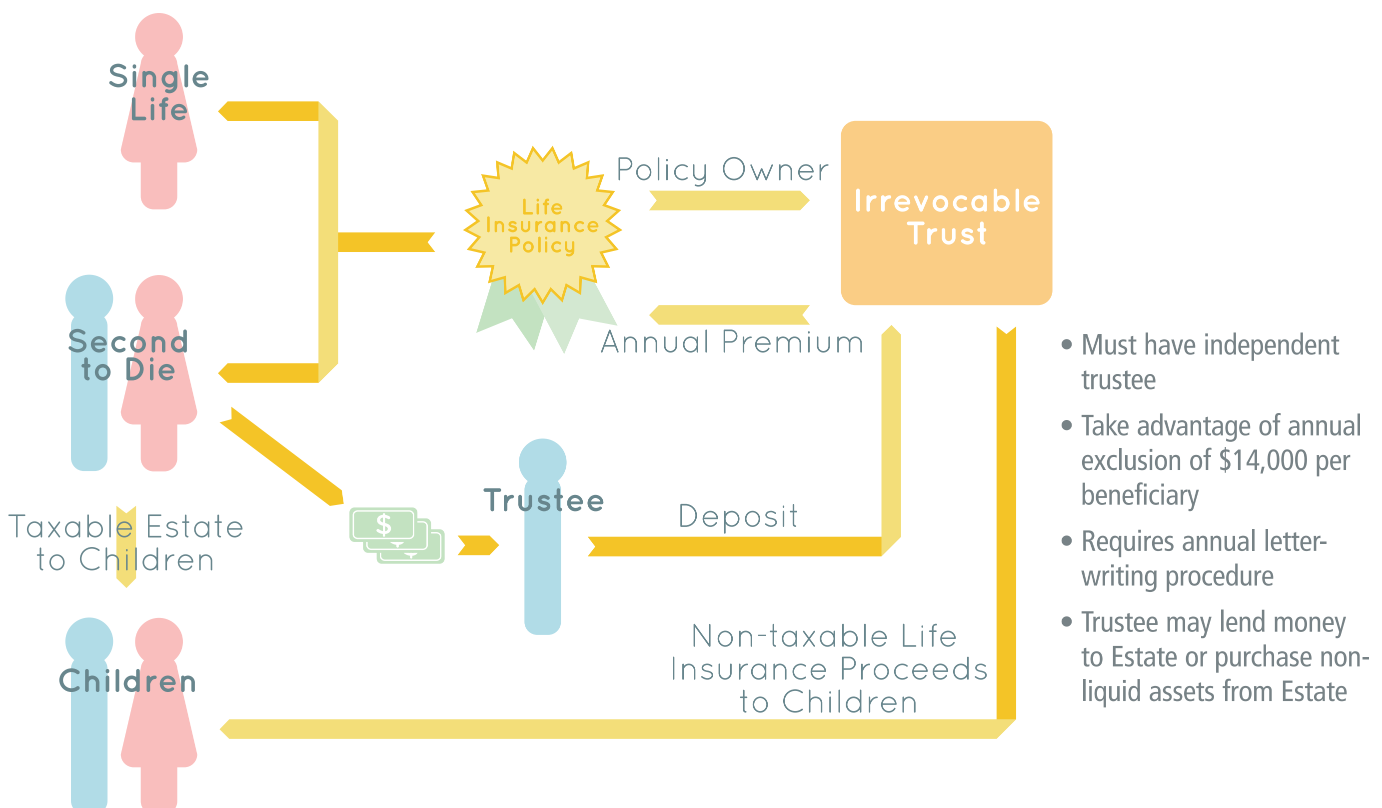
When an Irrevocable Trust Is Not:
Giving New Life to Insurance Trusts

by Kevin B. Rack



For decades, the Irrevocable Life Insurance Trust (ILIT) was a common estate planning vehicle intended to provide liquidity for the payment of significant estate tax liability anticipated by clients. These trusts could be established to purchase a single life or survivorship policy, depending upon family and financial circumstances. Often referred to as *Crummey*[1] trusts, these instruments, if properly structured and administered, protect the policy proceeds from taxation in the estate of the deceased insured, while providing liquidity and "wealth replacement" in the form of the death benefit. The proceeds of the more substantial policies may be held in trust for the continued benefit of generations of heirs without estate taxation (often referred to as a "dynasty trust").

How They Work

Once the irrevocable trust is created, it is funded with cash from the insured client to cover the initial premium on the policy. The trustee (who must not be the insured and should not be a trust beneficiary) applies for the policy and is named as owner and beneficiary. As the premium contribution is made into an irrevocable trust, that amount is considered a gift to the beneficiaries of the trust. Accordingly, in order to qualify the contributions for the annual exclusion from gift tax, the trustee must provide written notice to the beneficiaries of their right to withdraw their share of the cash contributed to the trust. When the brief window of opportunity to exercise this right closes, the contribution is applied to the premium for that year. This process typically takes place once each year.

Even the Joneses Have an ILIT

The popularity of the ILIT grew during the 1980s, when the estate tax exemption stagnated at $600,000, until around 2001, when it was increased to $1 million. As many Americans had homes and retirement plans with values in excess of those numbers, the life insurance option became a common element in a significant number of estate plans to address anticipated estate tax liability. For example, a client with a taxable estate of $1,650,000 in 1999 would expect an estate tax liability of $550,000 (55 percent of $1,000,000 after credit of $650,000). The life insurance policy purchased by the trustee of the new ILIT typically would bear a death benefit sufficient to cover the estate tax, but without estate tax due on those proceeds (because the insured did not own the policy).

The Changing Estate Tax Exemption

When Congress passed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA)[2] in 2001, the estate and gift tax landscape was altered dramatically with a series of substantial increases in the estate tax exemption amount over ten years. EGTRRA also gradually lowered the maximum estate tax rates over the same period. *(See graphic at right.)* While these increases were significant, many clients who had established an ILIT were persuaded to maintain it for some of the non-tax purposes served by trusts.

However, the passage of the American Taxpayer Relief Act of 2012[3] (2012 Tax Act) set the estate and gift tax exemptions at $5 million per person, adjusted annually for inflation, and the tax rate at 40 percent. (The exemption amount for 2015 is $5,430,000 and is still indexed for inflation.) As a result, many wealthy clients who had created estate plans when the exemption was between $600,000 and $3,500,000 no longer needed the ILIT implemented when their estates were exposed to estate tax.

Another reason that some clients may question whether they still need an ILIT is the so-called "portability" provisions, introduced in the Tax Relief Act of 2010[4] and made permanent in the 2012 Tax Act. The purpose of the portability provisions is to enable the surviving spouse to carry over the deceased spouse's unused estate and gift tax exemption after the first spouse's death without establishing a trust specifically for this purpose. It remains to be seen whether portability becomes a viable planning tool, given the strict IRS requirements for preserving the exemption. Nonetheless, the well-read married client may perceive the concept as a solution to the estate tax exemption/marital trust formula planning previously required to shelter the spousal credit. Needless to say, where the marital estate does not exceed even one spouse's exemption amount, the necessity of the ILIT, as well as the expensive life insurance policy owned by the ILIT, will come into question.

Changes to Estate Tax Exemption Since 1987

Calendar Year	Estate Tax Exemption Amount	Marginal Estate Tax Rate
1987–97	$600,000	55%
1998	$625,000	55%
1999	$650,000	55%
2000–01	$675,000	55%
2002–03	$1,000,000	50%
2004–05	$1,500,000	48%
2006–08	$2,000,000	46%
2009	$3,500,000	45%
2010	Estate Tax Repealed	35%
2011	$5,000,000	35%
2012	$5,120,000	35%
2013	$5,250,000	40%
2014	$5,340,000	40%
2015	$5,430,000	40%

Responding to the Client Inquiry

Given that the insured settlor is now aware that the new estate tax exemption amount is $5,430,000, the request from the trustee of the

ILIT for a cash contribution to the trust for payment of the next premium raises the very reasonable question:
Do I still need to make premium contributions if I do not require the life insurance death benefit in that trust to pay estate taxes?

The answer is a resounding, "It depends." Counsel must be prepared to persuade the client to evaluate the benefits of the trust, not to mention the substantial investment in the insurance policy, before deciding to abandon it. The attorney should acquire the critical policy information, determine the limitations of the irrevocable trust, and provide a summary of the findings and recommendations to the client on the ultimate issue of retention of these estate planning arrangements. It may be that a modification of the insurance contract to minimize or eliminate the annual outlay will suffice. In the end, modification of the trust or decanting of the policy may provide a better alternative to the all-or-nothing decision of surrendering the life insurance policy itself. This article presents a methodology for evaluating the financial, fiduciary, and practical factors to be considered and discussed with the client before simply abandoning the trust. There are several strategies designed to optimize the current value of these policies while working within the provisions of each individual irrevocable trust. This methodology also provides consistent results for solutions in cases where counsel is also serving as trustee of the ILIT when the client presents the question.

The Methodology

The methodology for ILIT analysis calls for a simple process of updating client profile information, gathering pertinent data for the insurance policy, evaluating the tax and non-tax purposes of the trust, and outlining the viable options for consideration by each client. Those options may range from maintaining the current plan of premium payments to the surrender and distribution of the policy proceeds to the beneficiaries (keeping in mind that the ultimate decision is within the discretion of the trustee). This consultative process of data and document collection and analysis is one performed by the attorney as legal and tax counsel, as opposed to a fiduciary transaction for the trustee.

Analyze Purposes for the Life Insurance Policy

Gather the updated family and financial information to make the initial determinations required for the analysis:

1. Determine status of insured (marital, financial, insurability).
2. Determine current estate planning strategies in place.
3. Determine non-tax reasons for retaining the policy in trust, such as:
   a. Provision of spousal support with the benefit of fiduciary-level investment management of the policy proceeds;
   b. Protection of inheritance from the creditors and predators of one's heirs;
   c. Preservation of inheritance from the actions of spendthrift children;
   d. Preservation of permanent policy in case of future need for life insurance coverage; and
   e. Preservation of a source of funds for payment of income tax on retirement plans payable on death to children.
4. Calculate the client's taxable estate to determine exposure to estate tax liability under current exemption amount.
5. Determine critical provisions of the irrevocable trust, such as whether the trust authorizes the outright distribution of trust funds versus an ongoing trust for beneficiaries, and whether the spouse and/or the children are permissible beneficiaries of the trust assets.

Analyze the Insurance Policy

The best approach to the ILIT question is to evaluate the options with the primary goal of preserving the client's investment in the policy and the trust while taking into account the non-tax reasons for both. Meaningful consultations among insured, counsel, and fiduciary are essential, but a conference with the insurance advisor early in the evaluation process is critical to obtain recommendations as to the options under the policy contract. Initial steps include:

1. Confirm type of policy (single life, universal, or survivorship).
2. Look for terms for preservation of "no-lapse" guarantees.
3. Evaluate initial illustrations for cessation of premium requirements.
4. Request an "in-force illustration" of policy values under the following scenarios:

a. Maintaining current premium payment schedule;
b. Making no further premium payments on policy (this should illustrate the duration of the policy if cost of insurance paid from cash value); and
c. Paying premium amount to cover cost of insurance only.

No Refunds

Some clients will assume that they may request and receive the policy, or the net cash surrender value, from the trustee and all have a nice day. Needless to say, the tax rules that apply to irrevocable trusts (and of gifts made into trust) prohibit the settlor from receiving the trust assets outright. In addition, the surrender of the policy by the trustee may incur penalties, but the payment of the cost of insurance from that cash value may produce a worse result over time. In every case, however, there are considerations for retention versus surrender of a trust-owned life insurance policy, including:

Tax free exchange for a paid-up policy under IRC Section 1035. This strategy is used to transfer the cash in an existing life insurance policy to a new policy without incurring tax liability for surrender of the policy. The typical goal of this type of exchange is to apply the cash value to purchase a new policy with a single premium. Another goal is to enable a policy owner to switch from a struggling insurance carrier to one that is financially stable.

Conversion to single-life paid-up policy. Conversion of an existing policy to a single premium whole life insurance policy provides lifetime insurance coverage with only the cash value from the existing policy.

Cash value is not net surrender value of policy. Before surrendering any policy, the trustee should confirm the negative effect of policy loans or high surrender charges on the cash value represented on policy reports.

Some Fiduciary Considerations

A trustee considering whether to retain or surrender a policy must be cognizant of the fiduciary duty owed to both current and remainder beneficiaries. The trustee must evaluate the terms of the policy and consider the provisions of the trust instrument carefully in order to avoid liability to the beneficiaries.[5] This dilemma becomes acute when the insured simply refuses to make a contribution to the ILIT, leaving the trustee with no funds from which to pay the premium. While most permanent policies will apply cash value to cover unpaid premiums, the value of the policy will be affected negatively. In fact, depending upon the type of policy, missed premium payments may result in the forfeiture of a no-lapse guarantee and, in some cases, the loss of the intended death benefit. The trustee has the fiduciary duty to take steps to preserve the trust assets for the beneficiaries.

Modification or Termination of ILIT

There will be circumstances in which the trust provisions, rather than the cost of the life insurance policy, have created the desire to terminate the arrangement. Counsel should evaluate potential solutions under the Virginia Uniform Trust Code (the Code), including modification of the terms of the irrevocable trust, termination of the trust, or the decanting of the policy into a newly created irrevocable trust with favorable provisions. Strategies will fall into a limited number of options:

Judicial modification with consent of beneficiaries. The Code provides that the settlor and beneficiaries, by consent, may petition the court to modify the terms of, or terminate, an irrevocable trust, even if the modification or termination is inconsistent with a material purpose of the trust. Further, the Code provides that the beneficiaries alone may petition the court to modify or terminate an irrevocable trust if they all consent and if the change does not materially alter the terms of the trust.[6]

Judicial modification due to unanticipated circumstances. The Code also allows the beneficiaries to petition the court for the modification or termination of a trust because of unanticipated circumstances, with the intent that the modification or termination must further the purposes of the trust. The modification should be made in accordance with the probable intent of the settlor, to the extent possible.[7]

Decanting into new irrevocable trust. If the trustee of an irrevocable trust is granted the discretion to distribute income and principal, the trustee could appoint those assets to a second trust with certain desired modifications. Pursuant

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to the decanting statute, the beneficiaries of the second trust must include only beneficiaries of the original trust; the discretionary power to distribute principal and income must be subject to the same ascertainable standard as the original trust; no beneficial interest can be accelerated to a present interest in the second trust; the terms of the second trust cannot reduce any fixed income, annuity, or unitrust interest of a beneficiary in the original trust; and the terms of the second trust must provide identical powers of withdrawal as the original trust.[8]

Summary

It is inevitable that clients with an ILIT in their estate planning arsenal will pose the question on the necessity of contributing the next premium payment once they realize that their estates are no longer exposed to estate tax liability. As this article should make clear, opportunities for solutions will be presented once the methodology is applied to the specific facts in each client matter. Before the policy is allowed to lapse or is surrendered by the trustee, the thorough evaluation of the trust and the insurance policy, conducted in the controlled setting of this methodology, will produce the most favorable options for recommendations to the trustee and the settlor/insured. In nearly every case, there will be family and financial considerations that make clear the path to good stewardship of this important element of one's estate plan.

Endnotes:

1 *See Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968).
2 Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38.
3 American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 (2013).
4 Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010, Pub. L. 111-312, 124 Stat. 3296.
5 VA. CODE § 64.2-763.
6 *Id*. § 64.2-729.
7 *Id*. § 64.2-730.
8 *Id*. § 64.2-778.1.

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