

Have Irrevocable Life Insurance Trusts Been Dealt a Lethal Blow?

Recently, a recent federal court, the United States District Court for the Eastern District of Virginia, ruled that a life insurance company did not have to pay the life insurance proceeds to the irrevocable life insurance trust of the insured because the trust lacked an insurable interest in the insured. Now, before everyone gets excited and loses faith in the viability of life insurance trusts, the case and its meaning need to be examined in further detail. The compelling question is whether this case will cause other courts to more closely examine whether insurance trusts have insurable interests. An insurable interest is a matter of state law and the case at hand applied the Maryland insurable interest law to the factual circumstances.

The rather bazaar factual circumstances of this case clearly led the court to find for the insurance company. The proposed insured originally applied for life insurance listing his physician's spouse as the owner. The insurance company refused to issue the insurance citing that the proposed owner of the insurance, the physician's spouse, lacked an insurable interest in the proposed insured. Then the proposed insured resubmitted the application for insurance listing himself and his physician's spouse as proposed owners of the life insurance each in his/her capacity as Trustee of an Irrevocable Trust which was for the benefit of the physician's spouse. The insurance company issued the \$1.0 mil. of insurance and, at a later date, increased the insurance from \$1.0 mil. to \$2.45 mil.

Additional relevant facts include the representations made by the insured both at the time the application was submitted and subsequently when the insurance coverage was increased. There were various misstatements about the medical condition of the proposed insured and various meetings the insured had with physicians were not disclosed. The court decided the case in favor of the insurance company to the surprise of few. The courts stated that, "The Defendant's insurance application was reasonably calculated to elicit the information that the decedent omitted in this case." In layman's terms, the insured lied on the application; therefore, the insurance company did not have to pay.

The concerning issue for estate planners is the reasoning for the court's decision beyond the attempted fraud by the proposed insured. The court indicated that, "Finally, even absent a material representation, the Plaintiff's (the physician's wife as the beneficiary) claim necessarily fails as a matter of law because the trust maintained no insurable interest in the life of the decedent thus rendering the policy void."

In reaching this conclusion, the court applied Maryland law as the policy and the documents procuring the increase in the insurance were delivered in Maryland. I will not examine all of the Maryland law, but in relevant part such law provides that, "one has an insurable interest in those related closely by blood or law." Additionally, "An insurable interest exists where one has a lawful and substantial economic interest in the continuation of the life, health (or) bodily safety of the individual." Finally, the

Maryland law provides that, “an interest that arises only by the death, disablement or injury of an individual is not an insurable interest.”

The court, in finding that the trust did not have an insurable interest, reasoned that, “The Trust promised to gain more assets upon the decedent’s death, i.e. death benefits under the policy, than it would have in the event that the decedent had lived. Further, the trust suffered no detriment, pecuniary or otherwise, upon the death of the decedent. As such, the Trust maintained no insurable interest in the life of the decedent.”

Given that all life insurance trusts “gain more assets” as a result of the deaths of the insureds, does this mean that none have insurable interests? Although a literal reading of the court’s reasoning could lead to this conclusion, I think that one needs to look further. Who are the beneficiaries of the trust? Do those individuals have insurable interests? For what purpose(s) was the trust created? If for a valid business reason, does that constitute an insurable interest? After carefully considering the factual circumstances, review the insurable interest rules of your state.

The decision of the U.S. District Court has been appealed to the U.S. Court of Appeals for the 4th Circuit so the fat lady has not yet sung. However, if the ruling stands other courts could follow the reasoning. Stay tuned for further developments, but I would not avoid the use of an irrevocable life insurance trust if it is an appropriate component of your estate plan.

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