

Premier analysis of federal legislative and regulatory developments for the nation's 2,000 most advanced life insurance planners, focusing on business, estate, qualified and nonqualified retirement planning.

Counsel

Buchanan Ingersoll & Rooney PC *PricewaterhouseCoopers*
Gerald H. Sherman William Archer
Deborah M. Beers Donald Carlson
Keith A. Mong

Ricchetti, Inc.
Steve Ricchetti
Jeff Ricchetti

Federal Policy Group
Ken Kies
Matthew Dolan

Arnold & Porter LLP
Martha L. Cochran
David F. Freeman, Jr.

AALU

David J. Stertz, *Chief Executive Officer*
Marc R. Cadin, *Senior VP of Government Affairs*
Chris Morton, *Vice President of Legislative Affairs*
Tom Korb, *Vice President of Policy & Public Affairs*
Sarah Spear, *Sr. Director of Legislative Affairs*
Anthony Raglani, *Director of Legislative Affairs*

101 Constitution Avenue NW, Suite 703 East
Washington, DC 20001
Toll Free: 1-888-275-0092 Fax: 202-742-4479
www.aalu.org

AALU Bulletin No: 11-105

December 8, 2011

Subject: IRS Rules Favorably on Use of “Power of Substitution” in Life Insurance Trust

Major References: [*Rev. Rul. 2011-28, 2011-49 I.R.B. 830*](#)

Prior AALU Washington Reports: 08-54; 11-82

MDRT Information Retrieval Index Nos.: 7400.00

**SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO
THE CONCLUSION OF THIS WASHINGTON REPORT.**

The Internal Revenue Service, in Rev. Rul. 2011-28, has ruled that the retention, in a nonfiduciary capacity, by the grantor of a life insurance trust of a § 675(4)(C) “power of substitution” over trust assets will not be viewed as the retention of an “incident of ownership” in the policy under § 2042. The ruling concludes that the retained substitution power will not cause inclusion of the proceeds of the policy in the grantor’s gross estate so long as (i) the grantor may not serve as trustee, (ii) the trustee has a fiduciary obligation to insure that the substituted assets are of equivalent value, and (iii) the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

The subject of Rev. Rul. 2011-28 has been included on the list of IRS “priority guidance” projects for many years (see, e.g., our Bulletin No. 11-82), and its issuance should be a welcome relief to insurance and estate planners, some of whom may have been reluctant to rely on the inclusion of this power in a life insurance trust to permit the sale of a policy to the grantor of the trust, or to another trust of which the grantor is treated as the owner for income tax purposes under the grantor trust provisions of the Internal Revenue Code.

In *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975), *acq. in result*, 1977-1 C.B. 1, the Tax Court held that a power of substitution “was not a power to alter, amend or revoke the trust within the meaning of section 2038(a)(2),” and thus did not cause estate tax inclusion. In *Jordahl*, the court determined that because the power of substitution was held *in a fiduciary capacity*, it could only be exercised in good faith and could not be used to deplete the trust or to shift property among the trust beneficiaries. Thus, it was determined by the Court also not to cause inclusion under § 2042.

Rev. Rul. 2008-22 (*see* our Bulletin No. 08-54) had previously set forth the specific conditions that must be present in order for a power to substitute assets that is held in a *nonfiduciary* capacity not to result in estate inclusion under either Code § 2036 (regarding the retention by the grantor of an interest in the income or assets of a trust) or Code § 2038 (regarding “revocable” transfers). Specifically, under that ruling, the grantor must (i) hold the power to substitute assets in a non-fiduciary capacity and be able to exercise the power without the approval or consent of any person acting in a fiduciary capacity; (ii) substitute assets of equivalent value; and (iii) not exercise the power in a manner that can shift benefits among the trust beneficiaries. Additionally, the trustee (but not the grantor) must have a fiduciary obligation, whether under local law or pursuant to the trust instrument, to ensure compliance with the terms of the substitution power by determining that the substituted property is indeed of equivalent value.

This ruling was considered to be of major importance to the estate planning community because many trusts achieve grantor trust status through the intentional granting of one or more administrative powers, which, if held by the grantor or any independent, nonadverse party, will cause the grantor to be taxed as the owner of the trust’s assets for Federal income tax purposes. Trusts containing one or more of these administrative powers are sometimes referred to as “intentionally defective” grantor trusts. Among these powers is the “power of substitution” – i.e., the power of the grantor or other independent, nonadverse party, acting in a nonfiduciary capacity, to substitute assets of the trust for assets of equal value.

However, because Rev. Rul. 2008-22 did not address the consequences of the grantor’s retention of the power of substitution under Code § 2042, some advisors have been wary of including such power in a life insurance trust, even though its inclusion may facilitate the sale of a policy to the grantor or to another grantor trust with more favorable provisions. Rev. Rul. 2011-28 should alleviate that concern, at least where the conditions of the ruling are met..

The facts of the 2011 ruling are similar to those of the 2008 ruling, although posited in the context of a life insurance trust, as follows:

The grantor initially funded the trust with cash. Thereafter, The trust, which is an irrevocable trust for the benefit of the grantor’s descendants, purchased a life insurance policy on the grantor's life. Trustee is the trustee of trust, and the terms of the trust prohibit the grantor from serving as trustee. The grantor makes gifts every year to the trust, and Trustee pays the premium on the insurance policy. The proceeds of the policy are payable to the trust upon the grantor’s death.

The grantor cannot revoke, alter, amend, or terminate the trust. The governing instrument of the trust, however, provides the grantor with the power, exercisable at any time, to acquire any property held in trust by substituting other property of equivalent value. The trust instrument provides that the power is exercisable by the grantor in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity. To exercise the power of substitution, the grantor must certify in writing that the substituted property and the trust property for which it is substituted are of equivalent value. In addition, under local law, the trustee has a fiduciary obligation to ensure that the property that the grantor seeks to substitute is equivalent in value to the property distributed to the grantor. Moreover, if a trust has two or more beneficiaries, local law requires the trustee to act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries. Finally, under local law and without restriction in the trust instrument, the trustee

has the 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.

The grantor has no incidents of ownership in the insurance policy unless his right of substitution is considered an incident of ownership. The grantor dies without having exercised the power to substitute with respect to the life insurance policy.

On these facts, the Revenue Service ruled that the “grantor's retention of the power, exercisable in a nonfiduciary capacity, to acquire an insurance policy held in trust by substituting other assets of equivalent value will not, by itself, cause the value of the insurance policy to be includible in the grantor's gross estate under § 2042, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.”

Thus, Rev. Rul. 2011-28 gives a favorable answer to a long-standing question about the effect of a power of substitution in the context of a life insurance trust. Planners would be well advised, however, to follow the roadmap laid out in the ruling, including the requirement of a written certification as to value and review of that value by the trustee. While best faith efforts in this regard (including reliance on a statement from the issuing insurance company, where available) should suffice, the prudent course, in cases where it is difficult to establish the value of a policy, may be to obtain an appraisal.

Any AALU member who wishes to obtain a copy of Rev. Rul. 2011-28 may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

In order to comply with requirements imposed by the IRS which may apply to the *Washington Report* as distributed or as re-circulated by our members, please be advised of the following:

THE ABOVE ADVICE WAS NOT INTENDED OR WRITTEN TO BE USED, AND IT CANNOT BE USED, BY YOU FOR THE PURPOSES OF AVOIDING ANY PENALTY THAT MAY BE IMPOSED BY THE INTERNAL REVENUE SERVICE.

In the event that this *Washington Report* is also considered to be a “marketed opinion” within the meaning of the IRS guidance, then, as required by the IRS, please be further advised of the following:

THE ABOVE ADVICE WAS NOT WRITTEN TO SUPPORT THE PROMOTIONS OR MARKETING OF THE TRANSACTIONS OR MATTERS ADDRESSED BY THE WRITTEN ADVICE, AND, BASED ON THE PARTICULAR CIRCUMSTANCES, YOU SHOULD SEEK ADVICE FROM AN INDEPENDENT TAX ADVISOR.

The mission of AALU is to promote, preserve and protect advanced life insurance planning for the benefit of our members, their clients, the industry and the general public.

For more information about how AALU's advocacy efforts help protect your business and the advanced life insurance marketplace, visit our website at www.aalu.org, or call toll free 1-(888)-275-0092.