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Spousal Lifetime Access Trust (SLAT) Brief

Situation, Goals & Objectives

- Couple has an estate valued at $20 million. They are working with an estate planning attorney to develop a plan to maximize their lifetime gift exemptions, reduce their taxable estates, and maintain as much control as possible of their assets.
- They have determined they need liquidity at each of their deaths to pay any estate expenses and taxes. Moreover, if Spouse 1 dies first, additional liquidity is needed to support the family.

The Concept

The attorney creates a Spousal Lifetime Access Trust (SLAT) with Spouse 1 as the grantor.

- The SLAT is an irrevocable trust for the benefit of Spouse 2 and the children. Spouse 1 transfers up to Spouse 1's unused federal gift tax exemption amount of his/her separate property to the trust. Spouse 1 files a gift tax return and utilizes his/her lifetime exemption. A trustee is chosen. Spouse 2 can be the trustee if the trust is properly written; however, it is wise to also have an independent co-trustee. If Spouse 2 is the trustee, distributions to that spouse/beneficiary must be limited independent trustee can be given the right to make distributions for any purpose. Spouse 2 also can be given the right to withdraw annually the greater of $5,000 or 5% of trust assets. When the trust beneficiaries include a spouse or children, it is important that the grantor of the trust, here Spouse 1, is not relieved of any support obligations that are owed to the beneficiaries. If the grantor is relieved of support obligations, a portion of the trust can be included in the grantor's estate at death.
- The trustee purchases a life insurance policy on Spouse 1. It is important that Spouse 1's separate property is used to fund the trust and for any subsequent contributions to the trust to avoid inclusion in Spouse 1's estate.
- During both spouses' lifetimes, the trustee can make distributions according to the trust terms. After Spouse 2's death, assets can remain in trust for the children. The trust can allow the children to be their own trustees if desired.

The trustee will have access to policy cash value in the SLAT during the insured's lifetime, giving the family a great deal of flexibility. Note that withdrawals and unpaid loans will be protected from lawsuits and creditors. Plus Grantor 1's estate has been reduced.

Insights and Caveats

Potentially, a trust can be created by the other spouse; however, certain additional considerations apply.

- Several months later, Spouse 2 could create a SLAT for Spouse 1 and the children.
- The trust setup is similar to the first SLAT. However, it is important that the trust terms are not the same. Possible differences can be: the distribution standard, when the property passes outright to the children, different beneficiaries, different trustees, etc. The attorney should work closely with the spouses to draft the trusts so that the reciprocal trust doctrine is not applicable. Basically if the reciprocal trust doctrine applies, the IRS will "uncross" the trusts, and treat the trusts as if Spouse 1 were the grantor and beneficiary of SLAT #2 and Spouse 2 were the grantor and beneficiary of SLAT #1.
- Assets in both trusts can receive protection from lawsuits and creditors; plus both estates have been reduced. ■

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Spousal Lifetime Access Trust (SLAT) Analysis

Situations

An irrevocable trust can be an excellent vehicle for providing controlled distributions of assets to heirs, while at the same time keeping the trust proceeds outside the grantor's taxable estate. One major drawback, however, is that in order to accomplish these objectives, such a trust must be irrevocable and the grantor cannot directly receive any benefits from the trust, and at best can hold very constrained control over the trust. Many people are unwilling to create an irrevocable trust because they are hesitant to give up access to, and management of, a large portion of their wealth.

However, two trust designs exist that provide a grantor's spouse limited accessibility during the spouse's life, while keeping the assets within the trust out of both the grantor's and the spouse's taxable estates. One is the SLAT mentioned above; the other is the Survivorship Spousal Trust (or Survivor Life SLAT).

Requirements and Logistics

Spousal Lifetime Access Trust

In a SLAT, the trust must be irrevocable and the grantor/insured must not have any incidents of ownership in an insurance policy on the grantor owned by the trust. Someone other than the insured should serve as trustee of the trust. The spouse may serve as trustee; however, certain limitations must be placed on his or her powers to make distributions to him or herself, in order to avoid inclusion of the trust principal in his or her estate. A concern arises if an individual is both a trustee and a beneficiary, and the trustee has discretion to distribute assets to him or herself. Under Internal Revenue Code (Code) §2041, such discretion can amount to a general power of appointment, which causes inclusion in the power holder's estate. To avoid this result, the trustee's power to distribute assets to himself or herself should be limited to an ascertainable standard" (one a court can enforce) related to health, education, support, and maintenance. The second limitation is known as the "5 or 5 power." In a SLAT, because the grantor's spouse is a beneficiary of the trust, the spouse's right as a beneficiary to withdraw assets from the trust in any one year can be limited to the greater of $5,000 or 5% of trust assets. If the spouse can withdraw more, the Internal Revenue Service (Service) could include that portion of the trust assets in the spouse's estate. The Service might argue the lapse of the right to withdraw the excess amount is the release of a general power of appointment. Under §2041(a)(2), the value of a decedent's estate includes the value of property subject to a general power of appointment if the release leaves in place a power forbidden under Code §2035-2038, such as a right to income. Under the gift tax law, gifts in amounts less than a specific dollar value (currently $14,000, subject to cost of living adjustments) may be made to each of an unlimited number of recipients annually. Such gifts are excluded from gift taxation only if they are "present interest" gifts, meaning that the recipient has current enjoyment of the gift. Gifts to trusts ordinarily would not convey immediate enjoyment to the trust beneficiaries, and thus would ordinarily be excluded from gift taxation. To convey immediate enjoyment, a beneficiary can be given a temporary right to withdraw the trust gift. A trust agreement will typically provide that a beneficiary's withdrawal right will lapse after a certain time (e.g., 30 days, 60 days). If the trust has more than one beneficiary, the lapse can trigger deemed taxable gifts between the beneficiaries. A withdrawal power is also a general power of appointment because the power holder can appoint property to him or herself. Code §2514 provides that the lapse of a general power of appointment is a taxable transfer to the extent the amount subject to all general powers of appointment exceeds the 5 or 5 amount. The deemed gift is a gift of a future interest and is not eligible for the annual exclusion.

If the grantor's spouse must serve as trustee, a combination of the 5 or 5 power and the ascertainable standard can exclude the value of the trust property from both the grantor's and the spouse's estate, while at the same time provide substantial access to the life insurance policy's cash value (or other trust assets).

On the other hand, if the client is looking for the most flexibility, in order to avoid the limitations of the 5 or 5 power and the ascertainable standard, a discretionary trust could be created. This would provide greater access to the trust principal. Because a trustee other than the spouse would be used, however, there is a risk that the trustee would be unwilling to make the desired distributions to the non-insured spouse. This risk may be mitigated by using a trustee who is attuned to the legitimate needs of the beneficiaries (e.g., family member, close personal friend). When funding a SLAT, it is important that the grantor use his or her own separate property. If any contributions to the trust are from property owned by the uninsured spouse, the uninsured spouse would be treated as a grantor of the trust, and his or her status as both grantor and beneficiary would cause inclusion of the trust property within the taxable estate at the uninsured spouse's death. It is particularly important to take preventative measures to avoid contributing assets of the uninsured spouse in community property states where both spouses are considered to own half of all community property. This may be accomplished by partitioning community assets into separate property and using the grantor's partitioned assets for contributions to the trust.

Also, if the grantor is considering the transfer of an existing life insurance policy to the trust, the uninsured spouse should gift any interest he or she owns in the policy to the grantor spouse before transferring the policy to a trust. (In community property states, partitioning of the policy may be required first.)

While it may appear that each spouse establishing a SLAT for the other's benefit could achieve additional leverage, couples must exercise caution. If two similar SLATs are created, the Service could look through the transactions and apply the reciprocal trust doctrine. This doctrine assumes each spouse established a trust for his or her own benefit, thus resulting in estate inclusion of the trust property for each spouse.

One major drawback of the SLAT is that the ability to access the trust comes only through the spouse's interest as a beneficiary. If the spouse should die before the grantor or if there is a divorce, this access may be lost. If the grantor remarries, the trust may provide that his or her new spouse may become the trust beneficiary. If the grantor does not remarry, he or she may still have access to the trust assets if the trustee has the power to lend trust property to the grantor. Repayment would become an obligation of the grantor and/or the estate.It should be stressed that access to the trust is not unlimited. If the spouse exercises a withdrawal right and consistently uses those distributions for the grantor's benefit, this could be considered a retained interest, thus triggering inclusion of the trust principal in the grantor's estate. To avoid this result, trust distributions should be used for the primary benefit of the uninsured spouse.

Survivorship Spousal ILIT or Survivor Life SLAT

An alternative to the Single Life SLAT is known as the Survivorship Life SLAT. Here, instead of using a single life policy to fund the ILIT, a survivorship policy is used. The only real difference between the Single Life SLAT and the Survivor Life SLAT (other than the type of policy used to fund the trust) is in the selection of the trustee. In order to avoid creating an incident of ownership and thereby inclusion of the trust-owned life insurance policy within either spouse's estate, neither spouse should serve as a trustee of the Survivor Life SLAT. Instead, a family member or close friend is typically named trustee.

As in a single life SLAT, only one of the two spouses should be the grantor of the trust. The grantor wants to be sure to use separate property to fund the trust. In addition, reciprocal trust issues are a concern if each spouse creates a trust.

When designing the permanent life insurance policy for a Survivor Life SLAT, if the policy is to be funded with annual exclusion gifts from the grantor (as described above), the clients also should consider one or more alternative funding strategies, in the event the grantor spouse dies before the premiums on the survivorship policy are fully paid. Otherwise, if the grantor is the first of the two insureds to die, the SLAT may lack the additional funds it will need to maintain the policy in force until the death of the second insured spouse.One alternative funding strategy to consider is for the SLAT to purchase a first-to-die term rider on the life of the grantor for a death benefit amount equal to the scheduled premiums. If the grantor dies while the first-to-die term rider is in force, the SLAT could then use the death benefit proceeds it would receive upon the grantor's death to help it fund any remaining premiums on the survivorship policy. Alternatively, if the grantor lives long enough and completes the funding of the survivorship policy, the first-to-die coverage could be dropped. A second strategy to complete the funding of the SLAT in the event of the grantor's premature death would be for the grantor to bequeath to the SLAT the additional funds it would need to complete the funding of the survivorship policy. This strategy could easily be implemented pursuant to a formula clause in the grantor's will or living trust.

Tax Ramifications

The primary goal of creating an irrevocable trust is to remove the trust assets from the grantor's gross estate for estate tax purposes. However, there are several ways an irrevocable trust can be includible in the grantor's estate. First, §2036 of the Code provides that a decedent's taxable estate includes any property transferred by the decedent in which the decedent retained a beneficial interest (including the right to income), or the right to control who owns or enjoys the use of the property. Section 2036 may apply indirectly if the trustee has the ability to control the ownership or use of the property and the grantor can replace the trustee with him or herself.

A second basis for inclusion is §2038 of the Code which requires inclusion of assets transferred if the decedent retained the right to alter, amend, revoke or terminate the terms of the recipient's enjoyment of the property. Section 2038 may apply indirectly if the trustee has the ability to change the terms of the beneficiaries' enjoyment of the property, and the grantor can replace the trustee with him or herself. If the trust owns permanent life insurance policies on the grantor's life, §2042 of the Code could require inclusion of the proceeds of the policies in the grantor's estate if the grantor/insured has any incidents of ownership over the policies. An example might be the right to borrow against the policy's cash surrender value. Similarly, if the grantor/insured transferred existing policies on his or her life to the trust and died within three years of the transfer, §2035 of the Code would cause inclusion of the policies in his or her taxable estate. Therefore, a properly drafted SLAT will not:

- Grant any beneficial interest to the grantor,
- Give the grantor any power to replace the trustee with himself or herself, or
- Give the grantor any incidents of ownership in the policy. ■

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Reciprocal Trust Doctrine

Overview

With the increased lifetime gifting opportunities, clients are often faced with seemingly conflicting objectives of reducing the taxable estate and retaining access to transferred assets at some point in the future. An irrevocable trust, created and funded by one spouse that names the other spouse as a permissible beneficiary (commonly referred to as a Spousal Access Trust or "SAT"), could be a way for an individual to make lifetime gifts of assets to an irrevocable trust, yet allow the beneficiary spouse to receive benefits in the future, which might indirectly benefit the grantor spouse. Husband and wife may each attempt to establish a trust benefitting the other to increase the amount transferred outside of the taxable estate, yet ensure that regardless of which spouse is the first to die, the surviving spouse continues to have access to at least a portion of the total transferred assets. When considering such an arrangement, planners should be extremely careful of the potential impact of the reciprocal trust doctrine. The reciprocal trust doctrine is a judicially-created doctrine developed in response to the perceived tax-avoidance where two parties create trusts for each other which, in effect, leave each other lifetime enjoyment over property while avoiding inclusion in the gross estates. Thus, if a husband and wife wish to employ the SAT technique for each other, it will be crucial to draft the trusts in a way that avoids application of the reciprocal trust doctrine.

The following seeks to summarize several pertinent court cases and IRS private letter rulings, highlighting the varying interpretations of the reciprocal trust doctrine handed down by the U.S. Supreme Court. These cases and rulings may provide guidance in drafting trusts that might successfully meet most, if not all, of the client's objectives.

Court Cases and IRS Rulings

Estate of Grace

The seminal U.S. Supreme Court case, *U.S. v. Estate of Grace,*[1] clarified a split among Circuit Courts as to the requirement of a "bargained-for" exchange in order to apply the reciprocal trust doctrine. The Court in *Grace* held that application of the doctrine would not depend on a "finding that each trust was created as a quid pro quo" for the other.[2] In order to apply the doctrine, the court required that the trusts be (1) "interrelated" and (2) that the arrangement leave the two grantors in "approximately the same economic position" as if they had created the trusts and named themselves as beneficiaries.[3] The Court concluded in Grace that the trusts created by Mr. and Mrs. Grace, naming each other as beneficiaries, were interrelated as they contained substantially identical terms, were created at the same time (15 days apart), and were part of a single transaction "designed and carried out by the decedent," Mr. Grace.[4] In addition, the trusts left each party in the same economic position, as each party continued to have an economic interest in trust property which would result in inclusion in the estate if the beneficiary were deemed to be the grantor of the trust. The Court "uncrossed" the trusts and concluded that Mr. Grace's estate should include the value of the trust established by Mrs. Grace in which her husband was a beneficiary, as if he had established and funded the trust himself.

There have been no reported court cases on point with the SAT technique since *Grace* where the grantor's spouse is given a right to trust income and/or principal. However, the interpretation of the doctrine in subsequent cases is illustrative as to how a court may apply the test outlined in *Grace* to future cases. Subsequent to *Grace*, the application of the reciprocal trust doctrine has been uncertain for several reasons. First, the Court in Grace did not define how it would test the "interrelatedness" of two trusts. Subsequent courts have expanded the relevant factors to include the identity of beneficiaries, identity of trustees, relationship of the grantors, and the corpus of the trusts, among other considerations. In addition, the "economic position" element of the *Grace* test has been expanded, as will be seen below.

Estate of Bischoff

In *Estate of Bischoff,*[5] the Tax Court applied the reciprocal trust doctrine to trusts established by a husband and wife, which named the other spouse as the trustee and the grandchildren as trust beneficiaries. The husband and wife were not trust beneficiaries. However, they were given, as trustees, the discretionary right to make income and principal distributions. The court concluded that the trusts should be "uncrossed" because they were interrelated. The court then determined that after uncrossing the grantors of the trusts, there was a basis for estate taxation under Section 2036(a)(2) and 2038(a)(1) where a grantor retains the power to determine who may possess or enjoy trust property. The court in *Bischoff* was unconvinced that the Supreme Court in Grace would provide for taxation of trust assets based on a retained life estate under Section 2036(a)(1), but would allow a transfer to escape taxation even if upon uncrossing two interrelated trusts, there would be potential inclusion under a different Code section. It appears that the court uncrossed the trusts solely on the basis of finding interrelatedness between the two trusts. After uncrossing the trusts, the court looked to see if the deemed transferor held a power or interest which would result in inclusion in the deemed transferor's estate.

Exchange Bank and Trust

The Federal Circuit Court followed the *Bischoff* rationale to conclude that UGMA accounts established by a husband and wife, naming each other as custodians were reciprocal, and therefore should be included in the estate of the husband who died while serving as custodian.[6] The court stated that the transfers were interrelated as they were made as a result of a common plan. In addition, "each spouse gained custodianship over assets equal in value to those assets relinquished, thus each donor was in the same economic position as one who transfers assets to himself as custodian.[7]" Thus, the court found a basis for uncrossing the custodial gifts and including assets in the husband's estate under §§ 2036 and 2038.

It appears from contemporary interpretations to the test as outlined in *Grace* that a taxpayer may avoid application of the reciprocal trust doctrine by employing one of two methods. (1) Avoid a characterization of the trusts as interrelated; or (2) even if the trust grantors are uncrossed, ensure that the grantor retains no power or interest which would result in inclusion in the grantor's estate. It would appear that with the SAT technique in which each spouse creates and funds a trust, it will be imperative to avoid a ruling that the trusts are interrelated, if the non-grantor spouse is to be a permissible beneficiary of each trust.

Estate of Levy

Often, the case of *Estate of Levy*[8] is cited as providing a potential solution to avoiding the creation of interrelated trusts by giving one spouse, but not the other, a special power of appointment over trust assets. Thus, husband and wife could each create irrevocable trusts, naming the other spouse as a beneficiary. By giving only one spouse a special power of appointment, the trusts would not be considered interrelated as they would not have substantially identical terms, a requirement outlined in *Grace*. While the *Levy* court concluded that the trusts established by husband and wife were not interrelated, there are important facts to note in interpreting this case. First, *Levy* is not a case in which the husband and wife were beneficiaries of each other's trusts. Rather, husband and wife set up trusts on the same day, named each other as trustees with their son as the beneficiary. The court did not address whether the reciprocal trustee issue (as seen in *Bischoff* and *Exchange Bank & Trust*) would apply. Rather, the IRS agreed to a stipulated outcome that the reciprocal trust doctrine would not apply if the special power of appointment given to the wife was considered valid under New Jersey state law. Thus, while the *Levy* case may provide some support as to the use of a special power of appointment to break the interrelated prong of the reciprocal trust doctrine test, it would be difficult to rely on the court's reasoning as a means to avoid the application of the reciprocal trust doctrine in the case of two SATs in which each spouse is a beneficiary of the other spouse's trust.

Private Letter Ruling 200426008

While Private Letter Rulings ("PLR") cannot be cited as precedent for future cases and are only binding between the parties referenced in the individual ruling, a 2004 PLR[9] may provide guidance on how two trusts created by husband and wife, naming each other as permissible beneficiaries, may be drafted to break the interrelated prong established in *Grace*. The facts presented in the PLR are as follows: Husband wishes to create a trust for the benefit of his wife and son, naming the wife as trustee. Husband wishes to contribute separate assets to the trust. Wife also wishes to establish a trust for the benefit of her husband and son, naming the husband as trustee and funding the trust with her sole and separate property. In the ruling, the IRS found five differences between the two trusts, and based on these differences, reached the conclusion that the trusts were not substantially identical and thus were not interrelated. Despite the fact that there may be a reciprocal trustee argument (although not addressed by the IRS in the ruling) and likely a reciprocal beneficiary argument (leaving the husband and wife in the same economic position), because the first prong of the *Grace* test was not met, the reciprocal trust doctrine would not apply.

The five differences between the two trusts listed in the ruling are the following:

- Husband's trust gives wife the right to withdraw the greater of $5,000 or 5% of trust assets, but only if the son were to predecease the wife.
- Husband's trust gives wife a special power to appoint trust assets to husband's issue or spouses of issue, but only if the son predeceases the wife.
- Husband's trust gives wife a testamentary special power to appoint trust assets to husband's issue or to a charity, but only if the son predeceases the wife.
- If husband's trust establishes a marital trust, wife has a testamentary special power to appoint marital trust assets to husband's issue or to charity.
- Wife's trust provides that husband is a permissible beneficiary of the trust *only* if husband's net worth is less than a stipulated amount and *only* after wife has been deceased for two years. This limitation would not apply to a marital trust created under the wife's trust, presumably to allow the trust to qualify for the marital deduction.

While the first four provisions may be considered nominal or minor changes, the fifth difference, included in the wife's trust, may be viewed as a substantial difference that would break the interrelated prong. The drafting of the trusts analyzed in the PLR may be a creative way to avoid application of the reciprocal trust doctrine, while ensuring that one spouse (potentially the non-"breadwinner") would always have access to the trust in which he/she is the beneficiary. The other spouse (possibly the "breadwinner") would have limited access as a permissible beneficiary to the trust established for his/her benefit, which presumably may be suitable as he/she would likely have sufficient assets or earning capacity for his/her needs, leaving the trust as an asset of last resort.

Structuring Trusts to Avoid the Reciprocal Trust Doctrine

In addition to the above mentioned differences, one might consider incorporating one or more of the following variations into SAT planning:

- Avoid a potential reciprocal trustee argument by naming different third party trustees, or co-trustees, for each trust.
- Fund the trusts with separate, different assets.
- Include different distribution standards, such as allowing one trustee to distribute income and principal based on the trustee's discretion, while allowing the other trustee to distribute income and principal subject to an ascertainable standard, such as health, education, maintenance and support.
- Draft one trust to continue for multiple generations while the other trust will distribute assets based on a vesting schedule.
- If the trusts are to be used in a leveraged asset shift, structure one trust as a grantor retained annuity trust and the other shift as a sale to an intentionally defective grant or trust. ■

[1] 395 U.S. 316 (1969).

[2] Id. at 324.

[3] Id.

[4] Id. at 325.

[5] 69 T.C. 32 (1977).

[6] Exchange Bank and Trust Company of Florida v. United States, 694 F.2d 1261 (1982).

[7] Id. at 1263.

[8] T.C.M. 1983-453.

[9] Priv. Ltr. Rul. 200426008 (June 25, 2004).

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Transferring a Life Insurance Policy to an Irrevocable Trust

Overview

The irrevocable life insurance trust (ILIT), when structured properly, is a staple of estate planning for high net worth families. An ILIT can provide a means to make leveraged transfers to heirs free of both estate and income tax. Ideally, the trust is drafted prior to application for and purchase of the life insurance policy that it will eventually hold as its primary asset. However, circumstances may arise which result in a need to transfer an *existing* policy into a trust. In this event, special measures must be taken to preserve the income and estate tax benefits of the ILIT. Generally, section 2035 of the Internal Revenue Code ("Code") provides that a transfer of a policy by an insured within three years of death will result in estate inclusion of all policy proceeds. However, under section 2035(d), the 3-year inclusion rule does not apply to a bona fide sale for adequate and full consideration. A sale of a policy to a trust, however, gives rise to its own set of issues, namely: policy valuation, trust funding, and the transfer for value rule under section 101(a) of the Code.

Policy Valuation

Since the three year rule does not apply to a bona fide sale for adequate and full consideration, it is crucial that the policy be appropriately valued—otherwise, a policy transferred for less than full value will be treated as a part gift/part sale. Such transfers would result in estate inclusion, under the three year rule, of policy proceeds in excess of the consideration received.

A policy should be sold for its fair market value. Generally speaking, the fair market value of a permanent policy will be equal to its interpolated terminal reserve plus unearned premiums. (However, in the first year of a policy's issue, the value typically will be premiums paid.) The value of a term policy will generally be equivalent to unearned premium.

This information can be obtained by requesting Form 712 from the insurance carrier.

Note, however, that the carrier will typically not provide a precise value to be used for gift tax purposes. Information provided on Form 712 may serve as evidence of the fair market value price, but actual fair market value may differ depending on the type of policy in question and other outside factors present. For example, in the case where death of the insured is imminent, fair market value of the policy may be closer to the death benefit face amount. Therefore, clients contemplating a sale should consult their CPA for guidance on valuation. If the situation warrants, the most conservative approach would be to obtain a professional appraisal

Trust Funding

To effect a sale of a policy to an irrevocable trust, the trust will need to obtain the consideration by some method. Typically, this can be accomplished through annual exclusion gifts to the trust, or perhaps through a single lifetime applicable exclusion gift. While a more aggressive planner might employ a promissory note, repayment at the applicable federal rate is still required. Of course, future annual gifts would then be needed to satisfy ongoing premiums and to service the note.

Transfer for Value Rule

While the bone fide sale strategy can prevent application of the 3-year rule, it can trigger application of the transfer for value rule in the absence of proper planning. Under section 101(a)(1) of the Code, transfer of a life insurance policy for valuable consideration results of the loss of the otherwise tax-free treatment of death proceeds. However, an exception to this transfer for value rule is where the policy is transferred to the insured. The sale of a policy to a grantor trust (in which the insured is the grantor) would fall under this exception to the transfer for value

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rule. Rev. Rul. 85-13 suggests that an existing life insurance policy can be sold by a grantor to a grantor trust without transfer for value issues, and Rev. Rul. 2007-13 specifically provides that a non-grantor trust's sale of an existing policy to the insured's grantor trust also falls into the exception.

A "grantor trust" is a trust that treats the grantor as the owner of the trust for income tax purposes. The owner must include all items of trust income, gain, loss, deductions, and credits in calculating the owner's individual income tax liability. To create a grantor trust, planners typically will grant one or more of several powers as listed in the Code to the grantor or a third person. For example, if the grantor or a third person has the right to acquire trust assets in a non-fiduciary capacity by substituting assets of equivalent value, the trust will be a grantor trust. I.R.C. § 675(4). Of course, it is imperative to avoid certain powers that will cause the trust to be a grantor trust, but will also cause inclusion of the trust in the grantor's estate for estate tax purposes. For example, a power to revoke the trust causes grantor trust status, but also causes inclusion. I.R.C. §§ 676(a), § 2038(a).

Besides avoiding transfer for value treatment, grantor trust status has the added advantage of eliminating tax on sales of appreciated property between the grantor and the trust (important if the policy has built in gain), and taxable interest income is eliminated on notes between the grantor and trust (although interest should still be paid on any notes for a debt to be respected). ■

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