

Self-Settled Life Insurance Trusts: A Viable Alternative?





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Self-Settled Trusts Should Not Be Included in a Decedent's Taxable Estate - Analysis

Section 2036(a)(1):

- Assets gifted by Decedent (in trust or otherwise) but Decedent retained for life:
 - “The right to the income from”; **or**
 - “The possession or enjoyment of” such assets
- If so, the assets are included in Decedent’s Gross Estate

Section 2036(a)(1):

- In a self-settled trust, the client/settlor does not retain the right to income (or principal)
- Does the client/settlor retain “***possession or enjoyment of***” the trust assets for life?

Section 2038:

- If the Settlor of a trust retains the right to ***alter, amend, revoke or terminate*** the trust at death, the assets will be includible in the Settlor's Gross Estate.
- BUT, in the properly designed self-settled trust, the Settlor does not retain any such powers.

Crux of Gross Estate Inclusion Analysis:

The lynch pin of avoiding estate tax inclusion for Self-Settled Trusts is the legal definition of the Settlor's "possession or enjoyment of" (2036(a)(1)) trust property.



On it's face, in a properly designed self-settled trust, there are no **rights** the Settlor has with respect to trust property. Thus the Settlor has no right to possess or enjoy the trust property (or income from such property).



But: State law creditors' rights

- Case law and IRS authority hold that if a governing jurisdiction's law allows creditors of a Settlor to attach a self-settled trust's assets, then the Settlor has retained "possession or enjoyment" of the trust assets.
- Conversely, case law and IRS releases have held that when the governing law does not allow a Settlor's creditors to attach trust property, the trust assets are not includible in the Settlor's Gross Estate.

- Most states subject self-settled trusts to creditor claims of the person creating the trust, and thus the trust's assets are included in the Settlor's Gross Estate under 2036(a)(1).
- Several states, including Alaska (one of the first) and Nevada, do not allow a Settlor's creditors to access self-settled trust property, if designed properly.
- Query: Some self-settled trust states allow alimony and child support claims (arising after transfers are made to a self-settled trust) to be enforced against the self-settled trust's Settlor → are ex-spouses/minor children "creditors" for purposes of gross estate inclusion analysis?

Does the gross estate exclusion legal theory
hold? **YES!**

PLR 200944002



Obtaining the benefits of a self-settled trust jurisdiction:

1. Resident Trustee;
2. Some trust assets are held in the self-settled trust state;
3. Resident Trustee must maintain trust records and prepare or arrange for the preparation of trust income tax returns; and
4. At least part of the trust administration must occur in the self-settled state.

- Will other states be required to respect self-settled trusts created by that state's residents in a self-settled jurisdiction?
- Federal case law seems to indicate yes.



Life Insurance Owned By a Trust Where the Insured is a Beneficiary of Such Trust

IRC §2042: If a Decedent retains any “incidents of ownership” in a policy insuring his/her life at death, the proceeds of such policy are included in the Decedent’s Gross Estate.

“Incidents of Ownership”

- The term is broadly defined
- Both Treasury regulations and case law enumerate them to include, among others, the power to:
 - Change beneficiaries
 - Surrender the policy
 - Assign the policy
 - Pledge the policy
 - Borrow from the policy
- Having a revisionary interest in the policy
- The right of the insured to the economic benefits of the policy
- Power to remove and replace the trustee
- Being the trustee of a trust that owns the life insurance in question

The IRS has issued a number of private letter rulings and one revenue ruling all allowing a trust to purchase insurance on the life of a beneficiary.

- Rev. Rul. 84-179

- PLR 97-48020, PLR 2006617008, PLR 9451053, PLR 200518005, PLR 201327010 (all which involved trusts for the benefit of a spouse where the trust owned survivorship policies or single life policies insuring the life of the spouse-beneficiary)

- PLR 9602010 and 9434028 (which involved trusts for children-beneficiaries owning policies on the children's lives)

Providing funds to pay premiums:

- In all the referenced PLRs and the Revenue Ruling, the IRS mentioned the fact that the insured-beneficiary had not provided the funds to pay the life insurance premiums.
- But this is not a 2042 incident of ownership issue. Instead, it may be viewed as a 2036 “possession and enjoyment” argument.
- And in ALL of these PLRs and the Revenue Ruling, there is no indication that creditors of the insured could access the trust’s assets. The trust assets, including the insurance proceeds, were not included in the beneficiary-insured’s gross estate.

The IRS position on gross estate-excluded trusts owning life insurance on a beneficiary has not changed over the years.

PLR 201919002

PLR 201919003

Creating a Self-Settled Trust That Can Own Life Insurance on the Settlor – Design Issues

The structure needs to mimic the typical provisions of any other well-designed self-settled trust intended for estate tax exclusion:

- Settlor cannot be the trustee or a co-trustee
- Fully discretionary distributions only
- No 5 and 5 power and no power of appointment for Settlor
- No remove and replace trustee power for Settlor
- Perhaps adverse party as trustee?
- No “requirement” to buy insurance or pay insurance premiums in trust (but trustee has discretion to do so)
- Settlor has no “rights” at all under the trust
 - Query → right to remove and replace protector?

Practical Considerations:

- Why use a self-settled trust for estate planning?
- Why use a self-settled trust to own life insurance on the Settlor?
- Weighing the risks vs. reward
- Back Doors/Decanting

“Non-reciprocal” Spousal Lifetime Access Trust Design vs. Self-Settled Trusts for Married Couples:

- Are the SLATs truly non-reciprocal?
 - Different trust terms
 - Executed at different times?
 - Funded at different times?
- Loss of access to half the assets upon death of first spouse
- Insuring the risk of losing access to half a married client's assets in the SLAT design → is it feasible (are both insurable?)
- Not an option for single clients (single, divorced, widowed, etc.)

Q&A



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