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## ILIT REFORMATION SAVES FEDERAL ESTATE TAX INCLUSION: PLR 200615025\*



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### SITUATION

H created an irrevocable life insurance trust (ILIT) that owned life insurance (H was the insured.) H also created a revocable trust (Trust B) that contained the usual marital deduction/ Unified Credit sub- trusts.

### PROBLEM

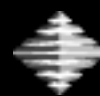
The ILIT contained provisions that permitted the distribution of income and principal to the surviving spouse and ultimately the children. The ILIT also contained a serious tax flaw in that it directed the trustee to distribute the trust assets to Trust B (the revocable trust) after W's death. Since H (prior to his death) could still change the provisions of his revocable trust (Trust B), he still had control over the assets in the ILIT. This control would give rise to federal estate tax inclusion under a variety of Internal Revenue Code sections, including IRC Section 2036 Transfer with Retained Life Use.

### SOLUTION

Upon review of the ILIT, this error was discovered. The clear intention of H was that he give up control over the ILIT. To remedy the problem, H petitioned the appropriate local court (usually the Probate Court) to "reform" the trust based on theory that the flaw was a "scrivener's error" i.e., the trust as drafted did not reflect H's intent.) The Court did grant the reformation. (Essentially, the "pour back to Trust B" provisions were eliminated.)

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## **SIGNIFICANCE**

ILIT's are a routine recommendation in many estate plans. But they are not "cookie cutter" documents and should always be read carefully before execution. In this case, the client was "lucky" in that this error was discovered before he died. The IRS might not have been so generous after H's death. The "fix" (the trust reformation and subsequent PLR request) undoubtedly cost money, time, and uncertainty on the part of the clients.

Nor should any taxpayer rely on the IRS to rescue a bad situation just because they originally had the "right intent." The IRS stamps every private letter ruling with warning that it "only applies to the taxpayer who requested it" and they mean it.

Special note: Universal life insurance policies, have charges such as premium based loads, cost of insurance, administrative and issue charges and surrender charges. These charges are different for each product and some may vary by age, gender, face amount, underwriting class, premiums and policy durations. These charges will have a significant impact on Policy Account Values.

In addition to these charges, certain universal life policies also have a mortality and expense risk charge and the underlying subaccounts have operating expenses, which include management fees and 12b-1 fees, if applicable. These expenses may also have a significant impact upon Policy Account Values.

Together with the additional charges, these expenses are reflected in each product's prospectus and should be reviewed with your client. Policy Account values for variable universal life policies vary with actual underlying fund performance. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.

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