Moore & Associates

Irrevocable Life Insurance Trust (ILIT)

Overview

An irrevocable life insurance trust (ILIT) can be a useful vehicle to hold life insurance policies outside the grantor’s taxable estate. When an insured owns a life insurance policy on his/her life, the insured controls and has ownership rights over the life insurance, but the policy will be included in the insured’s taxable estate. However, by giving up control and ownership over coverage held within an ILIT, death proceeds may be removed from the grantor's estate, reducing the grantor’s estate tax obligation and providing numerous other benefits. Although there are many advantages of using an ILIT, generally, the trust is appropriate when the grantor would like to utilize the gift tax annual exclusion amount to pay policy premiums, remove life insurance from the estate, leverage the generation-skipping tax (GST) exemption, and to provide asset protection for trust beneficiaries.

Upon the insured’s death, the trustee receives the life insurance proceeds income and estate tax free. To pay estate taxes or other outstanding liabilities, insurance proceeds are usually either lent to the estate or used to purchase assets from the estate.

Description & Operation

Creating the ILIT

Typically, an ILIT is drafted and executed prior to the time life insurance is placed within the policy. The grantor (also known as the settler or trustor) enters into a trust agreement with the trustee. The trust agreement names the beneficiaries, names the trustee, specifies trustee powers, stipulates the dispositive provisions of the trust (who gets what and when), and establishes rules for the administration of the trust.

Acquiring or Transferring the Policy

The ILIT may either apply for a new policy or an existing policy may be transferred to it. In the case of a new coverage, the ILIT purchases life insurance on the grantor/insured’s life and is owner and beneficiary of the policy. Funds are typically gifted by the grantor to the trust to make premium payments. To make non-taxable gifts, the gift may be applied towards the grantor’s annual exclusion amount or lifetime exemption amount. An existing policy may either be gifted or sold to an ILIT. If the policy is gifted to the trust, the grantor must live for at least 3 years after the gift is made or the policy will be brought back into the

grantor's estate. However, if the policy is sold to the trust for its fair market value, the 3-year rule does not apply.

Who should be Trustee?

As the insured, the grantor generally should not serve as trustee to avoid incidents of ownership over the policy, which would result in inclusion of the policy in the grantor's estate. However, a beneficiary may serve as trustee, as long as distributions are limited to an ascertainable standard such as health, education, maintenance and support to prevent inclusion in the beneficiary's estate and provide protection from the beneficiary's creditors.

If deemed capable, a beneficiary can serve as Trustee of his or her own share if distributions are limited to ascertainable standards of health, education, maintenance, and support (HEMS). Alternatively, the beneficiary may act as co-Trustee at a certain age and then sole Trustee at a later age. Additional advisors chosen by the grantor may also be added to the trust such as an investment advisor, a trust advisory committee, a trust protector, a special business trustee, or an insurance only trustee.

Distribution Standards & Triggering Events for Distributions

Common types of distribution standards range from a fully discretionary trust (defers all distribution decisions to the Trustee), to a trust limited to a HEMS. If limited to HEMS, many trusts also specifically authorize the trustee to make distributions for a wedding, first home down payment, starting a business, supporting a stay-at-home parent, or pursuing a charitable or political endeavor.

The trust can include incentives to encourage certain beneficiary behaviors while not undermining the motivation to pursue a professional career, higher education, or furtherance of important social or charitable causes. For example, the trust could require a certain grade point average, an undergraduate degree, or matching payments equal to earned income. Conversely, it could withhold distributions for specific conduct such as drug abuse or poor academic performance.

Asset Protection

An ILIT can protect assets from creditors of the grantor and the beneficiaries. This may have particular value for persons in litigation-prone occupations.

- **Grantor's creditors.** A trust in which the grantor retains a beneficial interest generally will be subject to the grantor's creditors' claims. A grantor's creditors typically cannot access an irrevocable trust unless they can show: (1) that the grantor conveyed the assets to defraud creditors; or (2) that the trust is a sham or the alter ego of the grantor. There is a statute of limitations on claims of fraudulent conveyance.
- **Beneficiary's creditors.** In order to protect the trust assets from claims of the creditors of the beneficiaries, the trust agreement can contain a spendthrift clause that prevents a beneficiary from transferring or encumbering his or her interest in the trust prior to distribution.

The strongest protection from creditors would require a fully discretionary trust with an independent trustee. However, if it is desired that a beneficiary be trustee, the power to make distributions by the trustee/beneficiary must be is limited to an ascertainable standard such as health, education, maintenance, and support. When a beneficiary is a trustee, care should be taken to ensure the beneficiary is not granted a general power of appointment. The power to appoint property to oneself constitutes a general power of appointment, which would not only cause estate inclusion, but also the ability for creditors to access trust assets.

Tax Implications

Income Tax Considerations

A trust can be a separate entity for income tax purposes. If so, the ILIT is subject to income tax under the Internal Revenue Code's (Code) trust tax rates. The Code compresses the trust income tax rates much more than the individual tax brackets, resulting in a higher tax rate being applied for less income. Generally, a trust follows the same rules as an individual taxpayer. However, the Code sets out several modifications to the individual rules such as a reduced personal exemption and different rules in computing charitable deductions, etc. Most importantly, if income is distributed to trust beneficiaries, it is taxed at the beneficiaries' tax rates and the trust can deduct income distributed under most circumstances.

A trust can also be a "grantor trust" for income tax purposes. As the owner of the trust, the owner must include all items of trust income, gain, loss, deductions, and credits in calculating the owner's individual income tax liability. There are several powers a grantor or a third person can possess that make the trust a grantor trust. For example, if the grantor or a third person has the right to acquire trust assets in a non-fiduciary capacity by substituting assets of equivalent value, the trust will be a grantor trust. However, certain powers, such as the power to revoke the trust, will cause the trust to be a grantor trust while also causing estate inclusion.

Gift Tax Considerations

Contributing an existing policy or funds to pay premiums generally constitutes a gift to trust beneficiaries.

The gift tax annual exclusion amount allows a donor to give an unlimited number of recipients up to the current annual exclusion amount per year without making a taxable gift. Even if only one spouse actually transfers property, both spouses may use their annual exclusion for a beneficiary by utilizing the "gift splitting" election. Only a gift of a "present interest" qualifies for the gift tax annual exclusion. A gift of a "future interest" is ineligible for the annual exclusion. A contribution to a trust is a gift of a present interest only under certain conditions: (1) when the beneficiary has a right to withdraw the amount of the gift from the trust; (2) when the beneficiary has the present right to trust income; or (3) when the trust is for the exclusive benefit of a minor and meets certain requirements.

In Crummey v. Commissioner, the Court of Appeals held that a gift to a trust is a gift of a present interest to the extent the beneficiary has a right to withdraw his or her share of the gift. In reference to that case, withdrawal rights in a trust are known as "Crummey rights." The Service imposes several requirements for a Crummey right to be effective. For example, the trustee must give the beneficiary notice of the contribution and withdrawal right. Also, the beneficiary must have a reasonable amount of time to decide whether to exercise the right before it lapses. Although there is no set number of days that qualifies as reasonable, generally, a withdrawal should continue for 30 days from the time the beneficiary receives notice.

If an individual having a right of withdrawal fails to exercise it, and if that power ultimately lapses, the lapse constitutes the release of a general power of appointment. By the Code, the release of a general power of appointment is a taxable gift. As such, the withdrawal beneficiary is considered to make a taxable gift of the lapsed amount to other trust beneficiaries. An exception to this rule is that the lapse of the power will not constitute a gift to the extent that it does not exceed the greater of (i) $5,000 or (ii) 5% of the value of the trust assets. A deemed gift to the trust would make the withdrawal beneficiary also a trust grantor. Because of this, any unlapsed withdrawal right could cause inclusion in the grantor/beneficiary's estate.

There are three ways to prevent a taxable gift of any unlapsed portion. First, separate shares can be created for each beneficiary. Because the beneficiary is the sole beneficiary, the gift is incomplete. Essentially, one cannot make a gift to oneself. Second, "hanging" powers, or a continuing withdrawal right, are often used.

Generally with a hanging power, the withdrawal right lapses up to $5,000/5%, but keeps intact any withdrawal rights in excess of that amount until such time (if ever) when the $5,000/5% exemption can absorb the lapse. Third, under the testamentary power of appointment option, the withdrawal right lapses up to $5,000/5%, and any unlapsed amount may be appointed at the withdrawal beneficiary's death. This prevents a gift-taxable lapse of the power of appointment, while preventing access by the withdrawal beneficiary during his/her lifetime.

Estate Tax Considerations

One of the main purposes of creating an ILIT is to remove death proceeds from the grantor's gross estate for tax purposes. In exchange, the grantor must give up control and ownership rights to the policy. Therefore, when drafting an ILIT, care must be taken to ensure that the policy is not inadvertently included in the grantor's estate. There are several ways an irrevocable trust can be includible in the grantor's estate:

- A decedent's taxable estate includes any property transferred by the grantor in which a beneficial interest (including the right to income) is retained, or the grantor has the right to control who owns or enjoys the use of the property. This may apply indirectly if the trustee has the ability to control the ownership or use of the property, and the grantor can replace the trustee with himself or herself.
- Assets may also be included if the grantor retains the right to alter, amend, revoke, or terminate the terms of the recipient's enjoyment of the property. This may apply indirectly if the trustee has the ability to change the terms of the beneficiaries' enjoyment of the property, and the grantor can replace the trustee with himself or herself.
- Inclusion of death proceeds may occur if the grantor/insured had any incidents of ownership over life insurance held within the ILIT. For example, if the grantor has the right to borrow against the policy's cash surrender value or if the grantor/insured dies within three years of gifting a policy to the ILIT, there would be estate inclusion.

Generation Skipping Transfer (GST) Tax Considerations

The GST exemption may be significantly leveraged if applied towards the grantor's lifetime transfers rather than waiting until death to utilize the exemption. Typically, this is done by allocating the grantor's GST exemption to gifts made to the trust. If properly structured, the contribution can be transferred gift, estate, and GST tax free. If gifts are used to pay premiums on life insurance, upon the insured's death, the GST exemption would be considerably leveraged, enabling the grantor to pass substantially greater assets in a long-term, tax and asset protected trust.

Meredith Moore, LUTCF, CLTC, Member Agent of The Nautilus Group®, a service of New York Life Insurance Company, Registered Representative offering securities through NYLIFE Securities LLC (Member FINRA/SIPC), a Licensed Insurance Agency, 1125 Cambridge Square, Suite C - Alpharetta, GA 30009 (770) 587-0281, Financial Adviser offering investment advisory services through Eagle Strategies LLC, a Registered Investment Adviser. Moore and Associates Wealth Management is not owned or operated by NYLIFE Securities LLC or its affiliates. Moore and Associates Wealth Management as well as NYLIFE Securities LLC and its affiliates do not provide legal, tax or accounting advice.

This material includes a discussion of one or more tax-related topics. This tax-related discussion was prepared to assist in the promotion or marketing of the transactions or matters addressed in this material. It is not intended (and cannot be used by any taxpayer) for the purpose of avoiding any IRS penalties that may be imposed upon the taxpayer. Taxpayers should always seek and rely on the advice of their own independent tax professionals. Please understand that New York Life Insurance Company, its affiliates and subsidiaries, and agents and employees of any thereof, may not provide legal or tax advice to you.

© 2015 New York Life Insurance Company, all rights reserved. SMRU:521231 exp: 10.17.2015