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Assisting Clients with Outdated Life Insurance Trusts

When the fog is lifted on the future of the federal estate tax, regardless of the outcome, many affluent families will come back to the table to discuss estate planning. They will bring with them outdated wills, trusts and other various estate planning documents that need reviewed and possibly amended. One such document, the irrevocable life insurance trust, may require special attention. A last will & testament may be modified with a codicil, a living trust may be amended or terminated, but what do you do with an ILIT that has irrevocable right in its name? Clients need to be aware of the options available to them.

When the ILIT that your client has in place no longer functions in the way it was intended to due to changing family circumstances, changes in tax law or simply a change in objectives, there are a number of options:

- 1) Reformation of the trust - Most States have laws on the books which allow irrevocable trusts to be reformed under certain circumstances. For example, twenty states have enacted, wholly or partly, the Uniform Trust Code which provides a number of ways to reform an irrevocable trust. Under the UTC an irrevocable trust may be modified if the settlor and all the beneficiaries consent to the changes. The trust may also be modified if all the beneficiaries consent (without the consent of the settlor) if the modification is not inconsistent with any material purpose of the trust. Even if there is a dissenting beneficiary the courts may still approve the modification as long as the interests of the dissenting beneficiary is protected. Keep in mind that the applicable State law is the law of the State in which the trust is located. So even if the client is residing in Florida, if the trust is a Delaware trust the trust laws of Delaware will apply.
- 2) Decanting statutes – A number of States have statutes that allow a trustee to decant trust property. Essentially the trustee is given authority to make modifications to certain trust provisions by transferring trust property to a new trust with the desired terms. The consent of the settlor and beneficiaries is not typically required.
- 3) Trust protectors – The trust document may provide for a trust protector who is a named individual who is given discretion to modify the terms of the trust under certain circumstances. If a trust protector is named it may be possible for that individual to make the modifications required without petitioning the courts.
- 4) Stop paying the premiums which will cause the policy to lapse and the trust to terminate (assuming no other principal is in the trust). The client may have a new ILIT drafted, apply for a new policy and start directing premium payments towards the new ILIT. This strategy has a number of obvious disadvantages – the client will lose access to any of the cash values in the existing policy and the proposed insured(s) must be in good health.
- 5) New ILIT purchases policy from Old ILIT – The client may have a new ILIT drafted to meet their current estate planning objectives and fund the ILIT via gifts and/or loans. The new ILIT may then purchase the existing policy from the

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old ILIT. This last strategy may be the most appropriate when your clients do not wish to seek approval from beneficiaries or take the time and expense to petition the courts.

The key point is that your client's irrevocable trust may not be as irrevocable as they think. It is important that clients work with their local attorneys and insurance professionals familiar with the options available.

Taxation of Employer Owned Life Insurance Update – IRS Notice 2009-48

In June of 2009 the IRS published additional guidance on IRC §101(j) in the form of IRS Notice 2009-48. The Notice provides guidance in five different areas:

- 1) The definition of employer owned life insurance
- 2) Exceptions to the application of §101(j)(1) – timing of the notice and consent requirement
- 3) Satisfaction of the notice and consent requirement
- 4) Transition rules and §1035 exchanges
- 5) Information Reporting under §6039I and Form 8925

One of the most frequently asked questions has been whether or not any relief is available for inadvertently failing to comply with the notice and consent requirements of IRC §101(j). With regards to that question the Notice stated the following:

Q-13. How can an inadvertent failure to satisfy the notice and consent requirements of § 101(j)(4) be corrected?

A-13. Section 101(j) does not contain a provision for correcting an inadvertent failure to satisfy the notice and consent requirements of § 101(j)(4). The Service will not, however, challenge the applicability of an exception under § 101(j)(2) based on an inadvertent failure to satisfy the notice and consent requirements if the following conditions are met:

- (1) the applicable policyholder made a good faith effort to satisfy those requirements, such as by maintaining a formal system for providing notice and securing consents from new employees;
- (2) the failure to satisfy the requirements was inadvertent; AND
- (3) the failure to obtain the requisite notice and consent was discovered and corrected no later than the due date of the tax return for the taxable year of the applicable policyholder in which the employer-owned life insurance contract was issued. Because § 101(j)(4)(B) requires that the employee's consent be written, failure to obtain such consent cannot be corrected after the insured employee has died.

While Notice 2009-48 is effective June 15, 2009, the IRS will not challenge a taxpayer who made a good faith effort to comply with IRC §101(j) based on a reasonable interpretation of the statutory provision prior to the effective date. It is important to keep in mind that failure to comply with IRC Sec. §101(j) consent and notice requirements will cause the death benefits to be subject to income taxes.

Correction on *Cochran v Keybank* Article

In the previous issue of our Professional Advisor Update we included an article titled *Cochran v KeyBank* – Prudent Investor Rule and Trust Owned Life Insurance. The article mistakenly stated in the last sentence that “the plaintiff prevailed in large part due to their attempts to delegate the monitoring of the life insurance policies to outside advisors.” That sentence should have stated that “the defendant prevailed” for the reason stated.

For questions or comments please contact (800) 966-9306

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