Featured Article: Your Swiss Army Knife

Louis S. Shuntich, JD, LLM
Director – Advanced Consulting Group
Nationwide Financial

Like a Swiss Army Knife, an "ILIT" or Irrevocable Life Insurance Trust is an incredibly versatile tool in the field of estate planning. We see it used to acquire life insurance for the purpose of funding some need while keeping the coverage out of the insured's gross estate. To make that happen, however, certain technicalities need to be observed. If they are not, considering the current 40% estate tax rate, the consequences to the customer are likely to be severe. Consequently, the goal of this article is to succinctly cover what you need to know when assisting your prospect in purchasing life insurance through an ILIT.

The application process. One way to avoid estate tax on death proceeds is for the trustee and not the insured to be the applicant, owner and beneficiary of the policy with the trust in existence when the application is submitted. In situations where the prospect is unwilling to spend the time and money to have an ILIT established before applying for the coverage (often because they do not know if they're insurable or insurable at a price they are willing to pay) a trial application should be used to determine underwriting. Then, if the prospect is willing to proceed with the actual purchase, an ILIT can be established to make the application and purchase the contract.

Qualifying for the annual gift tax exclusion. When making gifts to the trust to finance premium payments it is desirable to have such gifts qualify for the annual gift tax exclusion. That is because it allows the insured grantor to contribute $14,000 to the trust annually for each beneficiary gift tax-free. ($28,000 per beneficiary if the insured grantor is married.) In order to qualify for the annual gift tax exclusion, however, the gifts must qualify as "gifts of present interest" and that can be accomplished by providing in the trust instrument that the trust beneficiaries have Crummey withdraw rights as to the gifts.

The name "Crummey" comes from a court case in which it was decided that where a beneficiary has a right to withdraw gifts to the trust, those gifts qualify as gifts of present interests. This approach operates by providing in the trust instrument that when contributions are made to the trust, the trustee must notify the beneficiaries that each of them has a right to withdraw their share of the gift. This power of withdraw only exists for a limited period of time such as 30 days. That window of opportunity is sufficient, however, to make the gifts to the trust gifts of present interests that qualify for the annual gift tax exclusion.

Generation-Skipping Tax Considerations. Whenever an irrevocable life insurance trust has grandchildren or more remote descendants of the grantor as beneficiaries, there is a potential for generation-skipping tax liability. In such cases, the object of GST planning is to protect as much property as possible from the generation-skipping tax by using the GST exemption in the most advantageous way. This will depend on the facts and circumstances of the trust and the customer, and should be addressed by the estate planning attorney as part of the over-all design and establishment of the trust.

For trusts that are not designed to intentionally skip generations (such as trusts that are set up to provide funds to pay estate tax and are for the primary benefit of children, with grandchildren as contingent beneficiaries) generally no amount of the GST exemption should be allocated to gifts to the trust. On the other hand, for trusts that are intended to benefit as many generations as possible without incurring a generation-skipping tax ("dynasty trusts") the grantor's GST exemption should be applied to gifts as they are made to the trust.

Consideration in Selecting a Trustee. The insured grantor should not be a trustee of the trust because even powers held as fiduciary could be deemed "incidents of ownership" that would cause the proceeds to be included in the grantor's estate. The insured grantor may have the power to remove a trustee and replace it with another as long as the new trustee is not a related or subordinate trustee. Examples of related or subordinate trustees are the grantor's spouse, children, grandchildren, employees and business partners. A related or subordinate trustee may be appointed, however, where the related or subordinate trustee's powers are limited by an "ascertainable standard." This means that the related or subordinate trustee can make only discretionary distributions to the trust beneficiaries for their maintenance, education, health, and support (referred to as "MESH" powers).

Providing Estate Liquidity. If the trustee is required to use the insurance proceeds to pay the death taxes and administrative costs of the grantor's estate, the proceeds will be included in the grantor's gross estate. In order to avoid the above problem, while providing liquidity, the trust should state that the trustee has the discretion to either lend money to the estate or purchase assets from the estate. This will give the estate liquidity without causing the proceeds to be included in the gross estate.

Special Considerations for Trust Holding Second to Die Policies. Since the enactment of the unlimited martial deduction and the opportunity it created to defer the payment of all estate taxes until the death of the second spouse, "survivorship" or "second to die" policies have become popular. They have low premiums in relation to the amount of death benefit because they do not pay a death benefit until the second death of two insureds. In addition, because there is no martial deduction available upon the second death, they provide liquidity to pay estate taxes when the liquidity is needed.

In an irrevocable trust that is to be used in connection with a second to die policy, the two insureds should have no interest in the policy, or the trust, that could be deemed an incident of ownership under IRC Section 2042(2). For example,

neither insured should be a beneficiary of the trust, hold a Crummey withdrawal power, or be a trustee.

An ILIT trust should be drafted by an attorney who is knowledgeable about estate planning matters, and who can advise the customer regarding how to best satisfy the Crummey rights requirements (including how to avoid potential unintended consequences, such as a lapsed general power of appointment), who should be the trustee, what powers can be exercised by the grantor/insured, etc.

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