



WRMarketplace

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The WRMarketplace is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The WRMarketplace provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

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TOPIC: Which Way Do I Go - The Impact of State Laws on Insurance Trusts.

MARKET TREND: As state laws evolve and irrevocable insurance trusts ("ILITs") become more complex, the state in which the ILIT is established can significantly impact its long-term success.

SYNOPSIS: State laws play a crucial role in meeting client objectives when creating an ILIT. As these laws can vary greatly state to state, clients must carefully consider their long-term impact on the ILIT. If a proposed ILIT has a potential legal connection or "nexus" to multiple states, clients should choose the state for their ILIT deliberately, rather than by default. Several issues will likely affect the client's decision, including application of state income taxes, whether the state allows perpetual or long-term trusts, the degree of protection provided from creditors, etc. It is important to review the state's jurisdiction and laws to ensure that the ILIT is properly implemented.

TAKE AWAYS: As state laws can dramatically impact the taxation and administration of an ILIT, they play an important role in achieving client goals for the trust. Advisors should work with clients to proactively select among the states where the proposed

ILIT would have a legitimate nexus. The decision should not be based simply on the client's or trustee's residence, but should specifically address the factors that are most important to achieving the client's objectives. Choosing the most appropriate state, however, will require advisors and clients to understand the differences among the states' various tax and trust laws and the requirements for ensuring a legitimate nexus exists between the ILIT and the desired state.

PRIOR REPORTS: 15-38; 14-21.

ILIT planning requires a careful analysis of numerous factors, including the use of a grantor or non-grantor trust, the type of life insurance policy to buy and how to fund the purchase, whether to create a "dynasty" trust, etc. With all these issues, the potential impact of state laws on a proposed ILIT is often overlooked. However, increases in state income taxes and changes in the trust laws and perpetuities periods of many states have made choosing among the states where the ILIT has a legitimate nexus one of the most critical decisions in ILIT planning and implementation. When making this decision, clients will want to consider the following prominent factors (a short checklist summarizing these factors is also attached).

FACTORS IN STATE SELECTION

State Income Taxes. A key consideration when reviewing the impact of state laws on an ILIT is the application of state income tax to undistributed trust income. The imposition of state income tax (which, for most ILITs, typically occurs after the client's death when the ILIT has received and invested the policy death benefits) can impact trust growth, particularly for long-term trusts that allow for income accumulation. State income tax on the undistributed trust income of a non-grantor trust can vary significantly by state, ranging from no tax in Alaska, Florida, Nevada, New Hampshire, South Dakota, Texas, Washington, and Wyoming to tax rates of 12.696% in New York City and 13.3% in California.¹

Complex, conflicting, and often confusing state tax systems can make navigating state taxes challenging for both clients and their advisors. Some states will tax trust income based on the residence of the trustee, while others tax trust income based on the residence of the beneficiaries, and yet other states base taxation on both the residence of the trustees and of the beneficiaries or even the place where the trust is administered, potentially subjecting undistributed income to tax in more than one state. A more detailed discussion of the state taxation of income in non-grantor trusts (such as ILITs following the settlor's death) can be found in WRMarketplace No. 15-38.

Careful planning during the implementation of the ILIT requires taking these considerations into account.

Directed Trust Statutes. Another factor in state selection for ILITs is whether the state permits the division of trustee duties. A growing number of states have enacted statutes authorizing “directed” trusts, which allow one trustee to be directed by other trustees (such as a “distribution trustee” or an “investment trustee”) or by a trust advisor or committee as to trust investments and/or distributions. The statutes relieve the directed trustee from liability for following these directions. With directed trust statutes, a client can appoint a corporate or professional trustee to handle the trust’s administrative duties, while giving trusted individuals the authority to make the substantive investment and distribution decisions. This division of duties can provide comfort to the client that an individual familiar with the needs and complexities of the client’s family (such as a friend or family member) will make the important decisions impacting the interests of the trust beneficiaries, while also ensuring that trust administrative and reporting requirements are handled by an experienced trustee who is familiar with these obligations.

Trust Duration – Perpetuities Period. The client’s wishes regarding the duration of the ILIT also will impact state selection. A state’s perpetuities period determines how long the trust may be in existence before state law requires that the trust terminate and distribute all its assets to the beneficiaries. For a client that wants the ILIT terminated and distributed when the beneficiaries attain a specified age, a state’s perpetuities period will be a minor factor. However, a state’s perpetuities period will be a significant consideration if the client wants the ILIT to continue for multiple generations as a way to preserve family assets and/or provide continued creditor protection for the beneficiaries.

Many states still apply the old “common law” rule, which allows a trust to remain in existence until the date that is 21 years after the deaths of individuals who were alive at the time the trust was created (roughly a total period of 90-120 years). Several states, however, have either extended their perpetuities period or abolished it altogether. The chart below provides some examples of the differences in state perpetuities periods.

| State | Perpetuities Period |
|--|-----------------------------|
| Alaska, Delaware, Illinois, South Dakota | No Perpetuities Period |
| California | Common Law Rule or 90 Years |
| Florida | 360 Years |
| Nevada | 365 Years |
| New York | Common Law Rule |
| Utah, Wyoming | 1,000 Years |

Insurable Interest. ILITs must have an insurable interest in the insured’s life (i.e., an interest in the continued life of the insured) or the policy is voidable and rescindable by the insurer. As the determination of whether an insurable interest exists depends on applicable state law and varies by state, clients should only create ILITs in states where they can ensure that the ILIT will meet the insurable interest requirements.

Creditor Protection for Beneficiaries. Most clients will have concerns about protecting the ILIT assets from the claims of beneficiaries’ creditors, particularly from former spouses. While all states have spendthrift trust statutes, the degree of creditor protection varies by state. For example, spendthrift protection in Delaware prevents a creditor from attaching trust assets even if the beneficiary has committed an intentional tort, while Georgia does not. Further, in California, Delaware, and Florida, the ILIT may not be protected from a beneficiary’s child or spousal support obligations, while ILITs can be protected from such obligations in Alaska, South Dakota, and Nevada.

Modification of Trusts and Decanting Statutes. To serve their intended purposes, ILITs must be irrevocable and generally remain in place for a long period of time - at least for the lifetime of the insured. Over time, many changes can occur with respect to tax laws, the client and his or her family’s needs, and the statutes that govern trust administration. The ability under state law to modify the terms of the ILIT and/or to decant the assets into a new, updated ILIT without court approval can improve the

prospects that the ILIT will fulfill its purpose and the client's objectives, making this issue a key factor in selecting a state for the ILIT.

Note that state laws in this area are evolving rapidly. Some states allow the beneficiaries and the trustee to modify the ILIT in a non-judicial reformation. A growing number of states, including Florida, Delaware, Missouri, Nevada, New Hampshire, and South Dakota, have "decanting" statutes that allow trust assets to be poured into a new ILIT with more relevant or up-to-date terms than the old trust, subject to certain limitations.² A more detailed discussion regarding decanting of trusts can be found in WRMarketplace No. 14-21.

Trust Confidentiality – Duty to Inform and Report. Most ILITs provide beneficiaries with "Crummey" withdrawal powers during the settlor's lifetime to qualify gifts to the trust for the gift tax annual exclusion. These powers give beneficiaries knowledge of the trust and their withdrawal rights. Some clients, however, may have concerns that knowledge of the trust and/or its assets will undermine the beneficiaries' ambitions or their motivation to lead productive lives. These clients may wish to restrict the beneficiaries' access to ILIT information by avoiding the use of withdrawal powers and making taxable gifts to the trust (to which they could apply any available lifetime gift tax exemption). In such cases, the client will want to settle his or her ILITs in a state that allows the trust to remain confidential and/or requires minimal duties to report to trust beneficiaries. For example, Alaska, Delaware, Nevada, and South Dakota all have enacted statutes that allow a trust to prohibit the trustee and other fiduciaries from disclosing the existence of, or certain information regarding, the trust to the beneficiaries for a period of time (for example, until the beneficiary reaches a specified age). Alternatively, states like Delaware and Florida have enacted the concept of a "designated representative," which is an individual appointed by the settlor (or other selected person) under the trust agreement to represent and bind a beneficiary and to receive any notices, information, accounts, etc. related to the trust on a beneficiary's behalf, without making the beneficiary directly aware of the trust.

No-Contest Clause. For clients concerned about a beneficiary challenging the terms of the ILIT (for example, where there is an unequal division of the insurance proceeds or other assets among the beneficiaries), state enforcement of a no-contest clause will be a factor in state selection. A typical no-contest clause provides that a beneficiary will forfeit his or her interest in the trust if the beneficiary challenges its terms. Many states will enforce a no-contest clause but may place stipulations or limitations on enforcement. Other states will not enforce these clauses at all.

SETTLING IN A PARTICULAR STATE

Generally, to settle an ILIT in a particular state and make it subject to the jurisdiction of that state's courts, the ILIT must have a legal connection or "nexus" with the state. Depending on applicable state law, this connection is often established if the client or at least one trustee is a resident of the state, the trust owns assets in that state, and/or the trust has beneficiaries in that state. Once the client has chosen among the states where the proposed ILIT would have a legitimate nexus, the state requirements for nexus should be carefully complied with as part of the ILIT's implementation.

TAKE AWAYS

As state laws can dramatically impact the taxation and administration of an ILIT, they play an important role in achieving client goals for the trust. Advisors should work with clients to proactively select among the states where the proposed ILIT would have a legitimate nexus. The decision should not be based simply on the client's or trustee's residence but should specifically address the factors that are most important to achieving the client's objectives. Choosing the most appropriate state, however, will require advisors and clients to understand the differences among the states' various tax and trust laws and the requirements for ensuring a legitimate nexus exists between the ILIT and the desired state.

| Irrevocable Life Insurance Trusts – State Selection Checklist | |
|--|---------------|
| Prominent Factors | Yes/No |
| State Income Taxes. Will the state impose state income tax on the ILIT’s undistributed income if/when it becomes a non-grantor trust? | |
| Directed Trusts. Does state law allow the division of administrative, investment, and distribution duties among multiple trustees and/or permit other trustees or advisors to direct an administrative trustee with regard to trust investments and distributions? | |
| Trust Duration – Perpetuities Period. Has the state abolished its perpetuities period or enacted a perpetuities period of sufficient duration to satisfy the settlor’s objectives? | |
| Insurable Interest. Will the ILIT have an insurable interest in the insured under the state’s insurable interest laws? | |
| Creditor Protection for Beneficiaries. Will the state’s spendthrift laws provide sufficient creditor protection to address the settlor’s concerns (e.g., protection from spousal claims)? | |
| Trust Modification/Decanting. Does state law allow for non-judicial trust modifications and/or the decanting of assets from an existing trust to a new trust? | |
| Trust Confidentiality – Duty to Inform and Report. Does state law allow the trust to remain confidential, require minimal duties to report to trust beneficiaries, and/or permit the trustee to report only to a “designated representative” on a beneficiary’s behalf? | |
| No-Contest Clause. Will state law enforce a no-contest clause and require a beneficiary to forfeit his or her interest in the ILIT if that beneficiary challenges the ILIT’s terms? | |

NOTES

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¹ Income that is distributed to the beneficiaries will be taxed to the beneficiaries at their individual state income tax rates.

² For example, state decanting statutes generally prohibit adding a person who is not a beneficiary of the existing ILIT as a beneficiary of the new ILIT.

DISCLAIMER

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