The Wealth Counselor

A monthly newsletter for wealth planning professionals

The Continuing Relevance of ILITs

Volume 4, Issue 8

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At Price & Farrington, PLLC we work closely with our professional colleagues to help our clients plan, protect and pass their legacies to their loved ones through caring and confidential counseling.

The last issue of *The Wealth Counselor* addressed how life insurance is often a critical component of clients' estate and wealth plans, along with strategies for clients to pay for large insurance premiums. This issue addresses a similarly critical topic for clients and their advisors - the continuing relevance of Irrevocable Life Insurance Trusts (ILITs).

Perceived Disadvantages of Irrevocable Trusts in General

Some clients and advisors are predisposed against irrevocable trusts because they are a "hassle." If an irrevocable trust is not a grantor trust for income tax purposes (i.e., if it must report income and expenses as a separate taxpayer), that requires separate accounting and a tax return, which has its costs. If annual exclusion gifts are made to an irrevocable trust, there is the cost of Crummey letters and perhaps gift tax returns to allocate generation skipping transfer tax (GST) exemption. Use of an irrevocable trust is appropriate only if the benefits of using an irrevocable trust to own property - any property, including life insurance - outweigh the costs.

A second complaint from some advisors is that an ILIT complicates a life insurance sale and slows down the process, often to the point of effectively "killing" the deal.

Planning Tip: By working with an attorney whose focus is estate planning and thus understands the issues and regularly drafts ILITs, the financial advisor can ensure timely ILIT creation so that it does not slow down the process.

A third objection to the use of non-grantor irrevocable trusts is the possibility of a negative income tax impact due to the compressed tax rates for trusts. A non-grantor irrevocable trust hits the top bracket at under $11,000 of undistributed income in 2009, as compared to nearly $350,000 for a married couple filing jointly.

While increased taxes can be a legitimate concern, the real questions are:

1. What is the ***marginal*** or increased income tax as a result of the irrevocable trust not making distributions of income?
2. Are the asset protection and other benefits received worth more ***to the client*** than that additional tax?

Planning Tip: The "higher" levels of income tax only apply to interest income and rents. Taxable trusts, like individuals, pay a maximum of 15% federal income tax on realized capital gains and dividends. Thus, the planning team can often avoid the issue of increased taxes through investment and income tax management.

Advantages of Irrevocable Trusts

One significant benefit of irrevocable trusts is their ability to provide asset protection for beneficiaries. In all but a few states, clients cannot name themselves as beneficiaries of irrevocable trusts that they create (so-called "self-settled" trusts) and thereby protect the trust assets from their creditors. However, in all states, clients can set up irrevocable trusts for the benefit of spouses, children, grandchildren, and others and protect the assets in those trusts from the beneficiaries' creditors. Contrast this to an outright distribution to a beneficiary that ***is*** always subject to the claims of any creditor, including claims from a soon-to-be-former spouse.

Planning Tip: A carefully drafted irrevocable trust can ensure that the client's assets benefit those intended and not their creditors or "predators." Many clients cringe to think that the assets they've worked a lifetime to accumulate can (and often do) end up in the hands of a former son-in-law or daughter-in-law. Upon divorce, the assets distributed outright to a beneficiary cannot be identified and so go into the "pot" that is divided between the spouses.

Specific Benefits of ILITs

Most clients understand that life insurance death benefits are generally not subject to income tax. However, many clients do ***not*** understand that if they possess "incidents of ownership" over a life insurance policy when they die, the policy cash value (if they are not the insured) or death benefit (if they are) will be included in their estate for estate tax purposes. A properly managed ILIT ensures that neither the life insurance cash value nor death benefit is included in the client's estate. Stated differently, given the current federal estate tax rate of 45%, clients can almost double their insurance protection or halve their cost of insurance by using an ILIT.

Planning Tip: Incidents of ownership of a life insurance policy include (1) any right to alter it, change its beneficial ownership, or change its beneficiary designation; (2) the power to assign it; (3) the power to revoke an assignment of it; (4) the right to borrow against it; (5) the power to cancel or surrender it; (6) the right to use it to collateralize a loan; and (7) the right to a reversionary interest that exceeds 5% of the trust value immediately before the death of the insured.

Planning Tip: A properly drafted and managed ILIT will not be subject to estate tax upon the client's death but can provide the liquidity necessary to pay the tax on what is in the estate.

Lifetime Access to ILIT Assets
A common complaint about ILITs is that they block the client's access to the contributed assets (loss of control issue). However, a knowledgeable planning team can establish the trust in one of several ways so that the client or the client's spouse can have access to the ILIT's assets during the client's lifetime.

The Spouse as a Lifetime ILIT Beneficiary
One common way for an ILIT to allow access to trust funds is for the trust to provide that the spouse is a beneficiary during the client's lifetime and such access can be conditioned on their remaining married. The spouse's access to trust property is not attributed to the trust maker for purposes of the estate tax inclusion rules. If the ILIT owns a single-life policy on the client, the trustee can have the power to distribute trust income and principal to the client's spouse, which gives the client's spouse access to the policy's cash value. While this does not give the client direct access to policy cash values, it does give indirect access provided the client remains married.

Planning Tip: The assets of a properly drafted ILIT can be indirectly available during the client's lifetime if needed.

The Spouse as the ILIT's Sole Trustee
With proper ILIT design, the client's spouse can be the ILIT's sole trustee. However, if the spouse is the sole trustee, the spouse's power to distribute trust income and principal to himself or herself must be limited to what the IRS calls an ascertainable standard (i.e., distributions must be for health, education, maintenance and support), and distributions that satisfy the trustee's legal obligations of support must be prohibited. Otherwise, the spouse will possess a "general power of appointment" over the trust property, causing it to be included in the spouse's estate. Because of the risk that the spouse-trustee will violate those prohibitions, some practitioners do not draft ILITs with a spouse as the sole trustee.

Planning Tip: To ensure that the assets in the ILIT are not included in the client's estate, the ILIT must prohibit the trustee from using trust assets to relieve the client of any legal obligations of support towards his or her spouse.

Planning Tip: The trust maker's spouse cannot make gifts to the ILIT. That would cause at least a portion of the ILIT's assets to be included in the spouse's taxable estate. However, splitting gifts with the trust maker does not cause estate tax inclusion for the spouse (see IRC Section 2513(a)(1)).

The Retirement ILIT
Another way for a trust maker to gain access to an ILIT's assets during lifetime is through commercially reasonable loans from the trustee (i.e., loans evidenced by a promissory note bearing a rate of interest that is at least equal to the appropriate Applicable Federal Rate (AFR)).

Planning Tip: While it is possible to accrue interest with a balloon-payment loan, consider having the client pay interest annually to eliminate any IRS argument that the loan was a sham.

Upon the trust maker's death, the trust maker's estate will pay back any loan and cumulative interest to the ILIT, which should be deductible from the trust maker's gross estate as a bona fide debt. An added benefit of the loan technique is that the interest payments made to the ILIT are removed from the trust maker's estate. And if the ILIT is a grantor trust, the interest payments are not subject to income taxes and are essentially a tax-free gift to the beneficiaries of the ILIT to the extent that they exceed the interest charges on the policy loans.

Planning Tip: Giving the trust maker the right to borrow from the ILIT without adequate security is one of the specific provisions in the Internal Revenue Code that create grantor trust status for income tax purposes.

Survivorship ILIT
In Private Letter Ruling 9748029, the IRS provided a roadmap as to how to structure an ILIT owning a survivorship or "second-to-die" policy so that one of the insured spouses can have access to the policy's cash value during lifetime while avoiding estate tax inclusion in either spouse's estate.

First, the spouse with the shorter life expectancy (because of age, illness or gender) should be the trust maker of and sole contributor to the ILIT. The other spouse should not be a co-maker.

Second, the non-maker spouse should not make any gifts to the ILIT although, as discussed above, gift splitting with the trust maker spouse does not constitute a contribution by the non-maker spouse.

Planning Tip: To ensure adequate funding for the ILIT without the non-maker spouse making gifts to the ILIT, consider a single life policy on the trust maker's life in an amount sufficient to pay the remaining premiums. The ILIT can also borrow the necessary funds from the trust maker's estate, from the non-maker spouse, or from a third party, if necessary.

Third, the non-maker spouse should not serve as the sole trustee of the ILIT to avoid incidents of ownership and thus estate tax inclusion. Note, however, the non-maker spouse can avoid incidents of ownership by having a co-trustee serve with the non-maker spouse and by providing in the trust agreement that the non-maker spouse cannot exercise any incidents of ownership over the policy. The trust-maker spouse can name one or more children or other family member beneficiaries to serve as trustee or co-trustee. In addition, the trust maker can retain the right to remove and replace trustees.

Planning Tip: An independent co-trustee can provide the non-maker spouse with income and principal as needed without limitation.

IRA Preservation ILIT
Another excellent use for ILITs is as a vehicle to preserve an IRA that is not needed during the life of the IRA participant. With this strategy, the client acquires a life insurance policy inside an IRA Preservation ILIT (IRA ILIT #1). The client and spouse also acquire a survivorship life policy inside a joint IRA Preservation ILIT (IRA ILIT #2).

At age 59 1/2, the client can start withdrawing funds from the IRA to pay the insurance premiums without incurring a penalty. For clients younger than 59 1/2, the IRA can be split and one of the parts converted into an annuity to pay the premiums on the policy in IRA ILIT #1.

At the client's death, the IRA passes to the surviving spouse estate tax free under the unlimited marital deduction. The surviving spouse then converts the IRA to a Roth IRA and uses the death benefits in IRA ILIT #1 to pay the premiums on the policy in IRA ILIT #2.

Planning Tip: Consider a life insurance policy on the life of the non-participant spouse, purchased using a portion of the RMDs (or other sources).

The surviving spouse can borrow the death proceeds from IRA ILIT #1 to pay the income taxes due upon conversion, giving the surviving spouse full access to a tax-free Roth IRA. Since there is no required minimum distribution (RMD), the entire IRA principal can grow tax free.

At the surviving spouse's death, the death benefit proceeds from the survivor life policy in IRA ILIT #2 will be available to pay estate taxes. If the surviving spouse leaves the Roth IRA in Trust for children or grandchildren, the full value of the Roth is preserved and asset protected for these beneficiaries.

Planning Tip: By combining an ILIT with a Roth IRA conversion, the planning team can minimize income and estate taxes while providing estate-tax-free resources for generations that are creditor-, predator-, and divorce-protected.

Planning Tip: The IRA Preservation ILIT strategy preserves and maximizes the value of IRA assets passing to children and grandchildren, providing tax-free growth that creates intra-family wealth, as well as liquidity to pay income taxes and estate taxes. This strategy also converts an asset into one that is more flexible and income tax friendly for future generations.

Conclusion

Trusts offer significant benefits to clients and their beneficiaries, particularly in the context of owning life insurance. By working together, the planning team can utilize ILITs to minimize the client's overall tax impact, maximize asset protection, and ensure the plan meets each client's unique planning objectives.

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax adviser based on the taxpayer's particular circumstances.

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