

Irrevocable Life Insurance Trusts in Event of a Divorce

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When a married parent creates an irrevocable trust for the benefit of his or her children, the married parent, as the creator or settlor of the trust, often provides for his or her spouse to have certain rights with respect to the trust. For example, the settlor may name his or her spouse as a trustee of the trust or include the spouse as an income beneficiary of the trust during the spouse's lifetime, with the principal being held for the benefit of the children. Although it may be difficult to plan for the "what if" of a divorce in establishing a trust, the trust document should contemplate to what extent a former spouse will remain as a trustee or beneficiary of the trust in the event of a divorce.

Parents/spouses frequently establish an irrevocable life insurance trust ("ILIT") in which the trust is both the owner and beneficiary of life insurance policies on the settlor's life, with the insurance proceeds paid to the trust, avoiding the payment of federal estate tax. By definition, an ILIT is irrevocable. This can present serious problems if the settlor and his or her spouse later divorce and the former spouse is included as a beneficiary or trustee of the trust. Divorce lawyers should be aware of various techniques to address the removal of a former spouse as a beneficiary or trustee of an ILIT and other irrevocable trusts, such as qualified personal residence trusts ("QPRTs") and grantor retained annuity trusts ("GRATs").

As a preliminary matter, Sections 6111.1 and 6111.2 of the Pennsylvania Probate, Estates and Fiduciaries Code (the "PEF Code") address the effect of divorce (and pending divorce) on a spouse's interests with respect to certain revocable transfers and beneficiary designations, but not irrevocable transfers or beneficiary designations that are for the indirect benefit of a spouse.

Ideally, the ILIT will contain preventative measures that address the possibility of divorce. For example, the trust may be drafted in such a way so that a former spouse is treated as having predeceased the settlor for all purposes of the trust. The trust also may contain a provision that defines the settlor's children as children of the marriage, so that trust assets could not be used for the benefit of any children of a settlor's subsequent marriage.

If the terms of the ILIT do not exclude the former spouse as a beneficiary of the trust, then, as part of the overall resolution of the economic issues of the divorce, the settlor should ask the spouse to disclaim, renounce or otherwise waive his or her rights in the trust.

Another option is for the settlor and/or the trustee and beneficiaries of the ILIT to modify the terms of the trust with court approval or by a nonjudicial settlement agreement without

court approval, pursuant to the Pennsylvania Uniform Trust Act (see generally, Chapter 77 of the Pennsylvania PEF Code). If consent of the beneficiaries is required, then all beneficiaries – including contingent and remainder beneficiaries – must agree to the proposed modifications, which could be done in part through principles of representation. Pursuing this option may inevitably result in pitting a child against his or her parent as they may have conflicting interests in the trust.

In some circumstances, a trust may not be modified if the modification is inconsistent with a material purpose of the trust. It is unclear whether the removal of a spouse as a beneficiary, even with the spouse's consent, would violate a material purpose of the trust. Another consideration is that if a spouse relinquishes his or her income or principal interest in the trust by consenting to a modification, the spouse could be treated as making a gift to other beneficiaries of the trust. The spouse's advisors should be aware of any unintended gift tax consequences.

A fourth option to getting a spouse out as beneficiary is for the trustee to sell any insurance policies owned by the ILIT to a new ILIT that does not include the spouse as a beneficiary. The new ILIT could purchase the policy from the existing ILIT at its fair market value (typically the "interpolated terminal reserve value" of the policy), leaving just the sales proceeds, and not the policy proceeds payable upon the death of the settlor, in the existing ILIT. A sale of an insurance policy could, however, raise questions of whether the trustee of the existing ILIT has breached his or her fiduciary duty to the beneficiary spouse if the spouse is excluded as a beneficiary of the new ILIT. Presumably, a trustee would not take this action due to liability concerns if the former spouse was not in agreement.

Lastly, if permissible under the terms of the trust or state law, an independent trustee may "decant" the trust assets to a new trust for the benefit of one or more of the beneficiaries of the existing trust, other than the spouse. In exercising this power, care must be given to avoid any negative tax consequences. Again, presumably, an independent trustee would not take this action due to liability concerns if the former spouse was not in agreement.

Removing a former spouse as trustee is potentially an easier process, if the terms of the trust provide for the spouse's removal or the spouse agrees to resign as trustee. Most trust documents permit a trustee to resign without court approval. If the spouse is serving as trustee of the ILIT, the spouse can agree to resign as part of the marital settlement agreement, which might include an agreement as to who will serve as the new trustee, assuming this is consistent with the trust document. If the spouse is not currently serving but is named as a successor trustee, the spouse can renounce his or her rights to serve as a successor.

Divorce lawyers must be cognizant of the role of trust law in negotiating a marital settlement agreement as there may be certain benefits to the settlor of the trust in having the other spouse renounce his or her rights as a beneficiary of the trust or resign as trustee if the trust document does not permit the spouse to be removed. The benefit of resolving those issues as part of a settlement may be difficult to quantify, but such issues should be addressed as part of any

settlement, when there may still be room for negotiation, rather than attempt to be resolved when there may no longer be any incentive for the former spouse to relinquish his or her rights under the trust. As a precautionary measure, estate planning lawyers should always consider the impact divorce may have on a couple's estate plan and advise the couple of any complications or consequences that could result from divorce, particularly with respect to irrevocable transfers.