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TOPIC: One Size Does Not Fit All: Tailoring an Insurance Trust – A Menu of Options.

MARKET TREND: Blended families, mobile beneficiaries, and new approaches to trusteeships require a flexible and highly customizable approach to irrevocable life insurance trusts ("ILITs"), one of the most common legacy planning tools.

SYNOPSIS: ILITs, when tailored to the needs of the ILIT creator ("grantor"), can offer many benefits, including blended family planning, family financial security, estate liquidity, creditor protection, and centralized wealth management for ILIT beneficiaries. With proper implementation and administration, the ILIT's assets also should not be included in the grantor's taxable estate. To assist grantors in making the appropriate choices to customize their ILITs, this report provides a brief summary and a checklist of various ILIT options.

TAKE AWAYS: ILITs serve as a multi-purpose tool for dynastic legacy and life insurance planning and can address a range of needs, from generating estate liquidity by purchasing assets from the estate to providing centralized wealth management for generations of beneficiaries. ILITs also must navigate among a wide assortment of product options to find their optimal coverage, which means these trusts must have flexible powers with regard to both policy acquisition and funding. Accordingly, ILITs

must incorporate a dizzying array of options for both trustees and beneficiaries. A checklist of potential choices can make the selection process less daunting.

PRIOR REPORTS: 13-18, 14-04, 14-21, 14-31, 15-05, 16-25, 16-28.

ILITs have become increasingly popular in legacy planning as they keep the value of life insurance out of the estate while offering many other benefits, including blended family planning, family financial security, estate liquidity, creditor protection, and centralized wealth management for beneficiaries. To address these goals, however, ILITs must be highly-customized and flexible, as they typically last for multiple generations. The following provides a brief summary and a checklist of possible options to assist the grantor in the ILIT customization process.

ILIT MENU: POSSIBLE OPTIONS

The Policy. The goals for the ILIT – e.g., to provide estate liquidity, to give lifetime access to a spouse (as in a spousal lifetime access trust (“**SLAT**”)), to provide for blended family planning, etc. -- will impact the type of policy acquired by the ILIT, and, in turn, will affect the selection of trustees and various trust provisions discussed below. Basic policy considerations include:

- **Term vs. Permanent.** ILITs generally are better suited for permanent or convertible term life insurance products rather than straight term policies, due to the required formation and administrative requirements and expenses.
- **MEC vs. Non-MEC.** If the ILIT acquires a policy classified as a modified endowment contract (“**MEC**”), it will incur income tax and likely a 10% penalty on cash value withdrawals and policy loans to the extent of gain in the policy.¹ With non-MEC policies, in accordance with long-standing tax laws and principles, income tax generally does not apply to cash value withdrawals up to the policy owner’s investment in contract² or to policy loans. A preference to use a high cash value accumulation policy to meet the desire for current access to cash value, such as in a SLAT, may impact the policy selection.³
- **Single Life vs. Survivorship.** Single-life coverage may work best for a SLAT or if liquidity is desired upon the death of one spouse (e.g., to provide assets for children from a prior marriage or simply for financial planning due to the loss of a working spouse). Where the focus is estate liquidity largely for estate taxes/expenses at the death of the surviving spouse, then survivorship coverage may be the best solution.

The Trustee(s). As discussed in *WRMarketplace No. 16-25*, ILIT trustee selection is critical. Generally trustees will fall into one of three categories:

- Family members (possibly spouse or other trust beneficiaries) and friends (“FAFs”),
- Professional advisors, such as attorneys, accountants or financial advisors, and
- Financial institutions (but they may be unwilling to serve until after the insured’s death).

While FAFs may seem the easiest solution, they typically lack the knowledge, experience, and infrastructure to handle the ILIT’s administration (tax reporting, annual trust accountings, etc.). Moreover, ILIT beneficiaries and grantors often will have no recourse if a FAF breaches a fiduciary duty, due to a reluctance to sue a friend or family member and the fact that the FAF likely lacks the personal resources or errors and omissions coverage to compensate for the loss.

Using a combination of trustees (e.g., a FAF to handle trust distributions as a “distribution” trustee and a professional advisor to serve as “administrative” trustee) can maximize the benefits of each type of trustee while minimizing the issues. Note, however, that certain limitations may be required if an ILIT beneficiary serves as a trustee (see below). Also, professional advisors or financial institutions requested to serve may require special compensation provisions, liability exclusions, the location of the trust in a specific jurisdiction, and/or other terms in the ILIT agreement that the grantor may find undesirable.

Trust Distributions. These provisions are the most customizable in terms of achieving the grantor’s dispositive goals for the ILIT. Potential considerations include:

- **Distributions to Spouse.** Generally, a spouse who is not an insured under the policy and who is not an ILIT grantor can be an ILIT beneficiary during the grantor/insured’s life and/or after the grantor’s death.
- **Discretionary vs. Mandatory Distributions.** Mandatory distributions, such as to a beneficiary at specified ages, ensure that the beneficiary receives trust assets and may be desirable if the ILIT will last for only a set time (e.g. until the youngest child attains age 35). Discretionary distributions, however, will be more suitable for perpetual, “dynasty” trusts, as they can (1) let trustees address changing circumstances and beneficiary needs, (2) enhance creditor protection, and (3) allow better management of the trust’s portfolio and gain/loss realization. As noted below, a grantor can still provide non-binding guidance to the ILIT trustee on how to make discretionary distributions.

- **Precatory Guidance/Letters of Wishes.** Grantors of discretionary ILITs can provide the trustee with added guidance regarding discretionary distributions and the exercise of other discretionary powers by using non-binding (i.e., precatory) language in the ILIT agreement or providing a separate “letter of wishes.” This guidance can include desires for incentive distributions to beneficiaries for achieving certain goals, requests for the retention and management of certain assets, etc. As this guidance is not binding on the trustee, it does not limit the trustee’s flexibility to adapt to existing circumstances. Note that any precatory guidance included in an ILIT agreement generally is irrevocable and likely will be disclosed to the beneficiaries, while a letter of wishes to the trustee may be designated “confidential” and later updated by the grantor, subject to applicable state law.⁴
- **Powers of Appointment.** After the grantor’s death, an ILIT beneficiary can be given a limited power to appoint ILIT assets to the grantor’s descendants, charities, and/or others to provide flexibility and allow a beneficiary to engage in additional legacy management.
- **Ascertainable Standards.** An ILIT must impose certain limits on a trustee who is also a beneficiary, such as a spouse or descendant. For example, distributions by such a trustee must be limited to an “ascertainable standard” (e.g., for health, education, maintenance, and support), and the trustee must not be able to make distributions that would satisfy its legal support obligations. These restrictions avoid unintended estate tax consequences for the beneficiary and may also enhance creditor protection.

Grantor vs. Non-Grantor Trust. A “non-grantor trust” is treated as an entity separate from the grantor for federal income tax purposes and must report and pay taxes on its income. A “grantor trust,” however, is treated as owned by the grantor, requiring the grantor to report all trust income on the grantor’s personal income tax returns and pay the associated tax liability.

- **Grantor Trusts.** Grantor trusts can provide flexibility for funding the ILIT and incorporating future estate planning opportunities. For example, according to longstanding and appropriate tax principles, transactions between a grantor and the grantor trust or between grantor trusts with the same grantor are disregarded for income tax purposes, allowing a grantor to sell assets (including a life insurance policy) to a grantor trust without income or gift tax recognition and potentially without application of the three-year inclusion rule for estate tax purposes. Further, interest payments made by a grantor trust to the grantor on an installment sale or a

loan (such as a split-dollar loan) are not income to the grantor. The grantor's payment of income taxes on the trust's income also does not constitute a gift to the trust.

Grantor trust status occurs when the grantor or other party, such as a trustee or beneficiary, holds certain rights or powers over trust income and/or principal. As discussed in *WRMarketplace No. 2013-18*, most ILITs are grantor trusts because the trustee typically has the power, without the consent of an adverse party ("AP"),⁵ to use trust income to pay premiums on life insurance on the grantor or the grantor's spouse.⁶ Including the following powers in the ILIT can also trigger grantor trust status:

- *Income for Spouse*. The power, without an AP's consent, to distribute or accumulate trust income for the benefit of the grantor's spouse during the grantor's life.⁷
 - *Borrowing Power*. The power, exercisable specifically by the grantor in a nonfiduciary capacity, to borrow trust income or principal without adequate interest or security.⁸
 - *Substitution Power*. A nonfiduciary power exercisable by the grantor or a non-AP⁹ to reacquire assets of the trust by substituting other property of equivalent value.¹⁰
 - *Selector Power*. The power, exercisable by a non-AP with no current or future interest in the ILIT and without the consent of an AP, to add beneficiaries to the ILIT (such as charities, other designated family members (e.g., siblings, their descendants), etc.).¹¹
- **Non-Grantor Trusts**. Grantors with ILITs that will hold income-producing assets in addition to the policy may have concerns regarding the income tax burden associated with the on-going payment of the ILIT's taxes. In such situations, a non-grantor ILIT, which does not include the above powers, may be preferred. Alternatively, the ILIT provides for the termination of grantor trust status by allowing the release and/or termination of all grantor powers in the ILIT (for example, if the grantor releases a substitution power, the ILIT requires all other grantor trust power to terminate automatically).¹²

"Crummey" Withdrawal Powers. Generally, for 2016, the first \$14,000 of an individual's annual gift to another is excluded from federal gift tax. Gifts to ILITs can qualify for this annual exclusion if the ILIT gives the beneficiaries so-called "Crummey" withdrawal powers over the gift. The trustee typically provides notice of ILIT gifts to the

beneficiaries and the timeframe in which they may make withdrawals (typically 30 or 45 days). If a beneficiary does not exercise the power, the gift remains in the trust and can be used by the trustee to pay insurance premiums.¹³

Term vs. Dynasty Trust. Term ILITs generally are designed to terminate upon the occurrence of specified events and are often combined with mandatory distributions (e.g., mandatory distributions of all trust assets to beneficiaries upon attaining a set age). While mandatory terminations ensure ILIT beneficiaries receive and control all trust assets, they eliminate the flexibility for a trustee to adapt to a beneficiary's changing circumstances and the trust's ability to provide potential estate tax and creditor protection for trust assets. Perpetual or "dynasty" trusts, however, provide flexibility for the trustee, allow for the long-term growth of trust assets without estate and GST tax, and can offer consolidated wealth management, long-term creditor protection, and privacy for trust assets in the event of a beneficiary's divorce, litigation, etc.

Trustee's Duties. Over time, life insurance products evolve and the health of the insured can decline, potentially impacting the trust's policy. In addition, the amount and funding of a policy's premiums may be based on a variety of projected financial assumptions that may change throughout the years. Thus, ILIT grantors likely will want their trustees to have some duty to monitor the ILIT's policy and periodically conduct audits to gauge the policy's performance.

The trust laws of many states, however, require trustees to comply with strict "prudent investor" rules, which mandate the investment, management, and diversification of trust assets as a prudent investor would, considering the purposes, terms, and other circumstances of the trust. On the other hand, some states, like Delaware and Florida, have passed statutes that significantly minimize the trustee's fiduciary duties with respect to the ILIT's ownership of life insurance. Fortunately, most states allow ILIT grantors to customize the trustee's powers and duties, so the ILIT can strike a balance between these extremes, based on the grantor's wishes.

Decanting. Trust "decanting" is a bit of a double edged sword, since it allows a trustee to transfer assets from an existing irrevocable trust to a new or another existing irrevocable trust, which likely will have different terms. It can provide an efficient alternative to expensive judicial trust modifications and may achieve a wide range of goals, including adapting to changing beneficiary needs and/or tax and economic circumstances, but it also may result in alterations to the grantor's original wishes. Where permitted by state law, a grantor may want to include decanting provisions in

their ILIT agreements, particularly for dynasty ILITs, to help ensure flexibility over time (see *WRMarketplace No. 14-21* for a discussion of decanting).

CAUTION: DON'T GO IT ALONE

This summary and checklist serve only as a tool to facilitate ILIT planning and implementation. The drafting and execution of an ILIT should always be done with the assistance of an experienced, multi-disciplinary team that includes an attorney, accountant, and life insurance advisor.

TAKE AWAYS

ILITs serve as a multi-purpose tool for dynastic legacy and life insurance planning and can address a range of needs, from generating estate liquidity by purchasing assets from the estate to providing centralized wealth management for generations of beneficiaries. ILITs also must navigate among a wide assortment of product options to find their optimal coverage, which means these trusts must have flexible powers with regard to both policy acquisition and funding. Accordingly, ILITs must incorporate a dizzying array of options for both trustees and beneficiaries. A checklist of potential choices can make the selection process less daunting.

Checklist – Options for Irrevocable Life Insurance Trusts (“ILITs”)

Possible Options for ILIT	Check as Applicable
<u>THE POLICY</u>	
<i>Coverage Term (check all that apply)</i>	
Straight Term (is ILIT needed, particularly if coverage is short-term?)	<input type="checkbox"/>
Convertible Term and/or Permanent	<input type="checkbox"/>
<i>Modified Endowment Contract (“MEC”) Status (choose one)</i>	
MEC (cash value withdrawals and policy loans taxable and potentially subject to 10% penalty)	<input type="checkbox"/>
Non-MEC (no tax on cash value withdrawals (up to basis in policy) and policy loans)	<input type="checkbox"/>
<i>Lives Covered (choose one)</i>	
Single Life (non-insured spouse may be ILIT trustee and/or a beneficiary)	<input type="checkbox"/>
Survivorship (neither spouse should be ILIT trustees or beneficiaries)	<input type="checkbox"/>
<u>TRUSTEE(S) (CHECK ALL THAT APPLY)</u>	
<i>Family Member/Friend</i>	
Also a trust beneficiary (limits on their distribution powers may apply)?	<input type="checkbox"/>
<i>Professional Advisor/Financial Institution</i>	
Does the advisor or institution require special provisions in the ILIT agreement?	<input type="checkbox"/>
<u>DISTRIBUTION PROVISIONS</u>	
<i>Distributions to Spouse (spousal beneficiary should not be an insured) (check all that apply)</i>	
Available during insured grantor’s life (i.e., spousal lifetime access trust “SLAT”)	<input type="checkbox"/>
After insured grantor’s death	<input type="checkbox"/>
<i>Mandatory and/or Discretionary Distributions (choose one or both if combination used)</i>	
Mandatory distributions of income and/or principal at certain times/ages (ensures beneficiaries receive distributions at desired time but limits flexibility and tax/creditor protection)	<input type="checkbox"/>
Discretionary distributions (trustee flexibility, enhanced creditor	<input type="checkbox"/>

Checklist – Options for Irrevocable Life Insurance Trusts (“ILITs”)

Possible Options for ILIT	Check as Applicable
protection, and better management of the trust’s portfolio. Precatory language (below) can provide added guidance)	
Precatory Language and/or Letters of Wishes (choose one or both if combination used)	
Precatory (non-binding) distribution guidance to trustees included in ILIT (irrevocable and likely will be disclosed to beneficiaries as part of ILIT agreement)	<input type="checkbox"/>
Letter of Wishes (separate document provided to trustee; revocable and can be confidential)	<input type="checkbox"/>
Powers of Appointment Limited power to appoint ILIT assets to the grantor’s descendants, charities and/or others to provide flexibility and additional tax planning.	<input type="checkbox"/>
Ascertainable Standards (generally required if beneficiary is a trustee) Limits discretionary distributions by a trustee-beneficiary to an “ascertainable standard” (e.g., for health, education, maintenance, or support); prevents distributions that would satisfy trustee’s legal support obligations, etc.	<input type="checkbox"/>
<u>Grantor or Non-Grantor Trust (choose one)</u>	
Grantor Trust Typically the “default” status: trust treated as wholly-owned by grantor, who pays all trust taxes – <u>check all grantor trust powers below</u> that will be included in ILIT.	<input type="checkbox"/>
<u>Income to Pay Premiums</u> - Power to use income or accumulated income to pay insurance premiums on life of grantor or grantor’s spouse.	<input type="checkbox"/>
<u>Income for Spouse</u> - Power to distribute or accumulate trust income for the benefit of the grantor’s spouse during the grantor’s life .	<input type="checkbox"/>
<u>Borrowing Power</u> - Power, exercisable by grantor in a nonfiduciary capacity, to borrow trust income or principal without adequate interest or security.	<input type="checkbox"/>

Checklist – Options for Irrevocable Life Insurance Trusts (“ILITs”)

Possible Options for ILIT	Check as Applicable
<u>Substitution Power</u> - Nonfiduciary power exercisable by the grantor or person with no interest in the ILIT to reacquire assets of the trust by substituting other property of equivalent value.	<input type="checkbox"/>
<u>Selector Power</u> - Power, exercisable by a person with no interest in the ILIT to add beneficiaries to the ILIT (such as charities, designated family members, etc.).	<input type="checkbox"/>
<i>Non-Grantor Trust</i> Trust treated as separate from grantor; pays its own taxes. Generally less flexible and must not include any of the above grantor trust powers.	<input type="checkbox"/>
<u>“Crummey” Withdrawal Powers</u> Include withdrawal powers for ILIT beneficiaries to qualify contributions to ILIT for federal annual gift tax exclusion.	<input type="checkbox"/>
<u>Term or Dynasty Trust (choose one)</u>	
<i>Term ILIT</i> Generally designed to terminate upon the occurrence of specified events -- e.g., mandatory distributions of all trust assets to beneficiaries upon attaining a set age to ensure distributions to beneficiaries and give them full control over trust assets.	<input type="checkbox"/>
<i>Dynasty ILIT</i> Perpetual trust that can provide flexibility for the trustee, allow for the long-term growth of trust assets without estate and generation-skipping transfer tax, and can offer consolidated wealth management, long-term creditor protection and privacy for trust assets.	<input type="checkbox"/>
<u>Limit/Waive Trustee Duties</u> Waive any state law-imposed prudent investor standard duty to diversify and grant ILIT trustee broadest possible investment discretion.	<input type="checkbox"/>
<u>Allow Decanting</u> Authorize ILIT trustee to transfer assets from an existing irrevocable trust to a new or another existing irrevocable trust with potentially different terms to provide flexibility and the ability to adapt to future circumstances.	<input type="checkbox"/>

NOTES

¹ See IRC §§72(e) and (v).

² “Investment in the contract” is as defined in IRC §72(e)(6), which provides that investment in the contract is the (1) aggregate amount of premiums or other consideration paid for the contract, minus (2) the aggregate amount received under the contract, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws. See *WRMarketplace No. 14-31* for a discussion for basic income tax rules applicable to MEC and non-MEC policies.

³ The selection between a MEC and a non-MEC product should weigh the importance of access to policy cash value as compared to any investment benefits provided by up-front premium payments. The investment analysis should consider several factors, including that (1) low interest rates have diminished some of the merits of up-front premiums and (2) a non-MEC may offer a higher internal rate of return in the case of the client’s premature death. See *WRMarketplace No. 15-05* for a more detailed discussion on MECs.

⁴ See *WRMarketplace No. 14-19* for a more detailed discussion of precatory guidance and letters of wishes.

⁵ For purposes of the grantor trust rules, an “adverse party” (“AP”) is a person who has a substantial beneficial interest (that is, an interest that is not insignificant) in the trust that would be adversely affected by the exercise or non-exercise of the power in question, such as current beneficiary of the ILIT. See IRC §672(a).

⁶ IRC §677(a)(3).

⁷ IRC §677(a)(1). Grantor trust status is also triggered even if the spouse is not a current beneficiary of the ILIT but the income may be currently accumulated and later distributed to the spouse (e.g., after the grantor’s death).

⁸ Unless the trustee is authorized under a general lending power to make loans to any person without regard to interest or security. IRC §675(2).

⁹ A “nonadverse party” (“non-AP”) means anyone who is not an AP (generally a third party who has no current or future beneficial interest in the trust). See IRC §672(b).

¹⁰ IRC §675(4). See Rev. Rul. 2008-22 and Rev. Rul. 2011-28 for IRS guidance on including this power in an ILIT without inadvertently triggering estate tax inclusion of the trust assets in the grantor’s estate.

¹¹ IRC §674(a). Technically, any power exercisable by the grantor or a non-AP (such as a third party who has no current or future interest in the trust), without the consent of any AP, to control the beneficial enjoyment of trust income or principal would trigger grantor trust status. However, the power is generally given only to a non-AP, as it would cause the trust assets to be included in the grantor’s estate for estate tax purposes if held by the grantor.

¹² *WRMarketplace No. 13-18* provides drafting considerations for allowing termination of grantor trust status.

¹³ Note that most annual exclusion gifts to typical ILITs do **not** also qualify for the annual exclusion from the federal generation skipping transfer (“GST”) tax. In most cases, proper allocation of federal GST tax exemption will require the filing of annual federal gift tax returns. Further, the drafting of Crummey withdrawal powers requires careful consideration and additional decisions regarding how to structure these powers. See *WRMarketplace No. 14-04* for a greater discussion of these issues.

DISCLAIMER

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