

## Grantor's Ability To Substitute Assets In A Life Insurance Trust Not A Problem

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Planners often grant Code §675(4) power of substitution rights to a grantor of a trust to create a grantor trust (*i.e.*, a trust whose income is taxable to the grantor). That provision creates a grantor trust if the grantor has the power in a nonfiduciary capacity, without the approval or consent of any person in a fiduciary capacity, to reacquire trust corpus by substituting other property of an equivalent value.

Such planning was given a boost in Rev.Rul. 2008-22 which provided that such a power, when properly structured, will not result in estate tax inclusion of the trust assets in the gross estate of the grantor. Thus, the advantages of grantor trust status can be obtained without the cost of estate tax inclusion.

However, if the trust involved is an irrevocable trust holding a life insurance policy, the use of a power of substitution has raised the issue whether gross estate exclusion will apply as to the life insurance policy or proceeds. More particularly, the issue has been whether such a power of substitution constitutes an "incident of ownership" by the grantor in the insurance policy that results in gross estate inclusion at death under Code §2042.

The IRS has now ruled that such a power of substitution will NOT create an incident of ownership in the grantor. Thus, such grantor trust planning will not be problematic for trusts owning life insurance.

Note that Crummey withdrawal rights in a beneficiary, which are often used in life insurance trusts, will not defeat grantor trust status as to the grantor.

In relying on the ruling, planners should attempt to come as close as possible to the facts of the ruling as practicable, including:

1. The grantor is not the trustee.
2. The trust terms prohibit the grantor from serving as trustee.
3. The grantor has no power to revoke, alter, amend, or terminate the trust.
4. The substitution power is exercisable in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity.
5. The grantor must certify equivalent values when exercising the substitution power.
6. The trustee has a fiduciary obligation to confirm equivalent values on a substitution.
7. The trustee has a duty under local law to act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries, if there is more than one beneficiary.
8. The trustee has discretionary power to acquire, invest, reinvest, exchange, sell, convey, control, divide, partition, and manage the trust property in accordance with the standards provided by law.

Code §677(a)(3) provides that income of a trust that may be applied to premiums on a policy insuring the grantor's life creates a grantor trust. That being the case, an argument can be made that another grantor trust power, such as a substitution power, is not needed to create a grantor trust. However, the benefit of this ruling is that there is some uncertainty regarding whether Code §677(a)(3) creates a fully grantor trust, or only a partial grantor trust equal to the amount of the insurance premiums.

Many life insurance trusts do not earn income, so grantor trust status may not be needed. However, at other times, grantor trust is desired. For example, the trust may be funded with other income earnings assets, to help pay premiums or to be used for other purposes. Also, grantor trust status may be desirable so as to allow the trust to be funded with noncash assets via a sale to a defective installment trust.

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