or desirable, for the trustee's protection or because there are minor or unascertained beneficiaries and a Guardian ad Litem is needed to consent on their behalves. If all of the beneficiaries do not consent, Probate Code Section 15404(b) still permits the Court to terminate the trust, provided that the interests of the beneficiaries who do not consent are not substantially impaired.

B. Termination by All Beneficiaries.

Under California Probate Code Section 15403, all of the beneficiaries of an irrevocable trust may compel its termination. However, unlike Probate Code Section 15404, a termination by a Trust's beneficiaries, without the grantor, requires a court petition; and the Court will determine how its assets will be distributed upon termination, pursuant to Probate Code section 15410(c). If the continuation of the trust is necessary to carry out a material purpose of the trust, it cannot be terminated unless, in the Court's discretion, the need for the

termination outweighs the interest of carrying out the material purpose of the trust. Under Section 15403(b), the Court does not have the discretion to terminate a trust with a spendthrift provision. What constitutes a material purpose of a Trust is a question of fact and may be shown by the terms of the Trust instrument or extrinsic evidence. A Guardian ad Litem may have to be appointed for the reasons described in Part A.

C. Termination of Trust With Uneconomically Low Principal.

Under California Probate Code Section 15408, if the value of a trust is low in relation to the cost of administering it and its continuation will defeat or substantially impair its purposes, on petition by a trustee or beneficiary, the Court may terminate the trust and direct the distribution of its assets. California Probate Code Section 15408(c) specifically provides that a spendthrift provision will not impede a termination of the trust under these circumstances.

If the trust principal falls below $40,000, Probate Code Section 15408(b) provides that the trustee has the power to terminate the trust without a Court petition, in which case the trustee will distribute the assets in keeping with the directions contained in the trust or the grantor's intent. If neither is expressed adequately in the trust, the trust assets may be distributed to the living beneficiaries on an actuarial basis. See Probate Code section 15410(d).

D. Termination in Changed Circumstances.

Under California Probate Code Section 15409, on petition by a trustee or beneficiary, the Court may terminate a trust and direct how its assets will be distributed if circumstances have changed and the continuation of the trust would defeat or substantially impair the purposes of the Trust. Although the court may not deny the petition solely based on the existence of a spendthrift provision, it is a factor to be considered by the Court.

E. Caveat.

In seeking the termination of an irrevocable trust, consider the potential effect of the no contest clause (if any).

F. Practical Considerations.

In seeking the termination of an irrevocable trust:

- Determine whether a Guardian ad Litem is needed to consent on behalf of unascertained or minor beneficiaries. If a Guardian ad Litem is needed, it may be prudent to request that a particular individual be appointed as soon as possible, to prevent a delay in the proceedings.

- In your Petition, explain to the Court (a) the benefit to the beneficiaries of the termination, (b) why the relief you are requesting is necessary or

advisable (e.g., the circumstances that have changed or the expense involved in continuing the Trust), and (c) why the relief you are requesting does not defeat or impair a material purpose of the Trust.

- Comply with all procedural rules (including local Probate Rules) and notice requirements.

- When representing a trustee in these circumstances, it is important to bear in mind the trustee's duty to treat all of the beneficiaries fairly and impartially.

Tax Considerations

A. Income Taxes. Generally, the proceeds of a life insurance policy are not subject to income tax on the death of the insured. But if the policy is sold during the insured's lifetime, the proceeds will be subject to income tax under the transfer for value rules of Internal Revenue Code Section 101, with the following exception: The policy may be sold to the insured, a partner of the insured, a partnership in which the insured is a partner or a corporation in which the insured is a shareholder or officer.

If the insured wishes to take the policy back because estate tax savings are no longer a consideration, he may purchase the policy without having the proceeds subjected to income taxes at a later date as a result. A difficult question is how to arrive at a fair purchase price so that the trustee does not breach her fiduciary duties. In this era of life settlements, we cannot assume that a policy's cash surrender value or an interpolated terminal reserve value represents the market value of the policy.

A grantor trust is the insured's alter ego for income tax purposes. If instead of buying the policy, the insured prefers to set up another irrevocable life insurance trust to own the policy and the purchasing trust is a grantor trust, the exception to the transfer for value rules under Internal Revenue Code Section 101 will apply and the proceeds will not be subject to income taxes on the insured's death. See Revenue Ruling 2007-13, 11 I.R.B. 1.

B. Estate Taxes. If a policy owned by an irrevocable insurance trust is sold back to the insured, and the insured retains the policy until he dies, the proceeds will be subject to estate taxes in his estate. By the same token, if the policy is distributed to a trust beneficiary and the beneficiary retains the policy, any unspent proceeds will be subject to estate taxes in the beneficiary's estate (assuming the beneficiary survives the insured). This issue is of particular concern if that beneficiary is the surviving spouse of the insured. Under the insurance trust, a bypass trust may have been created for the surviving spouse's benefit so that the proceeds would not be subject to estate tax in her estate. Distributing the policy outright to her thwarts the estate tax plan.

C. Generation-Skipping Taxes. It is important to ascertain whether or not a grantor's generation-skipping transfer exemption has been allocated to an insurance trust that the trustee plans to terminate. Once made, an allocation of generation-skipping transfer exemption is irrevocable. Generation-skipping transfer exemptions may be allocated affirmatively, by the filing of a gift tax return or automatically, by operation of law (even if grandchildren or other skip persons do not benefit from the trust until some time in the future). If the trust is terminated, and its assets are distributed to beneficiaries who are not "skip persons" (i.e., persons two or more generations younger than the grantor), any generation-skipping exemption that was allocated to the trust will be wasted.

Conclusion

Irrevocable life insurance trusts work well for the right clients. However, they are not for everyone. If an insured and the trustee will not properly administer the trust after its establishment and funding (e.g., if the insured pays insurance premiums directly or the proper notices are not sent to holders of Crummey withdrawal rights), the trust's tax objectives will not be achieved. Similarly, if the client's life may be in a state of flux in the future (e.g., due to an unstable marriage), it may not be wise to advise the client to surrender control of an important asset in the name of saving transfer taxes.

Estate tax savings can also be achieved if an adult family member of the insured takes out the policy and pays all premiums, without a trust. For some clients, this is a better and simpler alternative than an insurance trust. Other clients refuse to let the tax tail wag the dog and are willing to pay the estate tax price in order to retain control of policies on their own lives.

It is important for professional advisors to appreciate differences among their clients when it comes to tax saving philosophies, parting with control of important assets and their willingness to see to the details of proper trust administration. Rarely in life does "one size fit all" and an irrevocable life insurance trust is not a good fit for everyone.

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